THE INSTITUTE OF DEFERRED TAX

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Abstract

The deferred income tax is purely a matter of accounting and as such has no impact on paying the income tax. This accounting category serves within double-entry bookkeeping to classify the cost that arose because of the obligation to pay the income tax in the correct accounting period. The deferred tax is rather a new category in the Czech accounting law and is connected to the acceptance of the new bill on accounting in 1993. Moreover, it was not widely known for a long time as it used to concern a small group of people. It was related to the main precondition of implementing the accounting reform at that time, which was simplicity, transparency and uncomplicated new legal changes with the aim of a gradual change over to market economy and adaptation to conditions of the European legislation. The low number of business units obliged to keep books of deferred tax was also caused by the complicatedness of the given area of accounting and tendency of companies to adjust accounting to the accounting aspects in the first years after the reform.

Keywords: IFRS, GAAP, international accounting, income taxes

1. Introduction

One of the main targets of today’s process of development of international accounting is providing fundamental changes in the content and function of financial reporting. The quickly-changing global market causes constant changes of investors’ needs as well as need of other users of financial information. At the same time, interests and needs of all these parties differ and it is necessary to lead a proper dialogue with marketed companies, investors, market regulators, creditors, employees, auditors and others with the aim to ensure stable and efficient functioning of capital markets and information needs of all the parties.

Nowadays there has been intensive work in progress on the project of so called “bringing IFRS and GAAP closer” in order to ensure international convergence. The

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convergence is bringing a lot of advantages as well as disadvantages. The advantage is
decrease of fundamental differences between IFRS and US GAAP. The disadvantages are
constant changes of the existing rules and procedures. To give the companies time to catch a
breath, the creators of IFRS (IASB) have decided to postpone the validity of all the new
standards to 2009. Although it is helpful, it also means that in 2009 there will be another wave
of changes.

One of the difficult areas is also the area of deferred tax which is set by the
International Accounting Standard IAS/IFRS 12 – Income Tax\(^2\), that is generally in
accounting applied for the income taxes, that means both for accounting of deferred tax and
for accounting of payable tax receivables and obligations. However, there is not much space
for its description in this article and therefore, this article will focus on one of the main
accounting tasks, which is revaluation of assets connected to the referred tax.

2. Revaluation of assets as of the balance day by real value

According to the Bill on accounting, the accounting unit must keep the books in such a
way that the accounting balance created on their basis gives a truthful and righteous picture of
the subject of accounting and of financial situation of the accounting unit. In this way,
individual assets are revaluated as of the balance day by real value, possibly there is a
recalculation of a choice of assets and obligations in a foreign currency with the exchange rate
of the Czech National Bank as of the balance day according to the article 24, par. 2, letter b/,
and article 27 of the Bill on accounting. The accounting regulations also set the impacts of
revaluation, that means whether the differences of revaluation will be booked into the income
or equity capital.

In comparison with the past, there is a change that valuation by real value may be done
by accounting units more often than just as of the balance day. It depends on the decision of
the accounting unit, on its plans in the area of securities, on users´ demands on accounting of
the individual accounting unit\(^3\).

It is necessary to realize, that if there is booking of revaluation differences into the
trading income, that are recognized by the accounting regulations, there is no difference
between the booking and tax values of the asset or obligation and therefore, no transitory

\(^2\) In literature there are two versions of translation of IAS 12 – Income Taxes. In Czech you may find this
standard either as “Daň ze zisku” or “Daň z příjmů”.

\(^3\) The way and frequency of real valuation is set in an internal direction of the company.
difference. However, if the revaluation difference is booked into the equity, there is a transitory difference between the booking and tax base of the asset or obligation. Depending on its character, it is a taxable or deductible difference, i.e. deferred tax obligation or claim, that will be—just as the revaluation difference—booked into the equity.

The transitory difference mainly happens with realizable (other) securities, i.e. in cases when the change of real value is booked into the equity, that means for the balance, by means of the account group 41 – *The basic capital and capital fund (account 414 – Valuation difference of revaluation of assets and obligations)*. This change of security value does not reflect in the tax base at the moment of revaluation, however, it will have an impact on the tax base in the future. Thus there is a change of the accounting value of the security without changing its tax base⁴. It is always necessary to consider the tax assessment of each operation and always to recognize which kind of security and share it is. Especially in the connection with sale of securities with the emphasis on the article 24 of the Bill on income taxes.

