IAS 12 — Tax Base, Temporary Differences & Deferred Tax

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1. Introduction

IAS 12 *Income Taxes* governs how companies account for the tax effects of their transactions and events. Its goal is to ensure that the tax consequences are recognised in the same period as the transactions themselves. This involves recognising both:

- **Current tax** — the amount payable or recoverable for the current period under applicable tax laws.
- **Deferred tax** — the future tax consequences of current events, arising from differences between accounting and tax treatments.

Why this is important:

- Financial statements follow accounting standards (book rules).
- Tax authorities follow tax laws (tax rules).
- Timing differences between these systems create *temporary differences* that must be tracked for accurate tax reporting.

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2. Key Definitions

Carrying Amount (CA)

The value of an asset or liability in the books, as shown in the statement of financial position.
Example: A machine purchased for ₹10,00,000 with accumulated depreciation of ₹3,00,000 has a CA of ₹7,00,000.

Tax Base (TB)

The value of an asset or liability for tax purposes — the amount that will be deductible (for an asset) or taxable (for a liability) in the future.

Temporary Difference (TD)

The difference between the CA and the TB of an asset or liability:

TD = CA – TB

- **Taxable Temporary Difference (TTD):** Will result in more taxable income in the future → leads to a **Deferred Tax Liability (DTL)**.

- **Deductible Temporary Difference (DTD):** Will result in deductible amounts in the future → leads to a **Deferred Tax Asset (DTA)**.

Permanent Difference

A difference between accounting and tax treatment that will never reverse (e.g., exempt income, non-deductible expenses). Permanent differences **do not create deferred tax**.

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3. Determining the Tax Base

A. For Assets

Rule: TB = Amount deductible for tax purposes in the future when the asset is recovered.

Illustrations:

1. **Depreciable Asset**
   - CA: ₹7,00,000
   - Tax WDV: ₹6,00,000
   - TB = ₹6,00,000
   - TD = ₹1,00,000 (taxable) → DTL.
2. **Receivable already taxed**
   - If income from the receivable has already been taxed, TB = CA → no TD.
3. **Receivable from non-taxable source**
   - If the receivable comes from exempt income, TB = CA → no TD.

B. For Liabilities

Rule: TB = CA – amounts deductible for tax purposes in the future.

Special Case — Advance Income:
If income is taxed when received, TB = 0, because when it is recognised in accounting income later, it won't be taxed again.

Illustrations:

1. **Provision for Warranty**
   - CA: ₹1,50,000 (not yet deductible for tax)

    - TB: ₹0
    - TD = ₹1,50,000 (deductible) → DTA.
2. **Advance Rent Received**
    - CA: ₹5,00,000
    - Already taxed now → TB = ₹0
    - TD = ₹5,00,000 (deductible) → DTA.

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4. Types of Differences

Type	Reverses?	Example	Deferred Tax?
Temporary	Yes	Depreciation timing difference	Yes
Permanent	No	Fines, exempt dividends	No

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5. Deferred Tax Assets (DTA) and Liabilities (DTL)

Deferred Tax Liability

- Arises from **taxable temporary differences**.
- Indicates you will pay more tax in the future.
- Example: Asset depreciated faster for tax than for accounting → higher CA than TB.

Deferred Tax Asset

- Arises from **deductible temporary differences**.
- Indicates you will pay less tax in the future.
- Example: Expense recognised in books now but deductible for tax in later years.

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6. Recognition Rules

- **DTL:** Recognise for all taxable TDs, except:
    - On initial recognition of goodwill.
    - On initial recognition of an asset/liability in a transaction outside a business combination that affects neither accounting nor taxable profit.

- **DTA:** Recognise for deductible TDs only if probable that sufficient future taxable profits will be available to utilise the deductions.

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7. Measurement Principles

- Use tax rates and laws enacted or substantively enacted by the reporting date.
- Do not discount DTA or DTL.
- Reassess DTAs at each reporting date — reduce if sufficient taxable profit is no longer probable.

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8. 4-Step Method for Problem Solving

1. **Identify** the item — is it an asset or a liability?
2. **Find the carrying amount** from the books.
3. **Apply the tax base rule**:
    - Asset: amount deductible when recovered.
    - Liability: CA minus amounts deductible in future.
    - Advance income taxed now: TB = 0.
4. **Compute TD = CA – TB** and **classify**:
    - Assets:
        - CA > TB → DTL (taxable).
        - CA < TB → DTA (deductible).
    - Liabilities:
        - CA > TB → DTA (deductible).
        - Special advance income case → TB=0 → DTA.

