IMPLEMENTATION ISSUES IN THE PREPARATION OF FINANCIAL STATEMENTS UNDER IFRS CONVERGED INDIAN ACCOUNTING STANDARDS

AOSSG INTERIM MEETING

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AGENDA

- Background
- Issue - with 3 views
- Arguments for view 1
- Arguments for view 2
- Arguments for view 3
- Examples

BACKGROUND

Situation A

- In India, companies with units in Special Economic Zones (SEZ) can avail deduction u/s 10AA of the Income-tax Laws on the profits made by these Units.
  - Deduction of 100% of the profits from the export for the first 5 years;
  - 50% for next 5 years; and
  - For further 5 Years 50% subject to creation of "SEZ Reinvestment Allowance Reserve A/c" and fulfilment of conditions relating thereto; failing which the unutilised or wrongly utilised Reserve would be deemed income.
- The said deduction is allowed only if the specified conditions are fulfilled. One of the condition is that the amount credited to SEZ Re-investment Reserve A/c is to be utilised for the purposes of <u>acquiring machinery or plant which is first put to use before the expiry of a period of 3 years</u> following the previous year in which the reserve was created.

BACKGROUND

- Where any amount credited to the Special Economic Zone Re-investment Reserve A/c:
  - has been utilised for any other purpose, then the *amount so utilised* for other purposes **shall be deemed to be the profits in the year in which the amount was so utilised.**

    or

  - has not been utilised for the specified purpose before the expiry of three years following the year in which the reserve was created, then the **amount not utilised shall be deemed to be the profits in the year immediately following the period of three years specified**.

  and shall be charged to tax accordingly.

Situation B :

Similarly, In India, banks are permitted to create a special reserve, which is tax deductible under Section 36(1)(viii) of the Income Tax Laws. The entities get tax benefit when reserve is created and are liable to bear tax burden if this reserve is withdrawn.

ISSUE

Because the deduction can become taxable in future period if qualifying investment within prescribed time limit is not made, the following views are emerging:

View 1: In the year of transfer to special reserves, the entity claims the deduction while computing current tax and upto a period of the next 3 years (i.e., the prescribed time limit) if it is determined that the condition on which the deduction was claimed will not be met, then it reflects the effect of the same in the current tax of that year. **No deferred tax liability needs to be created**.

View 2: In the year of transfer to special reserves, the entity claims the deduction while computing current tax and **deferred tax liability is to be created** on the said amount (irrespective of its probability to meet the qualifying conditions).

View 3: In the year of transfer to special reserves, the entity claims the deduction while computing current tax and no deferred tax liability is to be created, if it is probable that the qualifying conditions will be met. **If it is probable that the qualifying conditions will not be met, then DTL should be created**.

CURRENT TAX OR DEFERRED TAX?

Arguments in favour of View 1

Requirements of IAS 12

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Paragraph 46 of IAS 12 state as follows:

Current tax liabilities (assets) for the current and prior periods shall be measured at the amounts expected to be paid to (recovered from) the taxation authorities, using the tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period. (Emphasis added)

CURRENT TAX OR DEFERRED TAX?

Arguments in favour of View 1 (Current tax and no DTL)

- 50% deduction u/s 10AA in years 11-15 represents a conditional deduction. Conditional upon:
  - transfer an amount not exceeding 50% of the profits to a reserve account to be called the "SEZ Re-investment Reserve A/c (SEZ reserve)"; and
  - Utilization of SEZ Reserve for prescribed purposes (qualifying investment) within a prescribed time period (3 years).

- The entity would need to determine, at each reporting date within 3 years after taking the deduction, whether it would make the qualifying investment and if it is probable that it would meet the condition for the deduction.

- This assessment may require significant judgement. In making the judgement, management needs to consider all available evidence, including existing business plans, board's decisions, availability of financing and feasibility of making the qualifying investment.

CURRENT TAX OR DEFERRED TAX?

Arguments in favour of View 1 (Current tax and no DTL)

- As on the reporting date, if the entity determines that it is not probable that it would meet the conditions for the previous tax deduction, then it ***reflects this in measuring its current tax liability***. **This may occur before the qualifying period of three years expires.**

- It is argued that the amounts transferred to special reserves do not represent temporary difference. Also, temporary differences are in respect of assets or liabilities, however, special reserves are not liabilities.

- Hence, no deferred tax is to be created and the impact of the ***conditional deduction under Section 10AA is to be reflected in arriving at the current tax.***

CURRENT TAX OR DEFERRED TAX?

Arguments against View 1

- It is argued that transfer of amounts to reserves (as per the applicable laws) indicates that the entity expects to utilise reserve as per specified conditions, otherwise it would not have transferred the said amount in the first place.
- Accordingly, during the year 11-15, if the entity has transferred eligible amounts to SEZ reserve, then it is entitled to get the deduction while computing taxable income of that year, as per the applicable tax laws.
- As per the applicable tax laws, it is either after the end of 3 years or the year in which the amount is utilised for other purposes that the said **amount will be considered as income of that year and hence will be charged to tax as per the applicable tax rate of that year**.
- In other words, ***the liability to pay income tax on such amounts will arise either after the expiry of 3 years or in the year in which amount is utilised for other purposes.***

CURRENT TAX OR DEFERRED TAX?

Arguments against View 1

- For the purpose of calculating current tax of subsequent 3 years, as per the Income Tax Act, the entity is not liable to assess at each reporting period that whether it will be able to make the qualifying investment or not. Therefore, **there will be no impact in the current tax of subsequent 3 years even if qualifying investment is not made** upto the end of those years.

