



PART 2

DEFERRED TAX

0%, 14.5% OR 29%?

Since the introduction of the Capital Gains Tax (CGT) in South Africa, accountants have struggled to interpret the requirements of paragraph 51 of IAS 12 (AC 102), Income Taxes. This paragraph requires the measurement of deferred tax liabilities and deferred tax assets to reflect the tax consequences that follow from the manner in which an entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities.



recent circular issued by SAICA, Circular 1/2006, *Disclosures in relation to deferred tax*, recognises that the debate surrounding paragraph 51 of IAS 12 (AC 102) has focused particularly on measuring deferred tax in relation to investment properties. It appears that this issue has also come under the scrutiny of the GAAP

Monitoring Panel1 .

This article is the second of a pair of articles. Their purpose is to consider the interpretation of paragraph 51 and the application of this paragraph and Circular 1/2006 to various types of assets. In the first article, (Accountancy SA, September 2006), the meaning of the phrase "recovery of the carrying amount of an asset", the application of these principles to revalued property, plant and equipment, and the application of the requirements of the Circular to revalued property, plant and equipment were considered. In this, the second article, for the convenience of the reader, the authors first provide a brief overview of the principles established in the first article. Then these principles are applied to investment property measured in terms of the fair value model. Finally, the requirements of the Circular are illustrated for investment property carried at fair value.

1. The meaning of the phrase "the recovery of the carrying amount of an asset"

In the first article, the following principles were established:

- The carrying amount of an asset reflects, in substance, the future cash flows and cash equivalents to be generated by the asset.
- The carrying amount of an asset can potentially be recovered through use, sale or a combination of use and sale.
- Recovery through use is normally reflected in the passing of time, because, as time passes, the number of remaining years for which an asset can generate cash flows decreases. This implies that, for certain assets, for example, land, "use" cannot be a valid manner of "recovery", because the passing of time does not reduce the number of years for which an asset can generate cash flows (the cash flow stream continues in perpetuity). The carrying amount of land can therefore only be recovered through sale.

For a detailed discussion of these principles, readers should refer back to the first article.

2. Application of the principles to investment property

The principles established in the first article also extend to investment property measured in terms of the fair value model. IAS 40 (AC 135), *Investment property*, defines an investment property as property (land or buildings) held to earn rentals or for capital appreciation or for both. Under the fair value model, the asset is not depreciated. All fair value adjustments from one period to the next are treated as gains or losses in the income statement. Consequently, in terms of the fair value model, the income statement contains a mixture of realised gains and losses (for example, rental income and maintenance costs) and unrealised gains and losses (for example, increases in the value of future cash flows of the property caused by changes in market conditions). Paragraph 40 of IAS 40 (AC 135) makes it clear that, amongst other things, the fair value of investment property reflects rental income from current leases and reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume about rental income from future leases in the light of current conditions. Fair value is, therefore, a reliable measure at a specific point in time of the ability of the property to generate net cash inflows in future periods.

In the next section, the recovery of the carrying amount of investment property, and the resultant effect on the measurement of deferred tax, is considered, first, for investment property with a limited life and, second, for investment property with an unlimited life.

2.1 Investment property with a limited life (buildings)

In this section, the deferred tax consequences of buildings classified as investment property are considered first for buildings that the entity expects to keep until their cash generating capabilities have been fully used and then for buildings classified as held for sale and, finally for buildings where there is a dual intention of recovery (in other words, the building is to be retained for a period during which rental income is earned, after which it will be sold).

Even though buildings might have a very long useful life, nevertheless their useful life is still limited. This means that a building is not able to generate cash flows in perpetuity, and at some point in the future, the cash generating capabilities of the property will decrease and eventually disappear. The carrying amount of the building is therefore recovered as rental income is earned (as time passes) and the deferred tax balance should reflect this (this means that a rate of 29% is used to raise the deferred tax).

