HONG KONG SOCIETY OF ACCOUNTANTS

Financial Accounting Standards Committee

Urgent Issues & Interpretations Sub-Committee

Interpretation
20
Income Taxes - Recovery of Revalued Non-Depreciable Assets

Interpretations are authoritative guidance on the application of Statements of Standard Accounting Practice with which enterprises should comply if their financial statements purport to give a true and fair view. Unless indicated otherwise, Interpretations have the same status as the background material and implementation guidance contained in Statements of Standard Accounting Practice. Interpretations are not intended to apply to immaterial items.

Reference: SSAP 12 (revised) *Income Taxes*

ISSUE

1. Under SSAP 12 paragraph 51, the measurement of deferred tax liabilities and assets 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 those assets and liabilities that give rise to temporary differences.

2. SSAP 12 paragraph 20 notes that the revaluation of an asset does not always affect taxable profit (tax loss) in the period of the revaluation and that the tax base of the asset may not be adjusted as a result of the revaluation. If the future recovery of the carrying amount will be taxable, any difference between the carrying amount of the revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

3. The issue is how to interpret the term "recovery" in relation to an asset that is not depreciated (non-depreciable asset) and is revalued under paragraph 31 of SSAP 17.

4. This Interpretation also applies to investment properties which are carried at revalued amounts under SSAP 13.

CONCLUSIONS

5. The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset under SSAP 17 paragraph 31 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 that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

BASIS FOR CONCLUSIONS

6. The Framework indicates that an enterprise recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the enterprise. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistent with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. That is, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (that is, consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset.

7. The expected manner of recovery is not predicated on the basis of measuring the carrying amount of the asset. For example, if the carrying amount of a non-depreciable asset is measured at its value in use, the basis of measurement does not imply that the carrying amount of the asset is expected to be recovered though use, but through its residual value upon ultimate disposal.

DATE OF ISSUE: 30 July 2002

Effective Date: This Interpretation becomes effective for annual financial periods beginning on or after 1 January 2003. If an enterprise applies SSAP 12 (revised), Income Taxes, for periods beginning before 1 January 2003, it should also apply this interpretation and Interpretation 21, Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders, for the same periods and disclose that fact.

Appendix

The purpose of this appendix is illustrative only and does not form part of the Interpretation. The purpose of this appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

Example

A non-depreciable asset with a cost of 100 is revalued to 150. No equivalent adjustment is made for tax purposes. The enterprise holding that non-depreciable asset operates in a jurisdiction where there is no capital gains tax. The tax rate applicable to the taxable profits of the enterprise in the jurisdiction in which it operates is 15%.

Although a taxable temporary difference of 50, being the difference between the carrying amount of the asset of 150 and its tax base of 100, will arise, the enterprise recognises a deferred tax liability of nil because there is no tax on capital gains and therefore, should the property be disposed for consideration equal to or exceeding its carrying value, the tax rate applicable to the amount derived from the sale of the asset is nil.