Accounting for income taxes: Few practical considerations

This article aims to:

- Highlight the complexity in determination of effective income tax rate for interim financial statements statements and accounting for deferred taxes in a common control business combination

Accounting for income taxes has always been complex not only due to various interpretation challenges of any income tax law but also various judgemental considerations. Examples of judgement areas are assessment of probability for recognising deferred tax assets on accumulated losses, taxes on undistributed earnings, scheduling origination/reversal of temporary difference and change in assessment of deferred tax of either of the combining entities in a business combination under common control at the date of combination. The complexity may further increase when accounting for income taxes for any interim period.

Therefore, in this article, we highlight certain practical considerations in relation to:

i. Accounting for income taxes in any interim period

ii. Accounting for deferred taxes in business acquisition involving entities under common control.

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Accounting for income taxes in any interim period

The term 'interim period' is defined in Ind AS 34, *Interim Financial Reporting* as a financial reporting period which is shorter than a full financial year.

As per paragraph 30(c) of Ind AS 34, *'income tax is recognised in each interim period based on the best estimate of weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.'*

The best estimate of the weighted average annual income tax rate expected for the full financial year is calculated by estimating the 'total' tax charge for the year (comprising both current and deferred tax) and expressing this as a percentage of expected accounting profit or loss for the year. This 'effective' average annual tax rate is then used to compute the 'total' interim tax charge. Also, it is important to note that in certain situations actual tax computation for an interim period may be more relevant and acceptable when reliable estimate of full year pre-tax income cannot be made or when a small change in any item of tax computation results in a significant change in weighted average annual effective tax rate, etc.

Computation of effective tax rate is a matter of judgement and an estimate of the many critical aspects. Few important factors to be considered in determining annual effective tax rate are as follows:

- Tax rate and laws used are those which are applicable for full year that have been enacted or substantively enacted by the end of the interim reporting period
- Generally, separate estimated average annual effective income tax rate should be determined for each jurisdiction and for different categories of income (if different tax rate is applicable for those different categories)
- Expected annual pre-tax income and tax deductions which may be linked to events or income/expenditure expected to arise in future interim periods should be considered when estimating annual effective tax rate
- Accounting impact for one-off items
- Accounting for tax rate or law change, one-off deduction or significant income/expenditure item in any interim period, reassessment of any deferred tax item, etc.

While first three bullets are self-explanatory or to be accounted for in line with the broad principles of Ind AS 12, *Income Taxes*, it is important to understand how bullet 4 and 5 should be considered in determining tax expense/credit for any interim period.

Generally, a one-off event will be those items which are unusual or infrequent in nature and involves a relatively high degree of abnormality. It may not be possible to reliably estimate the effect of a one of event and therefore, accounting effect of such an event should be recognised in the interim period in which such one-off event arises instead of including this in estimation of weighted average annual income tax rate.

In respect of bullet 5 listed above, there could be an impact due to either re-measurement of existing deferred tax item or tax rate change for the current full year. Generally, there are two methods to estimating the weighted average annual income tax rate to apply to interim periods in relation to change in tax rate and reassessment of recognition of deferred taxes on carry forward losses. The method adopted to estimate the weighted average annual income tax rate to apply to the interim results for such items should be applied consistently as an accounting policy.

Under the first method, the weighted average income tax rate does not include the impact resulting from items listed in bullet 5 above and therefore, the impact of premeasuring these balances is recognised immediately in the interim period in which the change in rate is enacted or substantially enacted considering it as the one-off event.

Alternatively, the second method takes a contrary view where the impact effect of a change in the tax rate spread/allocated over the remainder of the annual reporting period via an adjustment to weighted average annual income tax rate.

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Accounting for reassessment of deferred tax of a merging entity with another common control entity

Currently, we routinely come across mergers and acquisition involving entities within common control. Other than business synergies, there could be tax positions and realisability synergies driving some of these transactions. Therefore, it is not uncommon to see a reassessment in deferred tax position of merging entity as on the date of combination in such transaction.

Generally, in a business combination between two entities which are not under common control while impact of such reassessment on the date of business combination is considered as an adjustment to acquired assets and thus will impact goodwill or bargain purchase gain computation, any subsequent change post acquisition date is considered to be an adjustment to the statement of profit and loss, subject to rules relating to measurement period.

However, for business combination among entities under common control, the general guidance is to apply 'as if pooling of interest method' and therefore, all items of assets and liabilities are combined from the first day of earliest comparative period presented or whenever entities came under common control, whichever is later. Therefore, neither goodwill nor bargain purchase gain is accounted for.

Ind AS is silent on the accounting treatment of re-assessment of deferred tax of combined entity i.e. whether it should be recognised in the statement of profit and loss or statement of changes in equity.

