

Tax Revenue — Basis for Conclusions

Section PS 3510

FOREWORD

CICA Public Sector Accounting Handbook Revisions Release No. 29, issued in February 2010, included a new standard, TAX REVENUE, Section PS 3510.

The primary objective of a Basis for Conclusions document is to set out how the Public Sector Accounting Board (PSAB) reached its conclusions. As well, it sets out significant matters arising from comments received in response to the proposals exposed and indicates how PSAB has dealt with the issues raised.

These documents are intended to assist financial statement users, preparers, auditors and other parties interested in public sector financial reporting in understanding the rationale followed by PSAB when developing the standards.

This document has been prepared by staff of PSAB. This document does not form part of the CICA Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles (GAAP) Basis for Conclusions documents also do not include any guidance on the application of the relevant Section or Guideline.

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BACKGROUND

- 1 PSAB initiated a project dealing with tax revenue because it is a major source of revenue for governments and the lack of standards dealing with the unique characteristics of tax revenue recognition and measurement needed to be addressed.
- 2 TAX REVENUE, Section PS 3510, is based on the high-level tax revenue principles set out in International Public Sector Accounting Standard (IPSAS) 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. However, this standard has been modified to address Canadian circumstances and to respond to input received from PSAB stakeholders. For example, unlike IPSAS 23, tax revenue and transfers are addressed in separate standards in Canada. There are other non-exchange revenue sources addressed in IPSAS 23 but excluded from Section PS 3510, such as fines and penalties. Other differences from IPSAS 23 are highlighted, where appropriate, below.
- 3 Some aspects of Section PS 3510 have the potential to affect accounting practices. As well, they may affect budgets and estimates as additional expenses may have to be voted.
 - (a) For some governments, the standard may mean that transfers made through a tax system would now be recognized as expenses rather than netted against tax revenue. In contrast, the standard states that tax revenue should not be grossed up for the amount of tax concessions. Section PS 3510 includes guidance that distinguishes tax concessions from transfers made through a tax system.

- (b) Regarding the attribution of tax revenue, the standard requires the government that imposes a tax to recognize the related revenue except in the case of purely flow-through arrangements.
- (c) Section PS 3510 requires that any expenses incurred in relation to a tax transaction, such as administrative costs or commissions on tax collection, be separately recognized in expenses and not netted against tax revenue.

DEFINING TAX REVENUE

4 The definition of tax revenue itself was not controversial. The base definition is substantially consistent with that of IPSAS 23. Consistent with IPSAS 23, tax revenue is also identified as revenue from non-exchange transactions. Thus, for the first time, the PSA Handbook includes definitions of exchange and non-exchange transactions.

Exclusions

- 5 The exclusions from tax revenue are more comprehensive in Section PS 3510 than in IPSAS 23, which excludes only fines and penalties imposed for breaches of the law and non-compulsory transfers to public sector entities. For example, interest earned on tax receivables is excluded from being recognized as part of tax revenue in Canada. Transactions that are more in the nature of exchange transactions, such as user fees, license or permit fees, are specifically excluded from tax revenue in Section PS 3510. A cross reference refers governments to RESTRICTED ASSETS AND REVENUES, Section PS 3100, for accounting for revenue from developer charges. Accounting for resource royalties is excluded from the scope of the standard as their substance and the accounting for such royalties has not yet been addressed by PSAB.
- 6 There was debate in the government community as to whether fines, penalties and interest related to tax transactions should be recognized separately from tax revenue in government financial statements. It was suggested that these items are integral to the tax system and embedded in tax legislation and would not be easily separable for accounting purposes. A question was also raised as to the appropriateness of separating out the elements of an integrated tax system for accounting purposes. It was concluded, however, that interest on tax receivables was comparable in substance to other interest earned by governments and that no special accounting treatment should be accorded interest on tax receivables. Interest earned on tax receivables is not a tax, and like fines and penalties, could be avoided by the taxpayer.
- 7 Regarding income taxes, federal-provincial agreements on tax collection indicate that the federal government retains the fines, penalties and interest related to the tax collection in return for bearing the bad debt expense. So, most provinces would not be recognizing fines and penalties related to breaches of income tax laws or interest on income tax receivables in their financial statements.
- 8 It was suggested that a constraint might exist in applying the requirement to separately recognize fines, penalties and interest related to tax transactions to some kinds of taxes, in particular those that are collected externally from the government. This is a practical constraint similar to that raised regarding the grossing up of administrative and collection costs related to tax revenue (see paragraphs 24-26). If the information does not exist or is not practicable to obtain, then it may not be possible to extract the fines, penalties and interest on tax receivables amounts for separate recognition from tax revenue. Such a situation is an area of professional judgment in applying the standard (i.e., if the information cannot practically be separated or the fines, penalties and interest estimated, then the fines, penalties and interest cannot be recognized separately). If the individual items are considered to be material but cannot be extracted for separate recognition, then there may be related assurance issues.

