

ACCOUNTING STANDARD – 22 ACCOUNTING FOR TAXES ON INCOME

"In this world nothing can be said to be certain, except death and taxes".

Let's Understand some important Income Tax Sections first along with their treatment in Books of Accounts: -

1) **Sec-32:** Depreciation deduction as per Tax law is different from Depreciation debit in P&L A/c

2) **Sec-35AD:** 100% deduction of specified capital expenditures in the same year:

Books	Income Tax
<ul style="list-style-type: none"> • Amortise/Depreciate in more than 1 year • Next years Amortised Expenses will be disallowed • Next year Taxable Income will be Increased 	100% Deduction in same year

3) **Sec-36:** Provision for bad debts debited in P&L is disallowed under Income Tax:

Income Tax will give us deduction only on actual Bad-debts incurred.

1st Year Provision for Bad-debts 15,000 debited in P&L, but there is no actual Bad-debts, then it is disallowed in Income Tax, Current Year Taxable Income is increased.

4) **Sec-37:** Personal Expenditure are always dis-allowed.

1st Year: - Personal Expenses of Director debited in Profit & Loss. But in Income Tax it is disallowed Permanently. Current Year taxable Income will be Higher.

5) **Sec-43B:** Deductions of some specified Expenses only on actual Cash Basis.

1st Year: - Bonus Payable is debited in P&L, then it will be Disallowed and Current Year Taxable Income will be Increased.

2nd Year: Bonus payable is actually Paid, Now Tax Law will give us deduction. Thus, Taxable Income will be reduced.

- 6) **Sec-35D:** - Preliminary Expenses incurred & fully debited in P&L, but as per Tax Law, 1/5th Deduction is allowed every Year.

	1 st	2 nd	3 rd	4 th	5 th
Income before Preliminary Expenses	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
Preliminary Expenses debited in P&L	(10,000)	-	-	-	-
Accounting Income (PBT)	90,000	1,00,000	1,00,000	1,00,000	1,00,000
TAX Law:					
Disallowed	10,000	-	-	-	-
Allowed 1/5	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Taxable Income	98,000	98,000	98,000	98,000	98,000
Timing Difference	8,000	(2,000)	(2,000)	(2,000)	(2,000)

- 7) **Sec-80G:** Donation to religious trust is never allowed as deduction under Income Tax (Disallowed Permanently).

1. DEFINITIONS

- Accounting income** is the Net Profit or Loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.
- Taxable income (tax loss)** is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.
- Current tax** is the amount of Income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.
- Deferred tax** is the tax effect of timing differences.
- Timing differences** are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.
- Permanent differences** are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Permanent differences do not result in deferred tax assets or deferred tax liabilities.
- Tax Expense (Tax Saving)** is the aggregate of Current tax and Deferred tax charged or credited to the statement of profit and loss for the period.

$$\text{Tax Expense} = \text{Current Tax Expense} + \text{Deferred Tax Expense} - \text{DT Income}$$

Examples of Timing Differences	Examples of Permanent Differences
<ul style="list-style-type: none"> • Depreciation as per Companies Act different from Depreciation as per Income Tax (Sec 32 of IT Act) - Resulting DTA or DTL • Sec 43B of Income Tax Act (Deductions available on cash basis not on provision basis - Bonus, Interest, PF etc) - resulting DTA • Preliminary Expenses deduction allowed in 5 years as per Income Tax, but as per AS 26 fully written off - resulting DTA • Scientific Research Expenses or Specified Expenses allowed 100% in the same year however in the Books only part is written off. • Provision for Doubtful debts disallowed under IT Act until actual bad debts occur. 	<ul style="list-style-type: none"> • Personal Expenses disallowed always, never allowed in the Future. • Donations to unspecified trust - Disallowed always.

2. UNABSORBED DEPRECIATION AND CARRY FORWARD OF LOSSES

- (a) Unabsorbed depreciation and
- (b) Carry forward of Losses

which can be set off against future taxable income are also considered as timing difference and result in deferred tax assets, subject to consideration of prudence.

3. PRUDENCE LIMITS: VIRTUAL CERTAINTY

- 1) Deferred tax should be recognized for all timing differences, **subject to the consideration of prudence** in respect of deferred tax assets.
- 2) Prudence concept is already being followed while creating DTL, but while recognizing DTA, income is recognized in the Profit and Loss.