- Either in the 4th year or the year in which the amount is utilised for other purposes, the entity will be liable to pay income tax on the said amount, and hence shall be accounted for in the current tax of that year as per the tax rate of that year.

- **As on the reporting date, there is no present obligation to pay tax on the said amount, hence no current tax liability should be recognised.**

CURRENT TAX OR DEFERRED TAX?

Arguments against View 1

- Since, the liability to pay income tax will not arise in the current year but, has the ability to impact taxability in future periods, accordingly, as on the reporting date the same should be reflected by creating deferred tax.

- Entity's assessment of its ability to make the qualifying investment should be reflected by creating deferred tax and not current tax.

CURRENT TAX OR DEFERRED TAX?

Arguments in favour of Deferred Tax

Requirements of IAS 12

- **Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.**
- **Taxable temporary differences are the temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.**

"8 The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods…."

"10 Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an entity shall, with certain limited exceptions, ***recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences****..." (Emphasis added)*

CURRENT TAX OR DEFERRED TAX?

Arguments in favour of Deferred Tax

Requirements of IAS 12

Objective paragraph of IAS 12 state as follows:

'It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. ***If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability*** *(deferred tax asset), with certain limited exceptions.' (Emphasis added)*

CURRENT TAX OR DEFERRED TAX?

Arguments in favour of Deferred Tax

Requirements of IAS 12

15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination;

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

(iii) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

CURRENT TAX OR DEFERRED TAX

Arguments in favour of View 2 (DTL to be created in all cases irrespective of probability)

- IAS 12 provides that DTL is to be recognised for ***all*** taxable temporary differences with limited exceptions.
- The given case does not fall in the exceptions provided and hence, DTL should be created on the entire amount transferred to reserves.
- It is also argued that the manner of utilisation of carrying amount of reserves can make future tax payments larger, i.e., **if qualifying investments is not made then it will make future tax payments larger as the amounts so transferred to reserves will be deemed profits and hence, will result in larger tax liability of that year**.
- Since, there is a possibility that the entire amount will be deemed profits if not invested, accordingly, the amounts so transferred can/may impact future taxability, i.e., it may result in the obligation to pay the resulting income taxes in future periods, and hence deferred tax is to be created on the entire amount.

CURRENT TAX OR DEFERRED TAX

Arguments in favour of View 3 (DTL to be created on the basis of probability)

- On a combined reading of objective of the Standard with paragraph 10, it can be interpreted that since utilisation/withdrawal from special reserves can be controlled by the entity, the entity needs to assess whether the utilisation/withdrawal from special reserves is probable in the foreseeable future or not.

- In case, it is probable that utilisation of reserve in specified investments will happen as per the stated conditions (situation 1) or it is not probable that withdrawal from special reserve would occur (situation 2), then deferred tax liability need not be created, as it will not result in the obligation to pay the resulting income taxes in future periods.

CURRENT TAX OR DEFERRED TAX

Arguments in favour of View 3 (DTL to be created on the basis of probability)

- However, in case it is not probable that utilisation of reserve in specified investments will happen (situation 1) or it is probable that withdrawal from special reserve would occur (situation 2) then deferred tax liability should be created, as it will result in the obligation to pay the resulting income taxes in future periods.

- The accounting policy adopted and the rationale for such policy should also be disclosed in the notes to accounts.

EXAMPLE

Let us understand this by an example.

Facts: SEZ Ltd. has a unit located in the SEZ area which has earned profits amounting CU 10 million in year (2021) (i.e.11th year) and has transferred CU 5 million to SEZ reserve, as per section 10AA of the Income tax Act. It is required to acquire P&M from the said amount. The P&M should be put to use latest by the year 2024.

Scenario: Upto the end of 2021, the entity was determined to acquire the P&M but due to financial losses in the year 2022, its ability to acquire the P&M was doubtful. The entity could not acquire P&M upto the end of 2024.

EXAMPLE

Let us understand this by an example

View 1:

- In the year 2021, the entity will claim deduction of CU 5 million and pay current tax on balance CU 5 million.

- In the year 2022, entity assess its ability to purchase the P&M and determines that it is not probable that it will meet the condition, hence, in the year 2022, the entity will take its impact in arriving at the current tax of the year 2022, i.e., by including CU 5 million as deemed income.

- No deferred tax to be created.

EXAMPLE

View 2:

- In the year 2021, the entity will claim deduction of CU 5 million and pay current tax on balance CU 5 million and will create a deferred tax liability.

- The expected manner of utilisation of the reserve at its carrying amount of CU 5 million might affect taxable profit, because the said amount may become deemed profits and be taxable. On utilising the reserves the entity will not get any tax deductions, but may create taxable income. Thus, DTL will be created on CU 5 million.

- *It may be noted that DTL will be created irrespective of the entity's assessment of its ability to meet the qualifying condition.*

EXAMPLE

View 3:

- In the year 2021, the entity will claim deduction of CU 5 million and pay current tax on balance CU 5 million.
- During this year, it is probable that it will be able to meet the qualifying condition, and therefore, no DTL will be created as the expected manner of utilisation of the reserve at its carrying amount of CU 5 million will not result in taxable income (as it is expected that it will not be deemed profits). Therefore, its carrying amount will be equal to its tax base.
- However, in the year 2022, if it is determined that it will not be able to acquire the P&M, then DTL will be created on CU 5 million.

Thank You

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