RECOGNITION

Attribution of tax revenue

- 9 The attribution rules for tax revenue in Section PS 3510 provide clarity as to which government should recognize tax revenue. In essence, if a government imposes a tax, then it should recognize the related taxes as revenue unless the imposition of the taxes is a product of a flow-through arrangement. The standard provides guidance as to when such a flow-through arrangement might exist. It also provides clarity regarding taxes collected on behalf of others.
- 10 The debate over the attribution of tax revenue in the government community represented a struggle to develop a high-level principle that would adequately address the variety of situations across Canada at all levels of government. The first attempt to define when tax revenue should be attributed to a government was based on a definition of when a government has imposed a tax or might be deemed to have imposed a tax. It was complex and did not successfully and simply address the diversity of Canadian situations. The final attribution provisions in Section PS 3510 are simpler and received a high level of support from the government community.
- 11 The attribution of tax revenue is addressed differently in IPSAS 23 in that it states that taxation revenue arises only for the government that imposes the tax, and not for other entities. It does not exclude flow-through arrangements from this requirement. Thus, unlike Section PS 3510, IPSAS 23 would require the government imposing the tax to recognize assets and revenue for the tax, and a decrease in assets and an expense for the transfer to the other government. The recipient government would recognize assets and revenue for the transfer. The conclusion in Canada was that this grossing up of revenue and expenses did not represent the substance of the situation in cases where a purely flow-through arrangement exists.

Taxes levied for specific purposes

12 PSAB issued an Exposure Draft in January 2008 proposing that taxes received subject to tax stipulations that create a liability would be recognized as an asset and a liability when received and tax revenue would only be recognized as the tax stipulations are met. The proposal was substantially based on theory set out in IPSAS 23. The Board struggled to identify examples of when the tax revenue and liability are demonstrably linked in this fashion. In the examples identified, the creation of the related liability was not a result of tax legislation but rather arose as a result of other legislation (for example, an agreement to provide a government transfer from the proceeds of the tax). In these cases, the tax revenue would be recognized when received or receivable and the transfer liability recognized separately in accordance with GOVERNMENT TRANSFERS, Section PS 3410.

13 Even after consultation with the government community, no concrete examples could be identified that had an identifiable link between a tax levied and the purposes for which it was levied that were substantive enough to create a liability for the taxing government to use the taxes only as specified.

14 It was not appropriate, therefore, to retain the requirement just to acknowledge the possibility that such liabilities might arise in the future. It was felt that although such liabilities might be theoretically possible in Canada, they were not likely given existing practices.

15 The exclusion of this issue from Section PS 3510 is a departure from IPSAS 23, which does allow for the possibility that such liabilities might arise. However, there is very little guidance on such liabilities arising in relation to tax revenue in IPSAS 23. The bulk of the discussion of recognition of liabilities relating to inflows of resources in IPSAS 23 deals with liabilities arising in relation to transfers received, which are addressed by PSAB in a separate standard.

Authorization

16 Authorization of a new tax or tax change determines whether the tax or tax change can be accrued at the financial statement date. An effective date for an authorized new tax or tax change, when considered in conjunction with the related taxable event, determines how much tax revenue can be accrued for that tax at the financial statement date.

17 Authorization is a key revenue recognition criterion in Section PS 3510. Only authorized taxes can be recognized as revenue. A tax is considered authorized when the effective date of the tax has passed and the earlier of the following has occurred: the related legislation, regulations or by-laws have been approved; or, in the case of jurisdictions where precedent allows it, the ability to assess and collect tax has been provided through legislative convention.

18 IPSAS 23 does not specifically address authorization as a recognition criterion for tax revenue (or transfers). It merely states that "an intention to levy taxation is not a past event that gives rise to an asset in the form of a claim against a taxpayer". This idea is not fleshed out any further in IPSAS 23, likely because of vast differences in authorization requirements across jurisdictions. However, authorization is considered a key concept in Canada in determining the recognition of one other major non-exchange transaction — government transfers — and stakeholders agreed that it was an important concept in determining the timing of the recognition of tax transactions too. In the absence of the mutuality and structure customary in an exchange transaction, credence must be given to the government's authority and exercise of that authority in determining when a government has lost its discretion to act and a (non-exchange) transaction or event has occurred that needs to be recognized in government financial statements.