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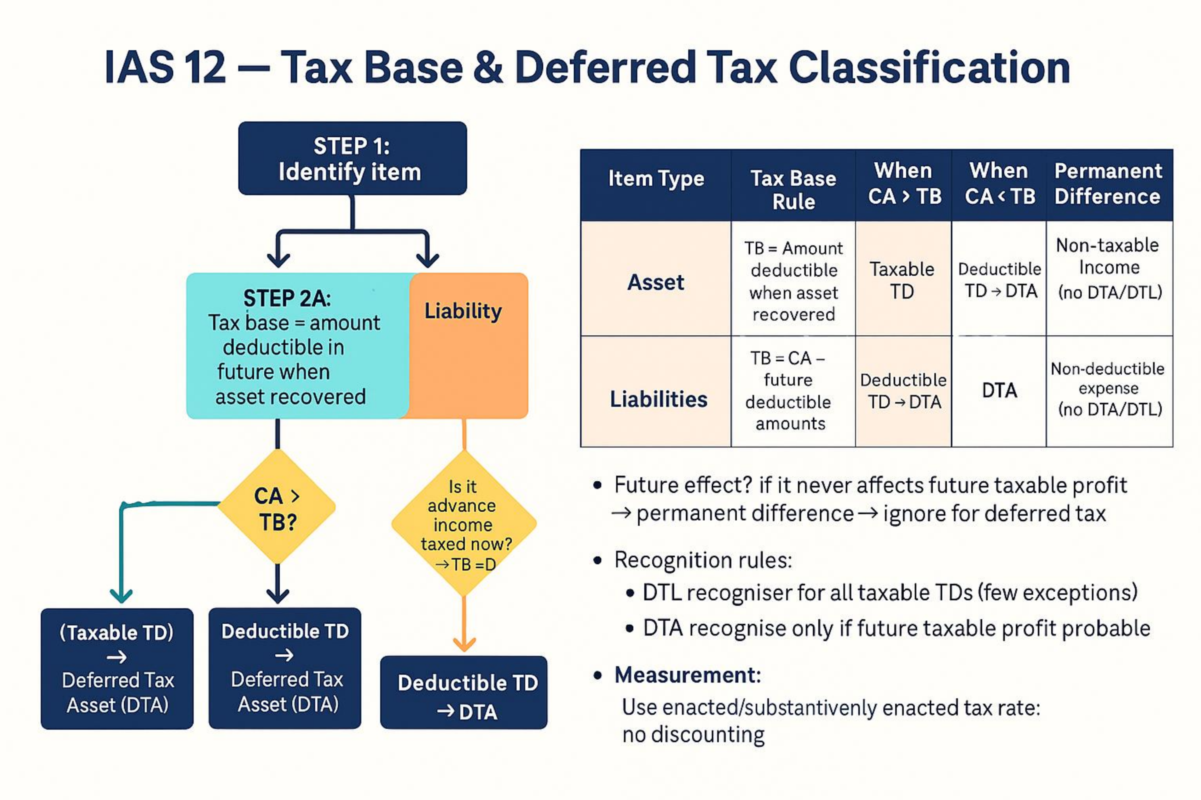
9. Quick Reference Table

Item Type	Tax Base Rule	CA > TB	CA < TB	Special Case	Permanent Difference
Assets	TB = Amount deductible when recovered	Taxable TD → DTL	Deductible TD → DTA	—	Non-taxable income
Liabilities	TB = CA – future deductible amounts	Deductible TD → DTA	—	Advance income taxed now → TB=0 → DTA	Non-deductible expense

10. Common Pitfalls to Avoid

- **Mixing temporary and permanent differences:** Only temporary differences result in deferred tax.
- **Reversing asset/liability logic:** The CA–TB test applies differently for assets and liabilities.
- **Ignoring "already taxed" clues:** Advance income taxed now almost always means TB=0 and a DTA arises.
- **Assuming all differences lead to deferred tax:** Recognition rules and probability tests apply.



12. Conclusion

Understanding the **tax base** is the foundation of solving IAS 12 problems.
By:

- Correctly identifying whether an item is an asset or liability,
- Applying the tax base rules,
- Calculating the temporary difference, and
- Distinguishing between temporary and permanent differences,

you can systematically determine whether to recognise a **DTA**, a **DTL**, or nothing at all. Once these concepts are clear, applying them to varied scenarios — such as provisions, advance income, or depreciation differences — becomes straightforward and mechanical.