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ACCOUNTING

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Video Transcription: Deferred Tax Assets - According to IAS12

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Like all assets, there are two issues to consider before recognising a deferred tax asset, namely:

- Is it appropriate to offset assets against liabilities, and present only the net figure or should the two balances be shown separately; and
- Does the proposed asset balance satisfy the probable future economic benefit part of the definition of assets?

Let's tackle the issue of offset, first. The general principle is that you can only offset an asset against a liability if you have both a legal right and an intention to offset the two amounts. If you buy raw materials from a company and supply them with finished goods – you would usually have both a payable and a receivable but if you had agreed that the net amount payable would be settled each month, offset would be possible. Using tax examples – it is not possible to offset a VAT asset account against company tax payable. SARS does not permit you to avoid paying your company tax because you have a VAT asset – you therefore have to recognise the asset and liability separately.

What about taxable gains and tax-deductible losses? We have to be careful here, and this requires some understanding of the requirements of the Tax Act. In terms of the Tax Act, we can offset trading losses against trading gains, and trading losses against capital gains, but we cannot offset capital losses against trading gains. If you incur a loss on a capital transaction, that loss can only be set off against future capital profits. You could therefore end up paying tax on trading profits despite incurring substantial capital losses.

So, what does this mean for deferred tax? At each reporting date we calculate all the temporary differences and recognise the deferred tax credit or debit balances calculated using either the full tax rate or the capital gains tax rate. Should we:

- Net them all off against each other and show only the net difference;
- Show all the debit balances as an asset with all the credit balances shown as a liability or
- Some combination of the two?

Following the general principle, it should not surprise you to know that the answer lies in the legal right to set off tax gains and losses. As we are not allowed to set capital losses off against trading profits, we cannot set off deferred tax assets, relating to capital losses, against other credit balances. Practically what this implies is that when you do your deferred tax calculations you will have to group those balances that will give rise to capital gains and losses separately from those that will be taxed at the full rate.

To keep it simple, assuming deferred tax on four temporary differences:

		Temp Diff	Tax rate	Deferred tax bal
A	Bad debts allowance	10 000	28%	2 800 Dr
B	Capital allowance machinery	(50 000)	28%	(14 000) Cr
C	Fair value adjustment property -gain	(40 000)	18.7%	(7 480) Cr
D	Fair value adjustment investment - loss	70 000	18.7%	13 090 Dr
	TOTAL			(R5 590) Cr

Adding all the deferred tax balances together suggests that we should have a credit balance of R5 590. Think about why that is not correct. We cannot offset the capital losses against the trading profits. What we would have to do is offset the deferred tax asset and liability relating to trading items against each other and show the net amount – that is a credit balance and therefore there is no problem in recognising the amount of R11 200.

		Temp Diff	Tax rate	Deferred tax bal
A	Bad debts allowance	10 000	28%	2 800 Dr
B	Capital allowance machinery	(50 000)	28%	(14 000) Cr
	TOTAL			(R11 200) Cr

We would offset the credit balance relating to capital gains against the debit balance relating to capital losses, as SARS permits the amounts to be set off – that would lead us to a deferred tax asset of R5 610.

C	Fair value adjustment property -gain	(40 000)	18.7%	(7 480) Cr
D	Fair value adjustment investment - loss	70 000	18.7%	13 090 Dr
	TOTAL			R5 610 Dr

As we will discuss in a minute, we will then have to consider whether that asset is recoverable and may be recognised. It is irrelevant that there is also a credit balance for other temporary differences – the losses that gave rise to this debit balance cannot be offset against those trading transactions and therefore the deferred tax also cannot be offset.

What happens if we did not have the capital loss – and only had the capital gain giving rise to the credit balance? Remember that SARS allows trading losses to be offset against capital gains and therefore the credit balance for the capital item can be set off against the trading items. In that case we would have a credit balance of R18 680, and deferred tax will be recognised in full.

		Temp Diff	Tax rate	Deferred tax bal
A	Bad debts allowance	10 000	28%	2 800 Dr
B	Capital allowance machinery	(50 000)	28%	(14 000) Cr
C	Fair value adjustment property -gain	(40 000)	18.7%	(7 480) Cr
	TOTAL			(R18 680) Cr

What about assessed losses? As you probably know, when a company has an assessed loss from trading activities at the end of the year, deferred tax should be recognised by debiting the statement of financial position and crediting profit or loss to the extent that it is appropriate to recognise the deferred tax. Incurring a tax loss in one year has the potential advantage of reducing the tax payable in the future – deferred tax may be recognised in the year in which that benefit arises i.e. the loss is incurred and reverses in the year in which the benefit is derived, in the form of a reduced current tax expense.

