The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Draft Guidance on Accounting for Minimum Taxes and Final Taxes

Comments to be provided by December 8, 2023

Accounting Standards Board

November 2023

Table of Content

A Brief facts of the Matter

A1 This guidance is made in the context of provisions of Income Tax Ordinance, 2001 applicable to companies and word 'entity' or 'entities' used in this guidance is for 'company / companies'.

Broadly, Minimum tax is applicable / charged to entities under Income Tax Ordinance, 2001 (ITO, 2001) in following scenarios:

- Minimum tax under section 113 of ITO, 2001.
- Minimum tax under other sections of ITO, 2001.

Whereas final tax (designated as such under various provisions of ITO, 2001) is charged / withheld / paid on certain income streams for certain tax payers under various provisions of ITO, 2001. Final tax is charged / computed, under ITO, 2001, without reference to income chargeable to tax at general rate of tax, and final tax computed, for a tax year, is construed as final tax liability for related income stream under ITO, 2001. Under ITO, 2001, for income streams involving final tax, it is not allowed to carry forward tax losses. Final tax paid is considered to be full and final discharge of tax liability of an entity for a tax year for related income stream.

A2 Minimum tax under section 113 of ITO, 2001

Minimum tax under section 113 of ITO 2001 is computed / charged on amount of turnover (as defined in section 113), where due to reasons stated in section 113:

(a) no tax is payable or paid by the person on income taxable at general rate of taxation for a tax year; or

(b) tax payable or paid by the person for a tax year (on taxable income subject to general rate of taxation) is less than minimum tax under section 113 of the ITO, 2001.

In case (b), under current provisions of section 113 of ITO, 2001, amount representing excess of minimum tax paid under section 113 over income tax determined on income streams taxable at general rate of taxation, is recoupable / adjustable against tax liability (relating to income streams of the entity taxable at general rate of taxation) arising in subsequent three tax years.

A3 <u>Minimum tax under other sections (other than section 113) of ITO, 2001</u>

There are certain provisions in the ITO, 2001, under which taxes withheld / computed / collected from receipts or other amounts (as defined in respective sections of ITO, 2001) against certain income streams by certain tax payers, is considered as *'minimum tax'* (designated as such in provisions contained in respective sections of ITO, 2001) for a tax year in case if the tax withheld/collected / computed is more than the amount of income tax determined (using general rate of tax) on taxable income related to such income streams for that tax year. In these cases, under the provisions of ITO, 2001, the excess of minimum tax withheld / collected / paid or computed over tax liability computed on (related income tax streams taxable at general rate of tax), is not adjustable against tax liability of subsequent tax years.

In this category of minimum tax, it is required to compute taxable income and tax liability using general rate of tax and in case, if tax liability computed on income using general rate of tax is higher than minimum tax collected / deducted / computed etc. then, entity is required to pay such excess amount to the tax authorities. Further, under provisions of relevant sections of ITO, 2001, for income streams chargeable to minimum tax in such situations, it is allowed to carry forward tax losses. These requirements make these minimum taxes different from final taxes computed under various other provisions of ITO, 2001.

A4 The purpose of this document is to provide guidance on accounting of minimum tax (for two cases i.e. (i) under section 113, (ii) under other than section 113 as explained above), and final taxes (termed and charged as 'final tax' under various provisions of ITO, 2001), under the requirements of relevant IFRS Accounting Standards and provide appropriate approaches to account for minimum taxes and final taxes in compliance with the requirements of IFRS Accounting Standards.

B Accounting Analysis of Minimum and Final Taxes

B1 The minimum taxes and final taxes are charged under ITO 2001 and computed based on turnover or other basis (as defined in relevant sections of ITO, 2001). Under the current practice in Pakistan, minimum taxes and final taxes are accounted for and presented as income taxes within the scope of IAS 12.

Paragraph 2 of IAS 12 explains income taxes as follows:

"For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. ………"

The term taxable profit/tax loss has been defined in IAS 12 as:

"Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)."

