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Deferred Tax consequence of measuring at fair value, Investment Property under IAS 40.

Preamble

In December 2001, Council issued guidance on measurement and recognition of deferred tax on revaluation of Property, Plant and Equipment. The guidance did not deal with the deferred tax consequences of revaluing to fair value, Intangible Assets under IAS 38, Financial Instruments under IAS 39 and Investment Properties under IAS 40.

The Institute has since been reviewing the deferred tax consequences of measuring Investment Property at its fair value after initial recognition with a view to guiding members appropriately. IAS 40 became operative for annual financial statements covering periods beginning on or after 1 January 2001. It supersedes IAS 25, Accounting for Investments, with respect to investment property.

Below is guidance on measurement and recognition of deferred tax arising from a change in fair value of Investment Property under IAS 40. Members are advised to comply fully with IAS 12 and the relevant SIC Interpretations and should only use this communication to assist in the implementation of the relevant parts of the Standard.

Basis for conclusions

IAS 12 Paragraph 20 provides that the difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

According to ***SIC 21 paragraph 5***, the deferred tax liability or asset that arises from the revaluation of a non-depreciable asset under ***IAS 16.29*** should be measured based on the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset (capital gains) that differs from the tax rate applicable to the taxable amount derived from using an asset (profit), the former rate is applied in measuring the deferred tax liability or asset related to a non depreciable asset.

Paragraph 4 of SIC 21 states that this interpretation also applies to investment properties which are carried at revalued amounts under ***IAS 25.23(b) (now IAS 40.27*** – fair value model) – but would be considered non-depreciable if ***IAS 16*** were to be applied.

IAS 16 does not give a definition of what a "depreciable" or non-depreciable asset is. However, ***paragraph 45*** states that: "Land normally has an unlimited life and, therefore is not depreciated. Buildings have a limited life and, therefore are depreciable assets".

IAS 12 paragraph 34 provides that a deferred tax asset should be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profits will be available against which the unused tax losses and unused tax credits can be utilised. One must sufficiently justify recognition of deferred tax asset in accordance with ***IAS 12*** especially in instances where no deferred tax liability exists on gains resulting on fair value adjustments on the investment properties.

From the above, it can be deduced that;

a. Since presently there is no capital gains tax in Kenya, no deferred tax would arise on fair value adjustments to a non-depreciable asset**.**

b. Freehold land is non-depreciable and therefore no deferred tax would arise on the fair value adjustments arising thereon.

c. Buildings would be regarded as depreciable and therefore deferred tax would arise based on the tax rate applicable to the taxable amount derived from the usage of the asset – i.e. 30% currently.

Conclusions:

(a). Deferred tax asset or liability at the tax rate applicable to the taxable amount derived from use of an asset (presently 30%) should be provided on fair value adjustments arising from measurement at fair value of buildings treated as investment properties under IAS 40.

(b). If a deferred tax asset arises from fair value adjustments then the recognition criteria under IAS 12 should be adhered to.