Some accounting commentators argue that the above interpretation, that a rate of 29% is used to measure deferred tax, is incorrect. They believe that the only tax payable on the fair value adjustments above the cost price of the asset is CGT, which will be levied when the asset is sold. Accordingly they believe that the deferred tax on these adjustments should be measured at the CGT rate of 14.5%, irrespective of the fact that the building generates cash flows in the form of rental income. The conceptual difficulty with this argument is that the carrying amount of investment property reflects the future stream of net cash inflows that will be generated by the property. If there is no intention to sell the property at some stage, the future economic benefits associated with the property will be realised in the form of rental income, which carries tax consequences at 29%. As time passes and the entity receives the cash flows (net rental income) generated by the property, the number of years that the property can generate cash flows decreases. This results in a reduction in the value of the asset, which is considered to be a recovery of the carrying amount for deferred tax purposes. This reduction in the value of the asset might not necessarily be reflected immediately in the financial statements, as a booming property market can result in a reflection of net fair value increases in the financial statements. The reduction in the value of the building as a result of the passing of time (the recovery of the carrying amount through use) might initially be offset by increases in the fair value of the remaining cash flows due to market conditions. However, a portion of the carrying amount of the property has been recovered and this recovery has been made by using the asset to generate rental income. At some point in the future, the building will no longer be able to generate cash flows.

This interpretation of IAS 12 (AC 102) also agrees with paragraph 4 of SIC 21 (AC 421), *Income Taxes – Recovery of Revalued Non-depreciable Assets*. SIC 21 (AC 421) determines that, for certain assets, sale is automatically assumed to be the expected manner of recovery of the carrying amount of the asset. The only assets that qualify for this automatic presumption are non-depreciable owner-occupied assets and investment property that would be non-depreciable if IAS 16 (AC 123), *Property, Plant and Equipment*, were to be applied (effectively the automatic presumption in SIC 21 (AC 421) therefore applies to land, whether it is accounted for as property, plant and equipment, or as investment property). This means that recovery through sale may not be automatically assumed for buildings classified as investment property. The rate applied to measure the deferred tax consequences of buildings classified as investment property is therefore established through the normal principles of paragraph 51 of IAS 12 (AC 102).

For buildings classified as held for sale, the expected manner of recovery of the carrying amount of the asset is through sale. This means that the component of the deferred tax balance relating to the

portion of the carrying amount of the asset above its CGT valuation date value is measured at 14.5%.

It is quite difficult to determine the portion of the carrying amount that will be recovered through sale for buildings that are measured in terms of the fair value model and for which there is an expectation of recovery through use and sale (in other words, the carrying amount reflects that the entity will use the asset for a period after which the property will be sold, provided that the entity has evidence to support such recovery methods). It is difficult to do so, because the entity is not required to determine a residual value for the purposes of applying the fair value model. However, it is submitted that the residual value should in any event be determined in such a case in order to quantify the portion of the carrying amount to be recovered through sale. The residual value should be based on the principles of IAS 16 (AC 123), as would have been the case if the property was accounted for under the cost model in terms of IAS 40 (AC 135).

To illustrate the above scenarios, if a factory building (the investment property) is carried at its fair value of R120 000, it has an original cost price (and 1 October 2001 CGT valuation date value) of R80 000 and a tax base of R20 000, the entity will need to determine how the carrying amount will be recovered, either:

- through use (in other words, the carrying amount represents a future stream of rental income);
- through sale (this is only possible if the investment property has been classified as a non-current asset held for sale); or
- through a combination of use and sale (this is only possible if an entity has evidence to support the sale of investment properties after a period of use; in such a case, the portion of the carrying amount recovered through sale must be quantified).