Paragraph 4 of the Basis for Conclusion of IFRIC 21 'Levies' explains that levies whose calculation use data such as the gross amount of revenue, assets or liabilities do not meet the definition of income taxes provided in IAS 12. The relevant part of paragraph BC 4 of IFRIC 21 is reproduced below:

"One of the questions that was submitted was how to account for levies whose calculation basis uses data such as the gross amount of revenue, assets or liabilities. The Interpretations Committee noted that those levies do not meet the definition of income taxes provided in IAS 12 Income Taxes because they are not based on taxable profit. In two Agenda Decisions (published in March 2006 and May 2009), the Interpretations Committee (then called the IFRIC) noted that the term 'taxable profit' implies a notion of a net rather than a gross amount. In those Agenda Decisions, the Interpretations Committee also observed that any taxes that are not within the scope of other Standards (such as IAS 12) are within the scope of IAS 37…"

B2 As the minimum taxes and final taxes (as explained in 'brief facts of the matter' paragraphs A1, A2 & A3) are not calculated on the 'taxable profit' as defined in IAS 12 but calculated on turnover or other basis (as per relevant sections of ITO, 2001), it can be argued that minimum taxes and final taxes should be accounted for under IAS 37/IFRIC 21 as levies [though these are charged under tax law] and not under IAS 12 as income taxes. This is based on wordings of BC 4 of IFRIC 21 as stated above, which confirms that taxes whose calculation is based on gross amounts of revenue are outside the scope of IAS 12.

B3 However, as for computation of minimum tax chargeable under various sections of ITO, 2001, provisions of such sections require its comparison with amount of tax attributable to income streams taxable at general rate of taxation, it is viewed that such minimum taxes are not fully outside the scope of IAS 12 and a certain portion of them falls in scope of IAS 12. Based on this, the minimum taxes under ITO 2001 (as explained in 'brief facts' paragraphs A2 & A3) are hybrid taxes which comprise of a component within the scope of IAS 12 (Income Tax) and a component within the scope of IFRIC 21 (Levies).

Based on Para BC 4 of IFRIC 21 and agenda decisions published by IFRIC in March 2006 & May 2009, minimum tax (as explained in 'brief facts of the matter' paragraphs A2 & A3) comprise of a component within the scope of IAS 12 (Income Tax) and a component within the scope of IFRIC 21 (Levies). Hence, minimum taxes (as 'explained in brief facts of the matter' paragraph) being hybrid taxes should be bifurcated into:

- a component representing income tax within the scope of IAS 12; and
- a component representing levy within the scope of IFRIC 21/IAS 37.

As regards final taxes (explained in 'brief facts of the matter' paragraph A1), as their computation (in relation to certain income streams as per provisions of ITO, 2001) is based on revenue or other basis other than taxable income, therefore, final taxes fall under levy within the scope of IFRIC 21/IAS 37.

C Accounting of Minimum Taxes levied under Section 113 or Other Sections of ITO, 2001

C1 Current tax considerations for minimum tax scenarios

For bifurcation of minimum taxes into above two components, following two approaches can be adopted:

(a) Designate the amount calculated on gross amount of revenue or other basis (such as receipts or other values etc. as provided in law) as a levy within the scope of IFRIC 21/IAS 37 and recognise it as an operating expense. Any excess over the amount designated as a levy is then recognised as current income tax expense falling under the scope of IAS 12.

(b) Designate the amount calculated on taxable income using the notified tax rate as an income tax within the scope of IAS 12 'Income Taxes' and recognise it as current tax expense. Any excess over the amount designated as income tax, is then recognised as a levy falling under the scope of IFRIC 21/IAS 37.

It would be an accounting policy choice for an entity to apply / use either approach (a) or (b). Any approach once adopted should be applied consistently.

C2 Deferred tax considerations for minimum tax scenarios

Calculation of deferred tax under each of the above approaches would be different as follows:

- Under approach (a), the deferred tax would be measured using the average effective rate of tax rather than the enacted/notified tax rate. The effective income tax rate varies, requiring the entity to reassess its estimate for measuring deferred taxes in the future even when the enacted rate of income tax is unchanged.

- Under approach (b) i.e. when the excess is treated as a 'levy', the effective rate of income tax is equal to the enacted rate of income tax.

