Guidance on the deferred tax implications of tax incentives in the manufacturing sector

Background

The DTI together with the Industrial Development Corporation and the South African Revenue Services have launched several new incentives to promote investment and employment in the manufacturing sector.

The Department of Trade and Industry (DTI) together with the Industrial Development Corporation and the South African Revenue Services have launched several new incentives to promote investment and employment in the manufacturing sector. The incentives fall under the banner of the Manufacturing Incentives Competitive Enhancement Programme (MCEP). The MCEP consists of various production incentives and two different industrial financing loan facilities, each with its own rules, qualifying criteria and maximum incentive values and are categorised as follows:

- Production Incentives offered by the DTI:
  - Capital Investment;
  - Green Technology and Resource Efficiency Improvement;
  - Enterprise Level Competitiveness Improvement;
  - Feasibility Studies; and
  - Cluster Competitiveness Improvement.
- Industrial Financing Loan Facilities offered by the Industrial Development Corporation:
  - Pre- and Post-dispatch Working Capital Facility; and
  - Industrial Policy Niche Projects Fund.

This guide has been drafted to assist preparers and auditors with the accounting implications for the recognition and measurement of these incentives. It is noted that the incentives have been formulated in several different ways and the regulation and incentive structures are constantly evolving.

Please supplement your judgements with advice from the appropriate experts where necessary.

The accounting implications of these incentives may be complex as:

- These incentives may be referred as investment tax credits. Investment tax credits are outside the scope of IAS 12 *Income Tax* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. This guide considers whether certain incentives are investment tax credits; and

- The incentive may be received as a cash grant from the DTI. The grant may be followed by an adjustment to tax deductions under the Income Tax Act. Therefore, the incentive can incorporate accounting consequences under both IAS 12 and IAS 20.

Example 1

Manufacturing Entity A enters into a capital expansion project that qualifies for an additional tax deduction in terms of the Income Tax Act. Entity A is able to claim an additional tax deduction based on 55% of the cost of new manufacturing assets in the year the assets are brought into use. In addition, Entity A will also claim normal tax deductions based on the cost of the manufacturing assets over four years, at a rate of 40% in the year the assets are brought into use and 20% in the three subsequent years. A total of R80 million was spent on the capital expansion and the assets are brought into use at the beginning of 2012. The manufacturing assets have a useful life of four years and a nominal residual value. The corporate tax rate is 28%.

Question 1:
Is the additional tax deduction an investment tax credit?

No. The tax deduction is factored into the determination of taxable income. Therefore, the accounting implications of the additional tax deduction are recognised in accordance with IAS 12.

IAS 12 guidance on investment tax credits

IAS 12:4 states that the Standard does not deal with methods of accounting for government grants or 'investment tax credits'. IAS 12 does not provide a definition for 'investment tax credits', which is a term used in many tax jurisdictions to describe a wide range of tax arrangements. Accordingly, in practice, the first step in accounting for an 'investment tax credit' is to determine whether it is within the scope of IAS 12. Even if a tax benefit is referred to by a tax authority as an investment tax credit, it is important to consider the substance to determine whether the tax benefit is outside the scope of IAS 12. A tax credit (outside the scope of IAS 12) provides a reduction to taxes payable and can be distinguished from a tax deduction (within the scope of IAS 12) which is factored into the determination of taxable income.
Source: iGAAP 2012 A13 2.3

Question 2:
Should deferred tax be recognised in the difference between the carrying amount and tax base of the asset on initial recognition?

No. Deferred tax is not recognised where there is a difference on initial recognition between the carrying amount of the asset and the amount that will be deductible for tax purposes for the asset. This applies provided the transaction is not a business combination and impacts neither accounting nor taxable profit on initial recognition.

In this example, the carrying amount will be R80 million. Accounting profit will only be affected when the asset is brought into use and depreciation commences. R124 million (R80*155%) will be deductible for tax purposes. The transaction does not impact taxable profit on initial recognition as the deductions only commence when the assets are brought into use in terms of the Income Tax Act.

Therefore, the temporary difference that arises from the additional tax deduction triggers the inital recognition exemption and will not give rise to deferred tax. This will result in a low effective interest rate when the assets are brought into use.

The table below illustrates the accounting implications of the tax deductions claimed in each financial year and the impact of the additional tax deduction on the effective tax rate.

	Initial recognition	2012	2013	2014	2015
Depreciation		20 000	20 000	20 000	20 000
Tax deductions		76 000	16 000	16 000	16 000
Carrying value [A]	80 000	60 000	40 000	20 000	-
Tax base [B]	124 000	48 000	32 000	16 000	-
Temporary difference [A-B]	(44 000)	12 000	8 000	4 000	
Initial recognition exemption [A X 55%]	44 000	-	-	-	-
Temporary difference adjusted by initial recognition exemption	-	12 000	8 000	4 000	-
Deferred tax liability @ 28%	-	3 360	2 240	1 120	-
Income statement					
Net profit before depreciation (no temporary differences)		100 000	105 000	110 000	115 000
Depreciation		20 000	20 000	20 000	20 000
Net profit before tax		80 000	85 000	90 000	95 000
Current tax @ 28%		6 720	24 920	26 320	27 720
Deferred tax		3 360	(1 120)	(1 120)	(1 120)
Effective tax rate		12.6%	28.0%	28.0%	28.0%
Balance sheet					
Property, plant and equipment	80 000	60 000	40 000	20 000	-
Deferred tax liability	-	(3 360)	(2 240)	(1 120)	-

The grant has two aspects; an initial cash injection from the fiscus and a reduction in the tax deductions.