In the case of use, the deferred tax liability is R29 000, calculated as follows:

(the carrying amount – the tax base) x the company tax rate of 29% = deferred tax liability

$$(120\ 000 - 20\ 000) \times 29\% = R29\ 000$$

In the case of sale, the deferred tax liability is R23 200, calculated as follows:

(the carrying amount – the original cost price) x the CGT inclusion rate of 50% x a company tax rate of 29% + (the original cost price – the tax base) x 29% = deferred tax liability

$$(120\ 000 - 80\ 000) \times 50\% \times 29\% + (80\ 000 - 20\ 000) \times 29\% = R23\ 200$$

If there is a combination of use and sale, and if the residual value is R95 000 [based on the principles of IAS 16 (AC 123)], the deferred tax liability is R26 825, calculated as follows:

(the carrying amount – the residual value) x a company tax rate of 29% + (the residual value – the original cost price) x the CGT inclusion rate of 50% x a company tax rate of 29% + (the original cost price – the tax base) x a company tax rate of 29% = the deferred tax liability

$$(120\ 000 - 95\ 000) \times 29\% + (95\ 000 - 80\ 000) \times 50\% \times 29\% + (80\ 000 - 20\ 000) \times 29\% = R26\ 825$$

(In respect of a building on which no allowances are granted for tax purposes, it should be noted that, as a result of the application of paragraph 15(b) of IAS 12 (AC 102), no deferred tax is provided for on the portion of the carrying amount below the cost price.)

2.2 Investment property with an unlimited life (land)

If an entity owns land that is classified as investment property,

All fair value adjustments from one period to the next are treated as gains or losses in the income statement. Consequently, in terms of the fair value model, the income statement contains a mixture of realised gains and losses (for example, rental income and maintenance costs) and unrealised gains and losses (for example, increases in the value of future cash flows of the property caused by changes in market conditions).

the principles established for land classified as property, plant and equipment also apply here (refer to the first article for more details). Because the cash flow stream embodied in land continues in perpetuity, the receipt of cash that flows from land does not "recover" the carrying amount of the land. Consequently, deferred tax is measured based on the tax consequences that will result from the sale of the land.

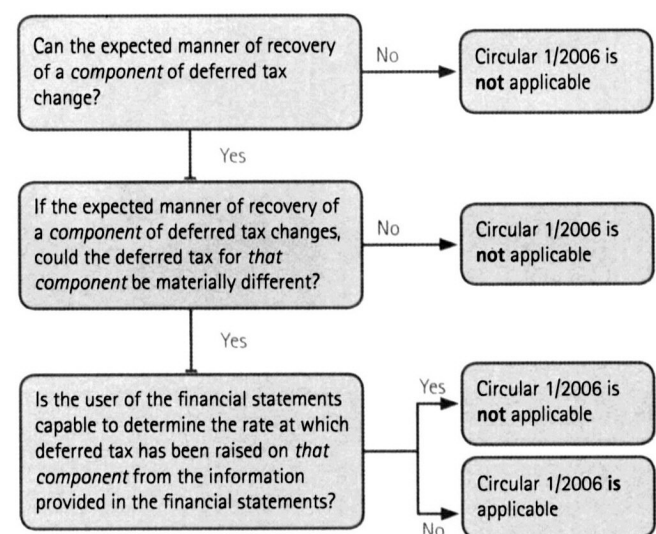
SIC 21 (AC 421) reaches the same conclusion, although a slightly different argument is used. SIC 21 (AC 421)⁵⁴ determines that the Interpretation (that the carrying amount of land can only be recovered through sale "because the asset is not depreciated") also applies to investment properties that are carried at revalued amounts in terms of IAS 40 (AC 135)⁵³, but that would be considered non-depreciable *if* IAS 16 (AC 123) were to be applied. Once again, the focus in the SIC 21 (AC 421) argument is on the non-depreciable nature of the asset, rather than on the fact that the cash flow stream of land will continue into perpetuity and that the receipt of one period's cash flow does not influence the (carrying) value of the property.

(It must be noted that, as a result of the application of paragraph 15(b) of IAS 12 (AC 102), no deferred tax is provided for the portion of the carrying amount of land below cost price.)