C3 Current and deferred tax implications for entities where minimum tax is paid under section 113 or other sections of the Income Tax Ordinance, 2001

C3.1 Where entity, based on its business model and future financial projections, is subject to minimum tax paid under section 113 of the ITO, 2001

<u>If approach (a) is used by an entity</u>

This approach may be suitable for and used by an entity which generally have zero tax attributable to income stream (chargeable to tax at general rate of taxation) or entities that may be in losses or will always remain under minimum tax due to its business model. However, entities should exercise their own judgement in choosing suitable approach according to their facts and circumstances.

Minimum tax paid shall be recognized as 'levy' in the profit and loss account.

There shall be no current income tax (in terms of IAS 12) in such a case. As regards deferred tax, entities should determine whether there is need to record deferred tax as per requirements of IAS 12. In this case, temporary differences shall arise but there shall be no deferred tax if entity is expected to be in non-tax/levy regime for foreseeable future as, in such a case, effective tax rate would be zero.

<u>If approach (b) is used by an entity</u>

This approach may be suitable for and used by entities which expect to have certain amount of tax attributable to income stream (chargeable to tax at general rate of taxation). However, entities should exercise their own judgement in choosing suitable approach according to their facts and circumstances.

In this case, amount paid to the extent of income tax liability (determined on taxable income using general rate of taxation) shall be recognized as 'current income tax' in the profit and loss account. This shall represent tax paid by the entity on net taxable income of the entity based on general enacted rate of taxation.

Any excess over the amount designated as income tax, is then recognized in profit and loss account as a levy falling under the scope of IFRIC 21/IAS 37 unless it is expected to be adjusted / realized in future against tax liability of subsequent tax years as allowed under section 113 of the ITO, 2001.

In case entity determines, based on expected future taxable profits, that excess paid under section 113 by the entity over and above its tax liability (on income stream(s) taxable at general rate of taxation) is expected to be realized in subsequent tax years, then, such excess shall be recorded as deferred tax asset adjustable against tax liability for subsequent tax years. This is shall be recognized as 'deferred tax asset' for the reason that it represents unused tax credit as it can be adjusted only against tax liability (of subsequent tax years) arising on taxable income subject to general rate of taxation. Such an asset shall be subject to requirements contained in IAS 12 'Income Tax'.

In case entity determines in the year of payment and / or at the relevant reporting date, based on expected future taxable profits, that realization of such excess amount in subsequent tax years is not certain, such excess amount shall not be recognized as an asset but shall be charged off to profit and loss account as 'Minimum tax levy'.

Deferred asset or part thereof remaining un-utilized (after period allowed under prevailing tax laws) shall expire and be charged off to profit and loss account.

In accordance with the requirements of paragraph 47 of IAS 12, in respective years, deferred tax shall continue to be determined and recorded by entity (in respect of income streams taxable at general rate of taxation under ITO, 2001) on temporary differences associated with related income streams of the entity, at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

C3.2 Where entity, based on its business model and future financial projections, is subject to minimum tax paid under other sections (other than section 113) of the ITO, 2001 i.e. minimum tax paid (in excess of tax liability determined at general rate of taxation) is not recoupable against tax liability of subsequent tax years

<u>If approach (a) is used by an entity</u>

This approach may be suitable for and used by an entity which generally have zero tax attributable to income stream (chargeable to tax at general rate of taxation) or entities that may be in losses or will always remain under minimum tax due to their business model. However, entities should exercise their own judgement in choosing suitable approach according to their facts and circumstances.

In this case, minimum tax paid shall be recognized as 'levy' in the profit and loss account.

There shall be no current income tax (in terms of IAS 12) in this case. As regards deferred tax, entities will determine whether there is need to record deferred tax as per requirements of IAS 12. In this case, temporary differences may arise but there shall be no deferred tax if entity is expected to be in non-tax/levy regime for foreseeable future as, in such a case, the effective tax rate would be zero.

<u>If approach (b) is used by an entity</u>

This approach may be suitable for and used by an entity which expect to have certain amount of tax liability for tax year attributable to income stream (chargeable to tax at general rate of taxation). However, entities should exercise their own judgement in choosing suitable approach according to their facts and circumstances.

In this case, amount paid to the extent of income tax liability (determined on taxable income chargeable to tax at general rate of taxation) shall be recognized as 'current income tax' in the profit and loss account. Any excess over the amount designated as an income tax, is then recognized in profit and loss account as a levy falling under the scope of IFRIC 21/IAS 37.

