Changes in accounting for deferred tax as at 31 December 2017 (3/45/17)

Latvia has adopted a new corporate income tax (CIT) system effective from 2018. The new CIT treatment and rates will significantly change the amount of deferred tax recognised on the balance sheet as at 31 December 2017. This article explores some of these changes.

Under section 13(5)(2) of the Annual Accounts and Consolidated Accounts Act, companies should apply International Accounting Standards (IAS), in particular IAS 12 *Income Taxes*, in recognising and measuring deferred tax. Among other things, this standard provides for recognising deferred tax at rates that will apply in periods when temporary differences making up such deferred tax are realised/settled in the light of any amendments to tax legislation adopted by the end of the reporting period, i.e. the expected future tax rate and legislation should be applied to deferred tax calculations.

On 28 July 2017 Parliament passed the CIT Act effective from 1 January 2018. The new law in fact cancels all temporary differences between the financial accounting basis and tax basis of assets and liabilities from 1 January 2018. With temporary differences between the values of assets and liabilities in financial accounting and for tax purposes ceasing to exist from that date, no deferred tax asset will be realised or deferred tax liability settled after 2017. This means that generally deferred tax assets or liabilities will no longer be recognised on the balance sheet as at 31 December 2017.

There are many specific aspects to consider with respect to CIT and deferred tax recognition:

- The tax liability on a profit distribution should be recognised when the company recognises a dividend liability to its shareholders. In Latvia this happens when the general meeting decides to distribute a dividend, usually in the year following the reporting year. If the shareholders approve an interim dividend, the tax liability on that profit distribution should be recognised in the reporting period.
- The tax liability on a deemed profit distribution should be recognised in the particular month according to amounts reported on CIT returns.
- There are no grounds to continue or begin recognising a deferred tax asset on the balance sheet as at 31 December 2017 due to any unused tax loss even if it is safe to expect that the tax loss can be utilised in a subsequent period, because a temporary deductible difference is zero-rated in relation to retained earnings. A reduction in CIT arising from the utilised tax loss will be recognised along with the tax liability on the profit distribution once approved.

According to IAS 12, income or expense arising from changes in deferred tax assets or liabilities as a result of amendments to tax legislation should be recognised in the profit and loss account (P&L) unless deferred tax has been recognised earlier with respect to any items recognised outside P&L:

- In general a deferred tax liability should be liquidated by taking deferred tax income to P&L for the current period, and a deferred tax asset should be liquidated by taking deferred tax expense to P&L for the current period.
- If the company revalues its long term investments etc, affecting the amount of its equity reserves, then a deferred tax adjustment should be made in the revaluation reserve.
- In the case of a fixed-asset revaluation (unless the company has adopted an approach where an amount equal to depreciation on the revalued part of a fixed asset for the year is moved from the

revaluation reserve to retained earnings in each reporting year), a deferred tax adjustment in the revaluation reserve should not be made for the full amount, but rather considering any deferred tax income recognised in P&L earlier. The amount of deferred tax to be moved back to the revaluation reserve in 2017 should then be calculated as follows (with the remaining adjustment recognised in P&L):

1. Measure the amount of deferred tax associated with the original amount of the revaluation reserve (for any revalued fixed assets still on the company's balance sheet);
2. Deduct from the amount so measured any reduction in the deferred tax liability recognised in P&L to date as deferred tax income relating to the part of an increase in the fixed-asset value resulting from revaluation.

- If the company has applied the "fair value as deemed cost" exemption to its fixed assets under IFRS 1 *First-time Adoption of International Financial Reporting Standards*, then a revaluation reserve was not recognised by making an adjustment to retained earnings at the time of switching to IFRS. In that case the cessation of deferred tax recognition should also be fully taken to P&L.