2.1 *The income method of valuation by real value*

The income method of valuation by real value applies to all securities set for trading, i.e. with the aim to reach profit from the securities in a short-time period (there was a change in 2004⁵ – see executive ordinance No. 500/2002, article 12, par. 3, in the current version).

The change of the real value is booked by the income accounting entry when—according to the difference found—the financial cost or revenue is booked and depending on this, the valuation of the given security increases or decreases on the analytical account of the financial asset.

**Securities for trading** are all securities given for trading by the accounting unit without considering at which market they are traded. In this way, the accounting unit should adjust the detailed register within accounting. With the effectiveness as of 1 January 2005⁶ the tax approach first returned prior to 2004 and *for the accounting purposes* there was left the accounting impact of revaluation for the real value. Although in the bill on income taxes, article 23, par. 4 i), there still remains a provision that a change of valuation of a share in a company or a cooperative by equivalence (countervalue), if it is booked according to a special

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4 When you revalue it for a higher amount, the accounting value of the asset will increase above its tax value, and there will be a taxable transitory difference leading to the deferred tax obligation. The company will report the tax impact of this revaluation and its subsequent modification in its own equity in the period when it arises.

5 By the end of 2003 in the accounting category of securities for trading, there were only securities traded in the public market (BCP, RM-S, foreign stock exchange; and they were booked in the account group 25 in individual accounts as “securities for trading”).

legal regulation\(^7\) as expense or revenue, is not included in the tax base. That is, valuation by equivalence (countervalue) is not considered as a real value for the purposes of this bill. The accounting regulations do not even allow report changes in valuation by equivalence in the income, but in the balance – *account group 41*. The amendment of the Bill on Income Taxes at the end of 2005 added a new paragraph into article 23. it expands the accounting effectiveness of valuation differences entered in the income\(^8\).

### 2.2 Revaluation of investments by equivalence as of the balance day

Investments\(^9\) kept on accounts *061 – Shares in Controlled and Operated Units* or *062 – Shares in accounting units with significant influence* are not valued by real value as of date of the financial statement.

What is a voluntary matter that completely depends on consideration of each accounting unit that owns these shares, is revaluation of investments as of date of financial statement by equivalence, or countervalue (24, par. 2b of the Bill on accounting, article 27 of the Bill on the accounting). This revaluation applies to the cost of acquisition of investment that is modified as of the day of the financial statement to the value corresponding to the level of investment of the accounting unit in the equity in the company, in which the accounting unit has the share.

If the accounting unit chooses the method of valuation of investments by equivalence, it is obliged to use it for all its investments. It is absolutely inadmissible to revalue by equivalence only some of all the kept securities and shares and not to revalue others, by

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\(^7\) Ordinance No. 500/2002 Coll., that accomplishes some provisions of the bill No. 563/1991 Coll., on accounting, in the version of later regulations, for accounting units that are businesses accounting in the double-entry bookkeeping.

\(^8\) *Article 23, par. 17 of the Bill on Income Taxes* (paragraph was added by the Ammendment of the Bill on Income Taxes at the end of 2005, that further expands the accounting effectiveness of valuation differences entered in the income).

For taxpayers who keep books, the trading income is not modified with the valuation difference from the change of real value according to a special legal regulation (Ordinance No. 500/2002 Coll., that accomplishes some provisions of the bill No. 563/1991 Coll., on accounting, in the version of later regulations, for accounting units that are businesses accounting in the double-entry bookkeeping):

- a) securities with the exception of bills of exchange,
- b) derivate and a part of asset and obligation secured by the derivate,
- c) obligation to return the security that the taxpayer has alienated and has not obtained it back by the moment of valuation,
- d) financial location and technical reserves at taxpayers who have licence to provide insurance or ensurance activities according to a special legal regulation (Bill No. 363/1999 Coll., on insurance and on a change of some related bills (Bill on insurance), in the version of later regulations).

whose revaluation the equity would decrease. The usage of the chosen method must also be kept between individual accounting periods.

From the point of the **income tax**, the valuation by equivalence is not considered as valuation by real value. There is no tax impact arising from the method of accounting of valuation by equivalence (balance). Valuation by equivalence is therefore done by the **balance**, by means of the account group **41 – Basic capital and capital funds** (**414 – Valuation difference from the revaluation of asset and obligation**).