In this case, any excess over the amount designated as income tax, shall remain / be classified as a levy falling under the scope of IFRIC 21/IAS 37 as such excess amount, under the provisions of ITO, 2001, is not allowed to be carried forward and utilized against tax liability of subsequent tax years.

In accordance with the requirements of paragraph 47 of IAS 12, in respective years, deferred tax shall continue to be determined and recorded by entity (in respect of income streams taxable at general rate of taxation under ITO, 2001) on temporary differences associated with related income streams of the entity, at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

C3.3 Transition from current recognition /classification of taxes paid by entities as minimum tax paid under section 113 or other sections of the Income Tax Ordinance, 2001 to approach for recognition of hybrid taxes under this guidance

Entities applying this guidance shall follow the requirements of *IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'* in respect of any restatements that arise as a result of application of this guidance.

Entities will apply requirements of this guidance note retrospectively (if consequential impacts are material) which will result in the following:

a) On adoption of approach (a) or (b), any previously recorded deferred tax would require re-assessment, and any necessary adjustments, if required, would be made through retained earnings;

b) Reclassification of amounts [representing excess of taxes paid and charged to profit and loss account over income tax subject to and determined using general enacted rate of taxation under ITO, 2001] previously classified as 'current income tax' in the profit and loss account to 'minimum tax levy'.

c) Reclassification of advance paid (if any) in respect of taxes paid under sections of ITO, 2001 (other than section 113) classified as 'income tax' asset and which ultimately fall under levy as explained above, from 'Income tax asset' to 'Prepaid asset'.

D Accounting of Final Taxes levied under Income Tax Ordinance, 2001

D1 Current and deferred tax considerations for final tax scenarios

As computation of final taxes (so designated under provisions of ITO, 2001 and explained in 'brief facts of the matter' paragraph A1) is not based on taxable income, therefore, final taxes fall under levy within the scope of IFRIC 21/IAS 37.

Hence, Final tax paid should be classified as levy and not income tax in the profit and loss account.

There will not arise any current and deferred income tax which need to be presented as such in the profit and loss account.

D2 Transition from current recognition /classification of Final taxes paid by entities under various sections of the Income Tax Ordinance, 2001 to approach for recognition of Final taxes under this guidance

Entities applying this guidance shall follow the requirements of *IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'* in respect of any restatements that arise as a result of application of this guidance.

Entities will apply requirements of this guidance note retrospectively (if consequential impacts are material) which will result in reclassification of Final taxes currently classified as 'Income Taxes' in the profit and loss account appearing below Profit before tax, to 'Final taxes (categorized as levy as per IFRIC 21/IAS 37) which shall be presented before 'Profit before income tax' as demonstrated in 'Example 2' on page 10.

Example 1 - Relevant portion of Profit and Loss Account, showing presentation of bifurcated portions of Minimum Taxes as per this Guidance

An extract of a sample Profit and loss account demonstrating presentation of bifurcated portions of minimum taxes (as per this guidance) on the face of the Profit and loss account is given below:

	20X1	20X2
P & L Presentation		
Profit before income tax and minimum tax differential	XXXX	XXXX
Minimum tax differential (levy)*	(XXX)	(XXX)
Profit before income tax	XXXX	XXXX
Income Tax		
current	XXX	XXX
deferred	XXX	XXX
	XXX	XXX
Profit after income tax	XXXX	XXXX

*this represents portion of minimum tax categorized as levy as per IFRIC 21/IAS 37.

Example 2 - Relevant portion of Profit and Loss Account, showing presentation of Final Taxes as per this Guidance

An extract of sample Profit and loss account demonstrating presentation of final taxes (as per this guidance) on the face of the Profit and loss account is given below:

	20X1	20X2
P & L Presentation		
Profit before income tax and final taxes	XXXX	XXXX
Final taxes (levy)*	(XXX)	(XXX)
Profit before income tax	XXXX	XXXX
Income Tax		
current	XXX	XXX
deferred	XXX	XXX
	XXX	XXX
Profit after income tax	XXXX	XXXX

*this represents final taxes paid under ITO, 2001 categorized as levy as per IFRIC 21/IAS 37.