19 Some commonality exists between jurisdictions in Canada regarding the authority needed to assess and collect taxes and thus it was possible for authorization to be defined for the purposes of tax revenue recognition in the Canadian standard.

20 The authorization requirements for the recognition of tax revenue allow for the possibility of two types of authorization — full and final approval of related legislation, regulations or by-laws, and another "deemed" authorization concept called "legislative convention". Stakeholders agreed that an earlier recognition point may be appropriate for tax revenue in some jurisdictions because of legislative (or what may be termed "parliamentary") convention in some Canadian senior government jurisdictions that allows the assessment and collection of taxes in advance of the final approval of legislation. It should be noted that, in contrast, similar parliamentary conventions common to all senior governments in Canada do not exist for the spending or use of public funds.

21 While there has been some debate about the extent and type of evidence needed to support an assertion that legislative convention is in place, there has been general agreement from the first time it was proposed that this concept was appropriate and recognized a unique aspect of Canadian taxation for governments. Input from stakeholders was considered and it was concluded that a four-part test would need to be met to support an assertion that legislative convention is in place:

- (a) the government already has a well-established practice that clearly establishes the legislature's acceptance of the practice and the government's right to levy and collect a tax in advance of the final approval of related tax provisions;
- (b) certain specified actions need to take place in the legislature as described in the standard;
- (c) a well-established framework and precedents (for example, precedents in a court of law) exist to support the assessment and collection of taxes in advance of final approval of legislation; and
- (d) if the new or revised tax measures that have yet to receive final approval relate to the current period, there is evidence that the government has plans and intentions to act on those tax measures in the current period.

These requirements are consistent with the practices and evidence in place in those jurisdictions that currently have legislative conventions that allow the assessment and collection of taxes in advance of the approval of the related legislation.

Taxable event

- 22 The taxable event is the event that the government, legislature, council or other authority has determined will be subject to taxation. In conjunction with authorization, the occurrence of the taxable event determines the timing of recognition of a tax transaction in revenue. The guidance about the taxable event and its role in recognition of tax revenue was not controversial over the course of the project. Suggestions were received that the taxable event should be specified for more types of taxes. However, the standard was always intended to be at a principles level and, therefore, includes only examples of the taxable event for the major types of taxation: income taxes; property taxes; sales and value-added taxes; and customs duties. The Canadian guidance is comparable to that in IPSAS 23 except that greater precision was used in the example of the taxable event for property taxes to reflect Canadian practices.

Taxes received in advance

- 23 Taxes received in advance are taxes received before the revenue recognition criteria in paragraph PS 3510.08 have been met (i.e., before authorization is in place and/or the taxable event has occurred). The approach in Canada is similar to that in IPSAS 23 except that guidance has been added in Section PS 3510 to address the inclusion of authorization in the revenue recognition criteria in Canada. Specific mention of income tax instalments was added to address questions raised by stakeholders. Section PS 3510 states that income tax instalments received are not considered to be examples of taxes paid in advance of the taxable event because the taxable event is the earning of income over the reporting period. The timing of income tax instalments is thus intended to simulate the timing of the taxes that would be levied on those earnings as they occur. Therefore, income tax instalments are deemed to be based on the occurrence of the related taxable event.

Grossing up of tax revenue

- 24 Although a majority of stakeholders agreed with the requirement to gross up expenses incurred in relation to tax transactions and recognize them separately in expenses, some stakeholders felt that tax revenue should continue to be reported net of associated collection and administrative fees. They noted that the commissions and administrative expenses are a necessary part of earning the tax revenue. It was suggested that grossing up tax commissions might present practical budget difficulties as these expenses would potentially require separate votes in the legislature whereas currently they may be net voted. It was also noted that if revenues exceed original estimates then the commission expense would also exceed the budgeted amount leading to the processing of unnecessary Special Warrants. Thus, the cost of the improved presentation of revenue and expenses was not considered justified. The potential that a requirement to gross up tax revenue and recognize commissions and administrative expenses related to taxes might require changes to budget practices in some jurisdictions was identified early in the project. This potential implication was acknowledged and the reasons for the requirement explained during the due process. Section PS 3510 is consistent with IPSAS 23 in making this requirement. The effective date for the standard is intended to give time to governments to make any needed changes in their budget practices if the PSA Handbook is used as a basis for preparing those budgets.