Investments are usually kept for the purpose of long-term control and the target is not selling them but their long-term control, management and collecting dividends or shares in profits. Increases in the valuation are then mainly source for payment of dividends or shares in profit from subsidiary companies. When solving a problem connected to deferred tax, it is necessary to use the legislation for support:

- Bill 563/1991 Coll., on accounting in the version of later regulations,
- Ordinance No. 500/2002 Coll., in the version of later regulations,
- Czech Accounting Standard (ČÚS) 003 – Deferred tax,
- Czech Accounting Standard (ČÚS) 008 – Operations with securities and shares,
- Czech Accounting Standard (ČÚS) 020 – Consolidation,
- Commercial Code No. 513/1991 Coll., in the version of later regulations,
- Bill on income taxes No. 586/1992 Coll., in the version of later regulations.

Another significant source is interpretation **1 – 4. Deferred tax from transitory differences when valuating investments by method of equivalence**10, approved by the National Accounting Board. The Bill on accounting in article 27 allows us to value by equivalence (countervalue) a share that represents investment with a controlling or significant influence. According to the Czech Accounting Standard No. 008 – Operations with securities and shares, the relevant change of valuation is booked by capital (by means of balance accounts in the account group **41 – basic capital and capital funds** → article 51, par. 3 of the executive ordinance of the Bill on accounting).

In case of a consolidated financial statement the equivalence method is used for investments with a significant influence, and according to article 66 of the ordinance No. 500/2002 Coll. and to Czech Accounting Standard No. 020 – Consolidation, the appropriate

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10 www.nur.cz
increase corresponding to the accrual of the share in the equity of the consolidated accounting unit will be **reported by the income**.

The deferred tax would then relate to the income tax from dividends or share in profit collected by deduction. As this deduction tax is freed according to the effective Bill on income taxes in most cases, the deferred income tax will not be booked in those cases when the exemption of the dividend receiver may be assumed. However, it is necessary to consider each situation individually, and if it is obvious that the deduction tax is going to be paid, the deferred tax will be booked just as the revaluation by equivalence into the capital of the parent company.

When there is revaluation by equivalence as of the balance day when the original price of the financial asset is modified to a lower value, you may consider booking the deferred tax only in case that there was booked deferred tax obligation, up to the amount of this obligation. Provision of the Czech Accounting Standard No. 003 – Deferred tax, does not factually solve the procedure of booking the deferred tax because of revaluation of the financial assets by equivalence, which means that the accounting unit should proceed according to the Czech Accounting Standard No. 003 mentioned above, and to book by the income.

However, this is in case of unconsolidated financial statement in contradiction with generally recognized accounting principles set in the Bill on accounting. In such a case the deferred tax should be booked against the unrecovered loss of the past years, or against the equity. On the contrary, in case of consolidated financial statement, when the annual increase of the net assets is reported as a share in the trade income in equivalence by the income, the possible related deferred tax will be booked by the income, too.

The equivalence method is used in cases of controlling or significant influence (for consolidation only in cases of significant influence). Although it is not unambiguously stated in our accounting regulations as it is for example in relevant IAS/IFRS, yet from the diction of article 66a of the Commercial code it is possible to conclude that controlling or significant influence is always related to the intention of long-term hold and control (application of share in control for significant influence), not intention to sell relevant investments (securities and investments) in near future.

This intention is decisive for assessment of the possible tax obligation as well. If the intention is to control or to share the control and to keep the relevant investment for a long period of time, then incomes from dividends (shares in profit) from relevant accounting units may only be considered. So if the increases in valuation by equivalence are reported before, it is necessary to consider them as sources that will possibly show later in revenues from
dividends (shares in profit). Thus the deferred tax in this case concerns tax from dividends or shares, that means tax collected by deduction. According to the current Bill on income taxes, this tax is freed in case of subsidiary companies defined by this bill. If there is an investment valued by equivalence in such a company that is a subsidiary company from the point of income tax, the deferred tax will not be reported. This applies both for consolidated and unconsolidated financial statement. Its calculation (in the amount of 15 per cent of the deduction tax) and its reporting is possible only in those cases when the controlling or significant influence is used in the accounting unit that is not a subsidiary company according to the Bill on income taxes. The reason may be for example not keeping the time limit of 24 months for a subsidiary company, or an existence of controlling or significant influence also for a smaller share than the limit set by the Bill on income taxes for a subsidiary company, which is possible only in specific cases \(^\text{11}\).