	Year 1	Year 2
(Loss)/Profit	(R100 000)Dr	R300 000 Cr
Current tax	Nil	(R56 000) (300 000 – 100 000) x 28%
Deferred tax?????	R28 000 Cr	(R28 000) Dr

To decide whether it is appropriate to recognise the deferred tax when an assessed loss arises, we need to keep in mind that important principle of offset. To the extent that there is a credit balance on the deferred tax account, the assessed loss will be recognised as the reversal of those temporary differences and will give rise to taxable income, which implies that the assessed loss would be used and therefore is recoverable.

Assume a deferred tax credit balance of R20 000 and an assessed loss of R100 000 at the end of the year. The first step is to work out the deferred tax relating to the assessed loss i.e. R100 000 x 28%.

Deferred tax – temporary difference			Assessed loss
	Bal	R20 000	R100 000 x 28% = R28 000

The first R20 000, in other words the amount equal to the existing credit balance, will automatically be recognised.

Deferred tax – temporary difference			Deferred tax – assessed loss		
	Bal	R20 000	Bal	R20 000	

Deferred tax balance = NIL

If the remaining R8 000 were recognised, that would give rise to a debit balance and we therefore have to consider whether that debit balance is recoverable.

Deferred tax – temporary difference			Deferred tax – assessed loss		
	Bal	R20 000	Bal	R28 000	

Deferred tax balance = R8 000 ASSET????

For a tax asset to be recoverable, it means that it will give rise to lower tax payments in the future or alternately, but less likely, a cash payment from SARS. Where the deferred tax asset relates to an assessed loss, the asset can only be recognised if it is probable that there will be taxable income in the future, which will then imply that the assessed loss will give rise to reduced future tax obligations.

Going back to our earlier example, if it is probable that there will be future taxable income, the full amount of the deferred tax on the assessed loss will be recognised, giving rise to a debit balance of R8 000 as a result of recognising the credit to deferred tax in profit or loss of R28 000. If it is not probable, R8 000 of the R28 000 will not be recognised and there will be a deferred tax balance of nil.

So what happens to the R8 000 that is not recognised? There are a few implications, for both current and future financial statements, some relating to note disclosures and others to the preparation of tax-rate reconciliations.

The R8 000 deferred tax that was not recognised – that reflects an assessed loss of R28 571 (R8 000/28%) for which the asset has not been recognised. That is a type of contingent asset and note disclosure is required to reflect that. The note would indicate that there is an assessed loss of R100 000, R71 429 (R20 000/28%) of which has been recognised as deferred tax and R28 571 of which has not.

	Assessed loss	Deferred tax
Loss at year end	R100 000	R28 000
Recognised in deferred tax	(R71 429) = R20 000/28%	(R20 000)
Deferred tax not recognised	R28 571 = R8 000/28%	R8 000

If deferred tax is not recognised when the loss is recognised, this will give rise to a reconciling item in the tax-rate reconciliation – as the tax charge will not be 28% of pre-tax income or losses.

Anticipated tax	Profit x 28%
Items increasing tax	
Assessed loss not recognised	R8 000 x 28% +

Note that a reconciling item only arises where deferred tax is not recognised – if that is not clear to you, watch Goolam's video on tax rate reconciliations to understand why (see "Tax Rate Reconciliation").

The full-deferred tax relating to the assessed loss must be recognised as soon as it is probable that it will be utilised, which may only be in the year in which the taxable income is generated. Assuming that at the end of year one it is not probable that there will be taxable income in the future but in year two it actually turns out that there was taxable income, in year two, you would first have to recognise the remaining R8 000 of the deferred tax asset (and corresponding credit to profit or loss). That implies that we will also have a reconciling item in year two as the R8 000 deferred tax that should have reduced tax in year one was only recognised in year two.

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Anticipated tax	Profit x 28%
Items decreasing tax	
Prior year Assessed loss recognised in current year	R8 000 x 28% -

Then, reverse out the full R28 000 assuming the R100 000 assessed loss is utilised in full. While it may be tempting to simply reverse out the R20 000 that has been provided, there is a specific disclosure requirement to show the extent to which prior year amounts of tax, current or deferred, are recognised in the current year and that applies to the R8 000.

This principle of assessing the recoverability of deferred tax assets applies to all debit balances. In the video that Gizelle has done introducing deferred tax (see "Deferred Tax – Introduction"), a deferred tax asset relating to revenue received in advance, is explained. In that case, recognition of the asset is usually appropriate as the company is making profits and the asset arises from a difference between tax and accounting treatment.

Where the debit balance arises from assessed losses, there is a greater chance that the balance will not be recoverable and therefore stronger evidence is required to support the recognition of the balance – the R8 000 we spoke about. Think about how that principle should be applied to recognition of a deferred tax asset for those temporary differences relating to capital losses that we looked at.

When you plan your approach to tackling a deferred tax question, remember to set out your workings in a way that you can identify the amounts that can and cannot be set-off against each other. Also, remember the implications in future years where deferred tax assets could not be recognised in the year in which it arose.