- 25 Tax revenue is to be recognized in the statement of operations at its gross amount (except for tax concessions). FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.081, encourages tax revenue to be reported on a gross basis so that the total magnitude of a government's revenue raising is reflected in the financial statements. That Section notes that such information is necessary for understanding and assessing the financial impact of a government's revenue raising and for enhancing legislative control. This general standard of financial statement presentation for governments is the primary reason for the requirement to recognize these items as expenses rather than netting them against tax revenue.

- 26 It was suggested that, for some types of taxes, a constraint might exist in applying the requirement to separately recognize administrative and collection costs, in particular, those taxes that are collected externally from the government. If the information does not exist or is not practicable to obtain, then it may not be possible to extract the administrative costs and collection cost amounts for separate recognition in expenses. Such a situation is an area of professional judgment in applying the standard (i.e., if the information cannot practically be separated or the costs estimated, then the administrative and collection costs cannot be recognized separately). Governments that are not able to practically estimate these costs because they are incurred by external parties such that the government receives net tax revenue would recognize such taxes on a net basis and those that can estimate such costs, if they are material, would recognize them separately from the tax revenue in expenses. If the individual items are considered to be material but cannot be extracted for separate recognition, then there may be related assurance issues.

MEASUREMENT

- 27 Section PS 3510 requires assets acquired through tax transactions to be measured at initial recognition at their realizable value. In contrast, IPSAS 23 requires assets acquired through tax transactions to be measured at initial recognition at their fair value. PSAB's first proposal was the same as IPSAS 23. Responses to this proposal for measurement at fair value were not favourable. Many felt that tax revenue was not the standard in which PSAB should introduce fair value for initial measurement, particularly given the ongoing controversy over the use of fair value in measuring financial

instruments. Some also felt that the fair value requirement was not necessary for tax revenue, noting that tax revenues are generally received in cash or cash equivalents. They noted that in cases where tangible capital assets are expropriated, the current guidance in TANGIBLE CAPITAL ASSETS, Section PS 3150, already considers the cost of such assets to be equal to their fair value.

- 28 These comments were felt to have merit and the Board's proposal in the April 2009 Re-exposure Draft was for initial measurement at realizable value. However, the explanation of realizable value included in the measurement proposals of the 2009 Re-exposure Draft was not the right one for tax revenue and some respondents felt that it implied the sale of tax receivables — an unintended interpretation but requiring some clarification of the Board's intent. There also appeared to be some confusion about the distinction between the requirement for initial measurement of assets received in tax transactions and the subsequent measurement of assets received in settlement of outstanding tax receivables.
- 29 Section PS 3510 addresses these concerns by including an explanation of realizable value in the measurement guidance that is more relevant to tax revenue. "Realizable value is the amount of cash or its equivalent into which an asset is expected to be converted in the due course of operations. It is expected at initial recognition that assets acquired in tax transactions by a government will be cash or cash equivalents, or tax receivables that will be settled in cash or cash equivalents." The standard also clearly distinguishes between the initial measurement of tax transactions at realizable value and the subsequent measurement of assets received in settlement of outstanding tax receivables at their fair value when acquired by the taxing government. The requirement relating to subsequent measurement is consistent with TANGIBLE CAPITAL ASSETS, Section PS 3150, regarding contributed capital assets.