According to the general accounting principles as well as to the content and purpose of the deferred tax, its booking and reporting should relevantly revise reached trading income and possible sources for distribution in relation to future tax obligations or claims connected to transactions already realized and other accounting operations of the accounting unit. If these transactions and operations have an impact on the trading income of a current period, it is necessary to report the correction by the income, too. However, if there are operations that have an impact on the income, which is here in the case of equivalence for the unconsolidated financial statements, then the relevant deferred tax should not be booked by income but capital.

According to the provisions of the Bill on accounting, when using accounting methods set by the executive legal regulations the accounting unit proceeds in such a way to give truthful and righteous reflection of accounting in the first place. In exceptional cases, the law allows to use accounting methods that deviate from the accounting methods set by the executive legal regulations. Therefore, in accordance with the principle of truthful and righteous reflection it is possible to report the deferred tax in cases stated above in relation to the accounting operation which caused the deferred tax, i.e. in the capital way. In case of consolidated financial statement, when the equivalence is used, the share in increase (or decrease) of the equity is reported in the form of share in the trading income by equivalence.

\(^\text{11}\) The reason is a definition of a parent and subsidiary company in article 19, par. 3 of the Bill on income taxes, that is conditioned by investment of over 10 per cent. At the same time the accounting procedures exclude stocks of a subsidiary company over 20 per cent of investment from the revaluation by real value. For the investment over 20 per cent it is not possible to apply the better article 24 par. 2r) of the Bill on income taxes, but a stricter article 24 par. 2W) of the Bill on income taxes. Related to the non-tax expense of holding of shares in a subsidiary company, the important part is article 25 par 1zk), article 24 par. 7 of the Bill on income taxes.
i.e. by the income. The possible deferred tax must be booked and reported by the income, too\textsuperscript{12}.

In conclusion, there is an overview of accounting the deferred tax when valuating the financial investments, short-time financial assets and derivate\textsuperscript{13}. There are also stated facts providing a general overview of accounting the deferred tax arising in relation to differences from the revaluation. The table is divided into individual groups of financial investments and there is also the procedure of accounting the deferred tax for each type of investment. Further, there is a column specifying the way of revaluation as of date of financial statement and way of accounting the revaluation difference, i.e. if it should be booked into the income and expense statement or against the accounts of the equity.

Table 1 Overview of accounting the deferred tax when revaluating the financial investments, short-time financial assets and derivate

<table>
<thead>
<tr>
<th>Group</th>
<th>Type</th>
<th>Accounting the revaluation</th>
<th>Revaluation Taxed</th>
<th>Limits of tax effectiveness</th>
<th>To book the deferred tax when revaluing:</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment with significant or controlling influence</td>
<td>Stock</td>
<td>Adjustment</td>
<td>income statement</td>
<td>No</td>
<td>1</td>
<td>NO</td>
</tr>
<tr>
<td></td>
<td>Share ltd. co.</td>
<td></td>
<td></td>
<td>No</td>
<td>1</td>
<td>NO</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>No</td>
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<td>N/a</td>
</tr>
<tr>
<td>Stock</td>
<td>Share ltd. co.</td>
<td>Equivalence</td>
<td>capital</td>
<td>No</td>
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<td>NO</td>
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<tr>
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<td></td>
<td></td>
<td></td>
<td>No</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>No</td>
<td>1</td>
<td>ANO</td>
</tr>
<tr>
<td>Stock – see realizable securities and securities for sale</td>
<td>Share ltd. co.</td>
<td>Adjustment</td>
<td>income statement</td>
<td>No</td>
<td>1</td>
<td>NO</td>
</tr>
<tr>
<td>Security held to maturity</td>
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</tr>
<tr>
<td></td>
<td>Bill of exch.</td>
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<tr>
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<td>Deposit certificate</td>
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<td>n/a</td>
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<tr>
<td>Security realizable for sale</td>
<td>Stock</td>
<td>Real value</td>
<td>Capital/ income statement</td>
<td>No</td>
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<td>YES</td>
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<tr>
<td></td>
<td>Bond</td>
<td></td>
<td></td>
<td>No</td>
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<td>YES</td>
</tr>
<tr>
<td></td>
<td>Bill of exch.</td>
<td></td>
<td></td>
<td>No</td>
<td>1</td>
<td>NO</td>
</tr>
<tr>
<td></td>
<td>Participation certificate</td>
<td></td>
<td></td>
<td>No</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td>Deposit certificate</td>
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<td>YES</td>
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<tr>
<td>Security for trading</td>
<td>Stock</td>
<td>Real value</td>
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<tr>
<td></td>
<td>Bond</td>
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<td>Yes</td>
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<td>Bill of exch.</td>
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<tr>
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<td>Participation</td>
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<td></td>
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</tr>
</tbody>
</table>

\textsuperscript{12} Source: Interpretation I - 4 – Deferred tax from the transitory differences when valuating investments by method of equivalence. www.nur.cz.