- 3) While creating DTA on deductible timing differences, certainty of future Taxable Income should be checked that insures sufficient future Taxable Income so that deductions could be claimed.
- 4) **Para 15 of AS 22:** - DTA on All Timing Differences except "Unabsorbed Depreciation & C/F Business Loss".
Recognise DTA Subject to Reasonable Certainty of Sufficient Future Taxable Profits Against which deductions will be allowed.
- 5) **Para 17 of AS 22:** - "DTA on Unabsorbed Depreciation & Business Loss carried forward"
Create DTA Subject to "Virtual Certainty supported by Convincing Evidence" that in future there would be Sufficient Future Taxable Profit against which Deductions of unabsorbed Depreciation and Business Losses will be allowed.
- 6) Most of times, DTAs are created considering **reasonable certainty** but there are some items on which DTA can be created by checking "Virtual certainty supported by convincing evidence (VCCE)"

Certainty of Future Taxable Income	
Reasonable	Virtual
Based on Past Experience	Near to or more than 90% probability of Earning Income
It is more likely that future taxable income will be available i.e. more than 50% Probability	Surety of sufficient future taxable Income For this level of surety convincing evidence should be available. Then only DTA to be created
Deductible Timing difference for which Reasonable Certainty is to be checked are: 1) Depreciation 2) Provision for Bad Debts 3) Sec 43B (Disallowed item)	Deductible Timing difference for which VCCE is to be checked are: C/f Business Losses, and Unabsorbed Depreciation

4. RE-ASSESSMENT OF "UNRECOGNISED DEFERRED TAX ASSETS"

At each balance sheet date, an enterprise re-assesses un-recognised deferred tax assets. (it can be treated as Change in **Accounting Estimates**)

5. MEASUREMENT

- 1) **Current tax** should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.
- 2) **Deferred tax** assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

6. DISCOUNTING

Deferred tax assets and liabilities should not be discounted to their present value.

7. REVIEW OF DEFERRED TAX ASSETS

The carrying amount of deferred tax assets should be reviewed at each balance sheet date.

8. PRESENTATION AND DISCLOSURE

An enterprise should offset assets and liabilities representing tax if the enterprise:

- (a) Has a legally enforceable right; and
- (b) Intends to settle the asset and the liability on a net basis.

9. APPLICATION OF MAT

- (a) Minimum Alternate Tax is different from Current Tax. MAT is calculated on Book Profit which is derived with the help of Section 115JB of Income Tax. Book Profit is different from Taxable Income.
- (b) While calculating Current Tax and Deferred Tax, we shall always use Regular Tax Rate and not the MAT Rate.
- (c) While calculating timing differences, we shall compare Accounting Income and Taxable Income (not the Book Profit)
- (d) MAT is Payable only when it is more than Current Tax. Although, the excess payment is allowed as Credit in Future Years if in Future Current Tax would be higher.

- (e) If MAT is higher than Regular Tax, then Current Tax will be Equal to Regular Tax. In that case the Excess of MAT amount over Current Tax amount shall be recognized separately in the Profit and Loss account as an additional Tax Expense.
- (f) Hence Items to be debited in Profit and Loss Statements are:
- (i) Current Tax calculated on Taxable Income at Regular Tax Rate.
 - (ii) Deferred Tax calculated on Timing Difference at Regular Tax Rate.
 - (iii) Excess of MAT over Current Tax.

10. TAX HOLIDAY

- (a) The deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised.
- (b) Deferred tax in respect of timing differences which reverse after the tax holiday period is recognised in the year in which the timing differences originate. However, recognition of deferred tax assets is subject to the consideration of prudence as laid down in paragraphs 15 to 18.
- (c) For the above purposes, the timing differences which originate first are considered to reverse first. (FIFO)

Important Examples to understand the Entire Tax Accounting

Example 1

Assume Income before Provision for Bad-Debts for 23-24 & 24-25 is 10,00,000 p.a.

In FY 23-24 Provision for Bad-Debts created of ₹ 70,000 & Debited to P&L but disallowed in Income Tax.

In FY 24-25 actual Bad-Debts occur for ₹ 70,000 & allowed in Income Tax.

Show Tax Accounting & P&L Extract for both years. Tax Rate 30%.

Solution:

1) Accounting for Provision and Actual Bad-Debts:

FY 23-24			
Profit & Loss A/c	Dr.	70,000	
To Provision for Bad-Debts A/c			70,000
FY 24-25			

Bad Debts A/c	Dr.	70,000	
To Debtors A/c			70,000
Provision for Bad-Debts A/c	Dr.	70,000	
To Bad-Debts A/c			70,000

2) Calculation of Accounting Income (PBT):

	23-24	24-25
Income Before Provision	10,00,000	10,00,000
(-) Provision for Bad Debts	(70,000)	-
A/c Income (PBT)	9,30,000	10,00,000

3) Calculation of Taxable income & CT thereon:

	23-24	24-25
PBT (A/c Income)	9,30,000	10,00,000
(+) Disallowed Provision	70,000	-
(-) Bad-Debts Allowed	-	(70,000)
Taxable Income	10,00,000	9,30,000
Current Tax @30%	3,00,000*	2,79,000**

FINANCIAL YEAR 23-24			
* (1) CT Expense A/c	Dr.	3,00,000	
To CT Payable A/c			3,00,000
(2) Profit & Loss A/c	Dr.	3,00,000	
To CT Expense A/c			3,00,000
FINANCIAL YEAR 24-25			
** (1) CT Expense A/c	Dr.	2,79,000	
To CT Payable A/c			2,79,000
(2) Profit & Loss A/c	Dr.	2,79,000	
To CT Expense A/c			2,79,000

4) Statement of P&L (Extract)

	23-24	24-25
Profit Before Tax (Accounting Income)	9,30,000	10,00,000
(-) Tax Expense	2,79,000	3,00,000
	23-24	24-25
CT Expense	3,00,000	2,79,000
(-) DTA (21,000)	-	
(+) DTA Reserve	-	21,000

5) Calculation of Tax Difference & DT

	23-24	24-25
Tax Difference Arise	70,000 (DTA)	-
Tax Difference Reversed	-	70,000 (DTA Reversal)
DT Created @30%	21,000 (DTA)	21,000 (DTA Reversal)
	DTA Dr. To P&L	P&L Dr. To DTA

Example 2

Following information is of X Ltd.

Sale	20,00,000
Cost of goods sold	11,00,000
Income from other sources (Bank Interest)	1,00,000
Salary	1,00,000
Provision for Legal Damages	40,000
Interest to Bank (Not yet paid)	30,000
Service Tax (Not yet Paid)	50,000

X Ltd purchased during the year one Machine for Scientific Research for Rs. 120000 whose life is 3 years and is 100% tax deductible during the year

X Ltd also made contribution for Scientific Research activity of Rs. 10000 on which 100% deduction is allowed in the same year. Effective Rate of Tax 32.33%.

Prepare Profit and Loss Account.

Solve Here:

Calculation of Deferred Tax

S.No.	Particulars	Timing Difference	Nature	DT Amount
1	Provision for Legal Damages	40,000	DTA	12,932
2	Interest Payable	30,000	DTA	9,699
3	Service Tax Payable	50,000	DTA	16,165
4	Capital Expenditure on Scientific Research	80,000	DTL	25,864
	Net DTA			12,932
	DTA A/c Dr. To P&L A/c			

11. TAX EXPENSE CALCULATION

Calculation of Tax Expense:

Current Tax Expense	XXX	Current Tax Liability on the Credit Side
(+) Excess of MAT over CT	XXX	Current Tax Liability on the Credit Side
(+) Deferred Tax Expense	XXX	DTL to be created
(-) Deferred Tax Income	(XXX)	DTA to be created
(+) Deferred Tax Expense	XXX	DTA Reversal
(-) Deferred Tax Income	(XXX)	DTL Reversal
Tax Expense to be Charged to P&L	XXX	

12. (MCQ's from ICAI Material)

1. As per AS 22 on 'Accounting for Taxes on Income', tax expense is:
 - (a) Current tax + deferred tax charged to profit and loss account
 - (b) Current tax-deferred tax credited to profit and loss account
 - (c) Either (a) or (b)
 - (d) Deferred tax charged to profit and loss account

2. G Ltd. has provided the following information: Depreciation as per accounting records = ₹ 2,00,000 Depreciation as per tax records = ₹ 5,00,000
There is adequate evidence of future profit sufficiency.
How much deferred tax asset/liability should be recognized as transition adjustment when the tax rate is 50%?
 - (a) Deferred Tax asset = ₹ 2,70,000.
 - (b) Deferred Tax asset = ₹ 1,35,000.
 - (c) Deferred Tax Liability = ₹ 2,70,000
 - (d) Deferred Tax Liability = ₹ 1,50,000

3. State which of the following statements are correct:
 - (1) There are no pre-conditions required to recognize deferred tax liability,
 - (2) Deferred tax asset under all circumstances can only be created if and only if there is reasonable certainty that future taxable income will arise.
 - (a) Both are correct.
 - (b) Only (1) is correct.
 - (c) Only (2) is correct.
 - (d) None of the statements are correct.

4. Which of the following statement are incorrect:
 - (a) Only timing differences result in creation of deferred tax.
 - (b) Permanent differences do not result in recognition of deferred tax.
 - (c) The tax rate used for measurement of deferred tax is substantively enacted tax rate.
 - (d) The entity has to recognize deferred tax liability/asset arising out of timing difference.
There are no conditions which are required to evaluated for their recognition.

ANSWERS	1	2	3	4
	c	d	a	d