Institute of Certified Public Accountants of Kenya

Draft Guidance on Deferred Tax on Revaluation Surpluses.

Tangible Fixed Assets & Investment Property

Comments should be sent to the Institute through e-mail (icpak@icpak.com) , postal address (P.O.Box 59963 Nairobi) or fax (02) 862206 so as to reach us not later than 31st of October 2001.

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Preamble

The Council wishes to reaffirm the position that compliance with International Accounting Standards is mandatory for all members of the Institute. Compliance should be in respect of all the applicable standards in line with IAS 1, *Presentation of Financial Statements* which provides as follows:

Paragraph 11: "Financial statements should not be described as complying with IASs unless they comply with all the requirements of each applicable standard…"

Paragraph 12: "Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies or by notes or explanatory material."

Paragraph 13: Where a departure from a requirement is necessary to deliver a fair presentation, an enterprise should disclose, among other things:

- the standard from which the enterprise has departed, the nature of the departure, including the treatment that the standard would require, the reason why that treatment would be misleading in the circumstance and the treatment adopted and
- the financial impact of the departure on the enterprise's net profit or loss, assets, liabilities, equity and cash flows for each period presented.

Below is guidance on measurement and recognition of deferred tax on revaluation of tangible Fixed Assets and Investment Property. Members should comply fully with IAS 12 and should only use this communication to assist in the implementation of the relevant parts of the standard. This guidance does not deal with the deferred tax implications of revaluing to fair value Intangible Assets under IAS 38 or Financial Instruments under IAS 39. It deals only with the deferred tax consequences of revaluing to fair value Property Plant and Equipment under IAS 16 and Investment Properties under IAS 40.

Property, plant and equipment

IAS 12 defines (in paragraph 5) a temporary difference as the difference between the carrying amount of an asset or liability in the balance sheet and its tax base. Taxable temporary differences are those temporary differences that will result in taxable amounts in determining the taxable profit (or loss) of future periods. Deferred tax liabilities are defined as the amounts of income tax payable in future periods in respect of taxable temporary differences.

When a company purchases freehold land or office buildings, a temporary difference arises, because the tax base from the date of acquisition is zero (since no tax deduction is available on acquisition or subsequently). To the extent that depreciation is charged against future profits, taxable amounts arise in the future, since the disallowance of the depreciation expense in the tax computation will give rise to a tax charge. However, paragraph 15 (b) of IAS 12 does not allow the company to recognise a deferred tax liability on such taxable temporary differences, which arise on the initial recognition of such an asset. This exemption, on that part of the taxable temporary difference that arises on the initial recognition of the asset, continues throughout the life of the asset, although the difference will decrease if the asset is depreciated. The reason for the exemption is explained in paragraph 22 (c) of IAS 12.

If the company subsequently revalues its freehold land and office buildings, this will increase the taxable temporary difference (the carrying amount has increased, but the tax base remains zero). The increase in the taxable temporary difference is not a taxable temporary difference arising on acquisition and therefore is not subject to the exemption given under paragraph 15 (b) of IAS 12. ***In principle, therefore, all revaluation surpluses give rise to a deferred tax liability on the increase in the taxable temporary difference. This is confirmed by paragraph 18 (b) and 20 of IAS 12.***

However, there remains the question of what tax rate should be applied to the taxable temporary difference in computing the corresponding deferred tax liability. IAS 12, paragraph 51, requires that the measurement of deferred tax liabilities should reflect the tax consequences that would follow from the manner in which the enterprise expects, at the balance sheet date, to recover or settle the carrying amount of the relevant asset or liability. Normally the carrying amount of an office building, say, would be recovered by depreciation charged against profits in future periods.

As explained above, the disallowance of this depreciation in future tax computations gives rise to a tax charge at the corporate rate of income tax (currently 30%) and this is therefore the rate that should be applied in computing the deferred tax liability. However, if the company intends to dispose of the building immediately after the balance sheet date (without further depreciation), then the carrying amount will be recovered through realisation and the tax rate to be applied would be the capital gains tax rate. In Kenya, capital gains tax is currently suspended, and the rate is therefore zero. Thus there is no deferred tax liability in this situation.

SIC 21 issued by the Standing Interpretation Committee of the IASB clarifies the position for non-depreciable assets, such as freehold land. Since no depreciation is to be charged against future profits, the recovery of the carrying amount can only be achieved through disposal, whether or not the company has any intention to dispose off the asset in the foreseeable future. In this situation the rate of tax that would apply on disposal (normally the capital gains tax rate) should be applied to the taxable temporary difference in computing the deferred tax liability. Again, in Kenya the capital gains tax rate is currently effectively zero, resulting in a deferred tax liability of zero.

Investment property

IAS 40 allows two alternative treatments for investment properties: the cost model (following IAS 16), and the fair value model. If the cost model is followed, the deferred tax implications are the same as for property, plant and equipment, as dealt with above.

If the fair value model is adopted, taxable temporary differences will arise between the carrying amount and the tax base. However, an investment property carried at fair value is a non-depreciable asset, and the guidance given in SIC 21, although it does not specifically refer to investment properties, should be followed. The rate applied in computing the deferred tax liability would most likely be the capital gains tax rate, currently zero.

It should be appreciated, however, that for some companies the profit on sale of an investment property would be treated as trading profit, subject to the corporate rate of income tax. In such a situation, it is that rate (currently 30%) that should be applied to the taxable temporary difference (excluding that part arising on initial acquisition), and a deferred tax liability (or asset if the fair value is less than cost) will arise.