TAX CONCESSIONS VERSUS TRANSFERS MADE THROUGH A TAX SYSTEM

- 30 Tax concessions (often called "tax expenditures") provide tax relief to taxpayers against taxes they paid in the past or currently owe to the government. They are considered to be foregone revenue. They are to be netted against tax revenue.
- 31 Transfers through a tax system provide financial benefits that are not tax relief and they are available to taxpayers as well as to those who are not taxpayers. These transfers are just like other transfers, but they are administered through the tax system. They are recognized as expenses and are not to be netted against tax revenue.
- 32 One of the major issues in the project was providing sufficient guidance to distinguish tax concessions from transfers made through a tax system. The distinction is critical because the standard requires transfers made through a tax system to be grossed up and recognized in expenses, yet tax concessions continue to be netted against tax revenue. Considerable input was received from stakeholders to assist in refining the distinguishing characteristics of the two categories. A decision tree that takes into account stakeholder feedback was added to Section PS 3510 to assist governments in classifying a payment or reduction in taxes payable as a transfer made through a tax system or a tax concession.
- 33 One area of confusion was the classification of refundable tax credits. It was clear that non-refundable tax credits were tax concessions. However, some stakeholders felt that the 2009 Re-exposure Draft proposals would require all refundable tax credits to be classified as transfers, grossed up and recognized in expenses. That was not the intent and the related guidance has been clarified in the final standard. Section PS 3510 now states that refundable tax credits may be either tax concessions or transfers made through a tax system depending on their substance, and also provides guidance, in the standard and the accompanying decision tree, as to when refundable tax credits would be tax concessions and when they would be classified as transfers.
- 34 A further issue in developing Section PS 3510 was the issue of whether individual tax transactions could be part tax concession and part transfer as suggested in the 2009 Re-exposure Draft. Input from stakeholders clarified that individual tax transactions would need to be classified as one or the other. However, an individual tax program might provide transfers to some classes of taxpayers and tax concessions to others. Such a tax program would have to be split into its component parts and each accounted for in accordance with Section PS 3510.
- 35 Some stakeholders initially resisted the idea that some payments through the tax system or reductions in taxes payable would be classified as transfers, disallowed from being netted against tax revenue and recognized in expenses. Like the comments regarding the grossing up of tax revenue and those regarding the exclusions from tax revenue, some stakeholders felt that these payments and reductions in taxes payable are an integral part of the tax system and that their extraction for separate recognition was not appropriate and was contrary to the intent of the related tax legislation. The majority of the comments on the 2009 Re-exposure Draft, however, focussed primarily on the distinguishing characteristics of the two categories.
- 36 Section PS 3510 builds on the guidance for "expenses paid through the tax system" and "tax expenditures" in IPSAS 23 but provides more extensive coverage of this important issue. IPSAS 23 does not include a definition for expenses paid through the tax system and the definition of tax expenditures in IPSAS 23 differs from the definition of tax concessions in Section PS 3510. The topic of tax concessions and transfers made through a tax system was an area where stakeholders believed guidance specific to Canadian circumstances was crucial in order for governments to be able to apply the differential accounting treatments required for the two categories of transactions. Thus, the distinguishing characteristics for tax concessions and transfers made through a tax system and the related guidance and decision tree in Section PS 3510 address circumstances particular to Canadian taxation systems.

TAX RECEIVABLES

- 37 Section PS 3510 does not address tax receivables except:
- (a) in the area of subsequent measurement in paragraphs PS 3510.31-.32;
 - (b) in the presentation and disclosure requirement in paragraph PS 3510.45 that requires a government to disclose the accounting policies adopted for the recognition and valuation of tax receivables if they are different from those for other receivables; and
 - (c) in the exclusion of interest earned on tax receivables from tax revenue.

IPSAS 23 does not address tax receivables either. Both Section PS 3510 and IPSAS 23 are revenue recognition standards. It was concluded that the disclosure and valuation requirements for receivables in FINANCIAL STATEMENT PRESENTATION, Section PS 1200, were adequate for tax receivables. Separate disclosure of tax receivables and the related valuation allowance was proposed in the 2009 Re-exposure Draft. This requirement was removed in finalizing Section PS 3510. It was concluded that tax receivables would include related fines, penalties and interest as the receivables would relate to total amounts owed by individual taxpayers so the relationship of the proposed receivables disclosure with the tax revenue reported would not be meaningful.

TRANSITIONAL PROVISIONS

- 38 The effective date of the standard is for fiscal years beginning on or after April 1, 2012. Earlier adoption is encouraged. The date was chosen to allow senior governments the time to make any necessary changes in budget practices if the new standard is to be applied in their budget. The date was also chosen to address input from local governments about the pace and volume of change in accounting standards. They are currently in the process of adopting the new capital asset, reporting model and reporting entity standards. Thus the effective date for most local governments would be January 1, 2013.
- 39 IPSAS 23 gave a five-year transition period, but given the variety of tax regimes of the countries involved with the IPSASB this was likely a necessarily long transition period. Such disparities do not exist to the same degree among Canadian jurisdictions so the two-year period was considered appropriate.
- 40 ACCOUNTING CHANGES, paragraph PS 2120.13, allows a government adopting new PSA Handbook standards for the first time to apply them prospectively or retroactively. In finalizing Section PS 3510, a decision was made not to override this provision and specify one treatment over another.

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