3. Disclosures required by Circular 1/2006

The Circular requires certain disclosures to be made where a change in the manner of recovery of the carrying amount of an asset could alter the deferred tax balance materially. The following flowchart details when disclosure is required to be made in terms of the Circular.

CIRCULAR 1/2006 – DECISION TREE



Even though buildings might have a very long useful life, their useful life is still limited. This means that a building is not able to generate cash flows in perpetuity, and at some point in the future, the cash generating capabilities of the property will decrease and eventually disappear.

To illustrate the application of the Circular to investment property:

A company owns a factory building classified as investment property. The building will be held until it can generate no further cash flows from use. It has a fair value of R120 000, an original cost price (and CGT valuation date value) of R100 000 and a tax base of R70 000. The deferred tax on the property amounts to R14 500 $[(120\,000 - 70\,000) \times 29\%]$. The deferred tax of R14500 consists of two components. The first of these is the deferred tax on the difference between the fair value of the property and the cost price of R5 800 $[(120\,000 - 100\,000) \times 29\%]$. The second is the deferred tax on the difference between the cost price and the tax base tax of R8 700 $[(100\,000 - 70\,000) \times 29\%]$.

If the manner of recovery for the first component changes from use to sale, this will have an impact on the measurement of deferred tax, as the rate that must be used to measure this component will change to 14.5%, as opposed to 29%. Disclosure is therefore required for this component in terms of the Circular. If the manner of recovery for the second component changes from use to sale, this has no impact on the measurement of deferred tax, as the rate that must be used to measure this component will remain at 29%. No disclosure is therefore required for the second component in terms of the Circular.

The authors are of the opinion that the required disclosure should be provided as part of the deferred tax note to the balance sheet as follows:

| | |
|-----------------------------------|---------|
| Analysis of temporary differences | |
| Investment property | R14 500 |

Included in the analysis of temporary differences on investment property is a component of deferred tax of R5 800 that relates to the difference between the asset's carrying amount (fair value) and original cost price. Deferred tax is provided for on this component at 29%, based on the assumption that the carrying amount of the asset will be recovered through use. If the carrying amount of the asset is to be recovered through sale, rather than through continuing use, deferred tax on this component should be measured at 14.5%.

4. Conclusion

In a Business Day article published on 26 May 2005, it was reported that a recently acquired subsidiary property company has aligned its accounting policy with its holding company. One of the adjustments referred to in the article, that was used in order to effect this alignment, is that the subsidiary changed its policy for recognising deferred tax on the fair value adjustments on investment properties to the 14.5% rate. Firstly, it should be noted that the appropriate rate to be used to measure deferred tax is not an accounting policy choice. The rate should be determined based on the expected manner of recovery of the carrying amount of the asset. Secondly, the 14.5% rate is only appropriate, in the case of buildings, if it is expected that the carrying amount of the asset will be recovered through sale, and then only to fair value adjustments above the CGT valuation date value of the asset.

The interpretation of IAS 12 (AC 102) §51 set out in this pair of articles is by no means an obvious interpretation of the standard. It is based on the wording of various standards, as well as the Framework, and it considers the interaction between these various documents with each other. In order to clarify the matter beyond all doubt, the authors submit that it would be best if this matter were clarified either as part of the revised IAS 12 (AC 102) that will result from the short-term convergence project between the IASB and FASB, or alternatively as a revision of SIC 21 (AC 421). **ASA**

End Note

1. www.saica.co.za GAAP Monitoring Panel, Summary of Matters, Issue 26

Elmar Venter MCom (Taxation) CA (SA) and Rieka von Well CA (SA) are both Senior Lecturers in the Department of Accounting at the University of Pretoria.

Editor's note:

A typing error occurred in the final version of the flowchart on page 15 of the September edition of ASA. The correct flowchart is included in this article.