In summary:

- If a depreciable asset is revalued upwards, resulting in a revaluation surplus being created, a deferred tax liability should be provided for, using the best estimate at the balance sheet date of the future tax rate on that revaluation surplus: if, at the balance sheet date, the enterprise intends to use the asset in the business, the rate to be used is the normal tax rate i.e.30% for a company incorporated in Kenya: if, at the balance sheet date, the enterprise intends to sell the revalued asset, and no further depreciation will be charged on that asset in the future, **no** deferred tax liability should be provided for, unless a tax liability would arise on the sale of the asset, in which case that tax liability should be provided for as a current or deferred liability depending on when the potential tax liability arises.

- If a non- depreciable asset, such as freehold land, is revalued upwards, and a revaluation surplus is created, **no** deferred tax liability should be provided for (whether the enterprise intends to use the asset in the business or to sell the asset), unless a tax liability would arise on the sale of the asset, in which case the position is similar to that for a depreciable asset.

- If a depreciable asset is revalued downwards after it was previously revalued upwards, the decrease in value leads to a reduction in both the revaluation surplus and the deferred tax liability (on a pro-rata basis).

- If a depreciable asset is revalued downwards and had not been previously revalued upwards, then the whole of the decrease in value is charged in the income statement.

- If a non-depreciable asset is revalued downwards, the whole of the decrease is charged against the revaluation reserve (if it had previously been revalued upwards and no deferred tax had been provided) or the income statement (if the asset had not been previously revalued upwards)

Illustration

K Ltd has erected a new office building, which has an estimated useful life of 50 years as at 1st January 20x1 and which was built on a piece of freehold land. The costs are Shs 200 million and Shs 100 million for the Building and Land respectively. The residual value of the Building is Nil and was first used in the year ended 31st December 20x1. Ten years later in the year ended 31st December 20y0, the freehold land is revalued at Shs 150 million and the Building at Shs 280 million. The remaining useful life continued as originally estimated, that is 40years with effect from 1st January 20y1. On 31st December 20z0, the freehold land is revalued at Shs 120 million and the Building at Shs 180 million. There was no change in the estimate of the remaining useful life. The rate of tax is 30% for all periods.

Suggested Solution

Journal Entries	**Dr** Shs	**Cr.** Shs
20y0		
Dec 31 Freehold Land Account	50	
" Building Account	120	
" Deferred Tax Account		36
" Revaluation Reserve		134
20y1 –20z0		
Dec 31 Income Statement: Depreciation	7	
" Depreciation on Building Account		7
20y1 –20z0		
Dec 31 Revaluation Reserve	2.1	
" Retained Earnings		2.1
20y1 – 20z0		
Dec 31 Deferred Tax Account	0.9	
" Income Statement: Deferred Taxation		0.9
20z0		
Dec 31 Depreciation on Building Account	70	
" Building Account		70
20z0		
Dec 31 Revaluation Reserve	30	
" Freehold Land Account		30
" Revaluation Reserve	21	
" Deferred Tax Account	9	
" Building Account		30

Ledger Accounts

Freehold Land Account

			Shs m			Shs m
Jan 1	20x1	Bal. B/f	100	20z0 Dec 31	Revaluation reserve	30
Dec 31	20y0	Revaluation reserve	50	"	Bal. C/d	120
			150			150
Jan 1	20z1	Bal. B/f	120			

Building A/C

			Shs m			Shs m
Jan 1 20x1	Bal. B/f		200	Dec 31 20y0	Depreciation	40
Dec 31 20y0	Revaluation reserve	(0.7 x 120)	84			
"	Deferred Tax	(0.3 x 120)	36	"	Bal. C/f	280
			320			320
Jan 20y1	Bal. B/d		280	31 Dec 20z0	Depreciation	70
				"	Revaluation reserve	21
				"	Deferred Tax	9
				"	Bal. C /f	180
			280			280

Depreciation on Building A/C

			Shs m			Shs m
				Dec 31 20x1	Profit & Loss A/c	4
				Dec 31 (20x2-20x9)	"	32
Dec 31 20y0	Building A/C		40	Dec 31 20y0	"	4
			40			40
				Dec 31 20y1	Profit & Loss A/c	7
				20y2-20y9	"	56
Dec 31 20z0	Building A/C		70	Dec 31 20z0	"	7
			70			70

Revaluation Reserve A/c

		Shs m			Shs m
Dec 31 20y1	Retained Earnings (70%x 3)	2.1	20y0 Dec31	Freehold Land A/c	5
Dec 20y2-20y9	Retained Earnings (70%x24)	16.8	"	Building A/c	8
Dec 20z0	Retained Earnings (70%x3)	2.1			
"	Freehold Land A/c	30			
"	Building A/c	21			
"	Bal. C/d	62			
		134			134
			20z0 Jan	Bal. B/d	62

*The balance of 62 is made up of Freehold land 20 m and Building 42 m

Deferred Tax Account

			Shs m			Shs m
20y1 Dec 31	Profit & Loss A/c	(30%x 3)	0.9	Dec 31 20y0	Building A/c	36
(20y2-20y9)	"	(30% x 24)	7.2			
20z0 Dec 31	"	(30%x 3)	0.9			
"	Building a/c		9			
"	Bal. C/d		18			
			36			36
				20z0 Jan 1	Bal. B/d	18