\textsuperscript{13} http://www.deloitte.com/dtt/cda/doc/content/Accounting_News_06_21_May_cze.pdf.
Notes to the Table:

Limits of the accounting effectiveness

1. Loss arising from sale may not be tax acknowledged (acc.to the Bill on income taxes, article 24, par. 2 w) and ze). The deferred tax does not arise.

2. The deferred tax may arise at the taxpayer whose main subject of activities is purchase, sale and recovery of receivables, if the conditions in article 24 par. 14 of the Bill on income taxes are met.

Notes

(i) “YES” for the question if the revaluation is taxed, is given in cases when booked revaluation is tax acknowledge and thus there is no transitory difference. In cases of adjustments “NO” is given, because accounting adjustments are not automatically tax acknowledged; of course, deferred tax arises only from the difference of accounting and tax adjustments, not from the whole amount of the adjustment.

(ii) „MAYBE“ includes cases when the formation of the deferred tax depends on the impact of the limiting conditions (see the Notes, point 2). It is necessary to assess this individually.

(iii) Revaluation „DOWN“ includes cases when revaluation of real value is booked (or value by equivalence) or an adjustment is booked.

Revaluation „UP“ includes cases when increase of real value is booked (or value by equivalence).

Notes

a In exceptional cases it is possible to argue that the company, on the basis of its influence, can enforce with a sufficient certainty that the revenue arising from the increase of the value will be realized by payment of the dividend. As of 1 May 2004 this rate, when other conditions are met, is 0 per cent.

In such a case, the deferred tax does not arise (or it arises in the zero value). Assess this following the principle of caution (as this procedure leads to not accounting the deferred tax obligation).

The referred tax is always booked (into the profit and loss statement or against the equity) identically with accounting the revaluation from which the deferred tax arises.

3. Conclusion

The deferred tax as an accounting category forms a very complicated and complex area of the financial statement and is still undergoing significant changes. A straight amendment of IAS 12\(^\text{14}\) has not been done yet, yet the approach to individual accounting transactions is interconnected with other standards, too. It is necessary to consider for

\(^{14}\) There have been two separate interpretations published to IAS 12 which are still valid, namely:

- SIC 21 Income Taxes - Recovery of Revalued Non-Depreciable Assets,
- and SIC 25 Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders.
example IFRS 2 – Share-based payment, and formation of tax payable and deferred tax in relation with payment that is performed in the way of stocks, or IFRS 3 – Corporate Combinations, that includes rules of reporting the deferred tax for corporate combinations, IAS 16 – Land, Plant and Equipment, IAS 39 – Financial Instruments: accounting and valuation.

The main aim of the standard is to provide rules, according to which the business subject must reflect the tax consequences in its financial statements:

- Future settlements of accounting value of the assets that are currently reported in the balance of the company,
- Future settlements of accounting value of obligations that are currently reported in the balance of the company,
- Transactions and other events of a current period that are reported in the financial statement of the company.

In the financial statement it is necessary to divide these facts into current tax consequences and deferred tax consequences. In practice, it is essential to compare the value of the asset or obligation in the balance, i.e. its accounting value, with the tax base.

The development in the area of financial accounting will be far away from being complete and this fact will need for subsequent reactions within the whole system (eg. by modification of the accounting procedure in the area of deferred tax at deviation from the basis of historical prices for long-term tangible assets) and therefore, this current amendment in the area of deferred tax has not reached its final version. With the obligation methods there are also some uncertainties and risks connected and thus, there are always new methods and procedures appearing trying to minimise these disadvantages.

At the moment the preparation of the transformation of IAS 12 – Income taxes has been in progress and a newly rewritten standard IFRS 12 should be finished in 2008. It should already include changes connected to the convergence project of IFRS and US GAAP. Within this process, the following areas have been mostly being discused: areas related to assets and obligations, whose tax base differs from the amount in which they were originally reported; acknowledgement of deferred tax arising from the primary acknowledgement of goodwill; allocation of tax between the trading income and capital, and internal transfer of assets.

15 For more information see www.iasb.org, www.efrag.org
References


[10] Zákon č. 593/1992 Sb., o rezervách pro zjištění základu daně z příjmů, ve znění pozdnějších předpisů