Under U.S. GAAP, the deferred tax consequences of changes in the tax bases of the combined entity's remaining assets and liabilities caused by the common control merger would be included in equity.

Therefore, under Ind AS entities should carefully assess whether under a common control business combination the impact due to reassessment of deferred taxes would be accounted in the statement of changes in equity or statement of profit and loss on the basis of facts and circumstances of each case.

Conclusion

As is evident from an interim financial reporting perspective, it is important to appropriately classify and account for one-off event/items and making long-term driven accounting policy choice to reflect the impact of certain reassessments caused either due to internal estimation or due to change in tax laws or rates. From the perspective of transactions under common control, it is important that whether the tax effect of a particular item especially reassessment of deferred tax of merging entity on the date of combination will be accounted as an adjustment to equity or through the statement of profit and loss.

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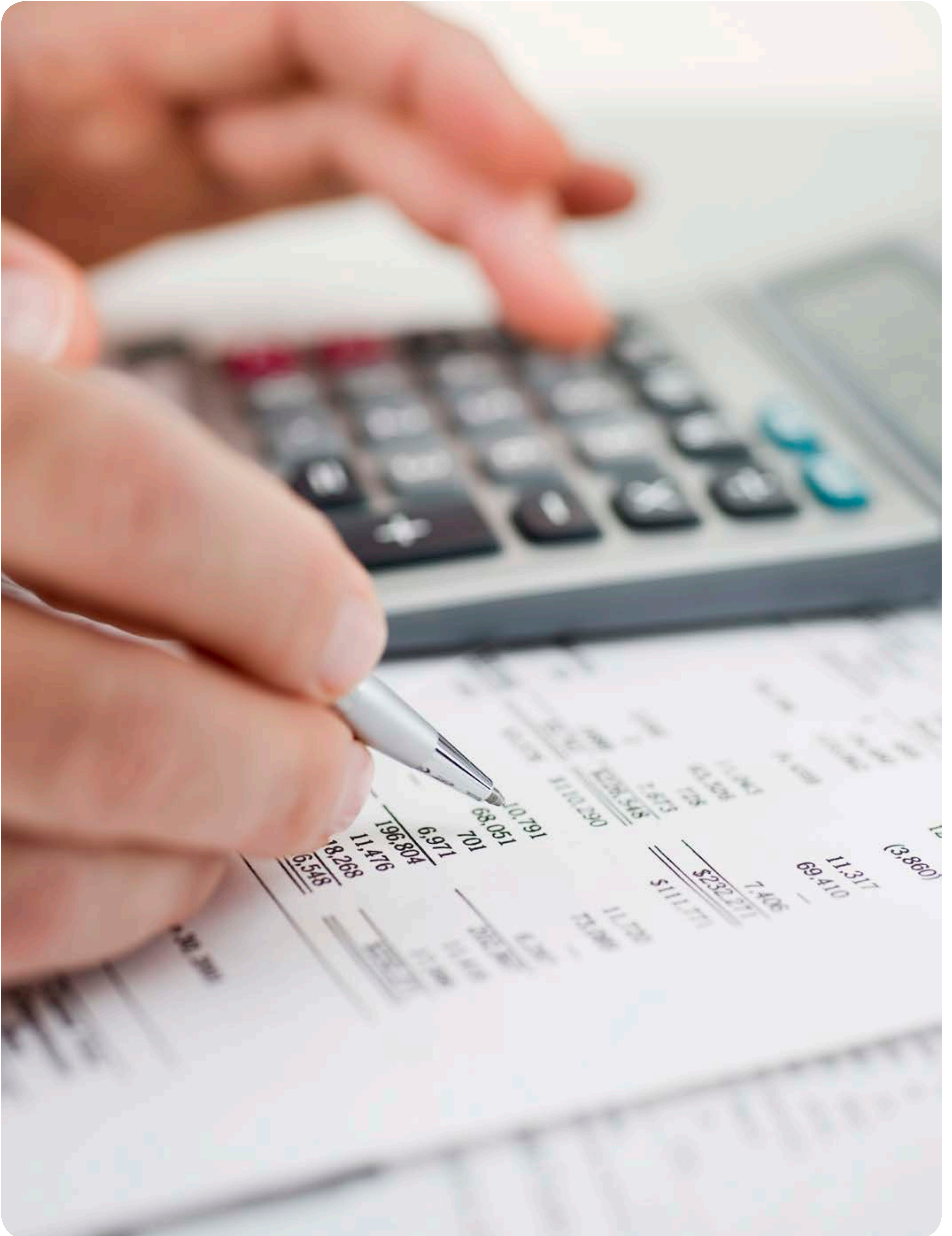

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