Example 2

Manufacturing Entity B is planning to upgrade its major manufacturing facility, which has resulted in a 30% increase in production capacity. The total cost of upgrading the facility is R30 million, all of which was incurred in 2011. The assets are brought into use at the beginning of the 2012 financial year and have a useful life of four years and a nominal residual value. The corporate tax rate is 28%.

Entity B is awarded a grant from the DTI of 10% of the cost of the investment. The grant was received on completion of the project and is exempt for tax purposes. The entity is required to satisfy qualifying conditions throughout the life of the asset. The tax deduction which Entity B may claim on the facility will be reduced by the grant received resulting in tax deductions being limited to R27 million which will be claimed at a rate of 40% in the year the assets are brought into use and 20% in the three subsequent years.

Question 1:
Is the grant an investment tax credit?

No. The grant has two aspects; an initial cash injection from the fiscus and a reduction in the tax deductions which may be claimed on the asset in the determination of taxable income.

The capital injection is a government grant relating to assets and should be accounted for under IAS 20. The cash grant causes an adjustment to the tax deductions which may be claimed in the determination of taxable income. Therefore, the accounting implications of the adjustment are recognised in accordance with IAS 12.

Refer to IAS 12 guidance on investmen tax credits in question 1 of example 1.

Question 2:
Does the receipt of the grant and the adjustment to the tax base of the asset result in immediate deferred tax consequences?

No. Deferred tax is not recognised where there is a difference on initial recognition between the carrying amount of the asset and the amount that will be deductible for tax purposes for the asset. This applies provided the transaction is not a business combination and impacts neither accounting nor taxable profit on initial recognition.

The entity may elect one of two methods in presenting government grants relating to assets in the financial statements. One method sets up the grant as deferred income which is recognised as income on a systematic and rational basis over the useful life of the asset. The other method deducts the grant in arriving at the carrying amount of the asset. The grant is recognised as income over the life of a depreciable asset by way of a reduced depreciation charge.

In this example, the cumulative net asset value of the asset and grant is R27 million. The tax base will be reduced by R3 million resulting in R27 million being deductible for tax purposes. There is no difference between the carrying amount and tax base on initial recognition and accordingly there are no deferred tax implications for this transaction on initial recognition.

The tables below illustrate the accounting implications of the tax deductions claimed in each financial year and the impact of the tax deductions on the effective tax rate.

	Accounting	Tax
Initial recognition of the property, plant and equipment	30 000	30 000
Initial recognition of the grant	(3 000)	(3 000)
Therefore, deferred tax is based on	27 000	27 000

Policy 1: Grant adjusted to carrying amount of the asset				
	2012	2013	2014	2015
Depreciation	6 750	6 750	6 750	6 750
Tax deductions	10 800	5 400	5 400	5 400
Carrying value [A]	20 250	13 500	6 750	-
Tax base [B]	16 200	10 800	5 400	-
Temporary difference [A - B]	4 050	2 700	1 350	-
Deferred tax liability @ 28%	1 134	756	378	-
Income statement				
Net profit before depreciation (no temporary differences)	100 000	105 000	110 000	115 000
Depreciation	6 750	6 750	6 750	6 750
Net profit before tax	93 250	98 250	103 250	108 250
Current tax @ 28%	24 976	27 888	29 288	30 688
Deferred tax	1 134	(378)	(378)	(378)
Effective tax rate	28.0%	28.0%	28.0%	28.0%
Balance sheet				
Property, plant and equipment	20 250	13 500	6 750	-
Deferred tax liability	(1 134)	(756)	(378)	-

Policy 2: Grant reflected as deferred income				
	2012	2013	2014	2015
Depreciation	7 500	7 500	7 500	7 500
Grant income	750	750	750	750
Tax deductions	10 800	5 400	5 400	5 400
Carrying value - asset [A]	22 500	15 000	7 500	-
Carrying value - deferred income [B]	(2 250)	(1 500)	(750)	-
Tax base [C]	16 200	10 800	5 400	-
Temporary difference [A + B - C]	4 050	2 700	1 350	-
Deferred tax liability @ 28%	1 134	756	378	-
Income statement				
Net profit before depreciation and grant income (no temporary differences)	100 000	105 000	110 000	115 000
Depreciation	7 500	7 500	7 500	7 500
Grant income	750	750	750	750
Net profit before tax	93 250	98 250	103 250	108 250
Current tax @ 28%	24 976	27 888	29 288	30 688
Deferred tax	1 134	(378)	(378)	(378)
Effective tax rate	28.0%	28.0%	28.0%	28.0%
Balance sheet				
Property, plant and equipment	22 500	15 000	7 500	-
Deferred tax liability	(1 134)	(756)	(378)	-
Deferred income	(2 250)	(1 500)	(750)	-

Deferred tax is generally not recognised where there is a difference on initial recognition between the carrying amount of the asset and the amount that will be deductible for tax purposes.

Example 2A

Assume the same fact pattern as example 2 except that the tax deductions which Entity B may claim on the facility will not be reduced by the grant received.

Question 1:
Should deferred tax be recognised in the difference between the carrying amount and tax base of the asset on initial recognition?

No. Deferred tax is not generally recognised where there is a difference on initial recognition between the carrying amount of the asset and the amount that will be deductible for tax purposes for the asset. This applies provided the transaction is not a business combination and impacts neither accounting nor taxable profit on initial recognition.

In this example, the balance sheet will be adjusted by the government grant of R3 million whilst there will be no associated impact on the amount of tax allowances that may be claimed by the entity. Therefore, on initial recognition of the grant, a temporary difference arises between accounting and tax values resulting in the initial recognition exemption being triggered.

	Accounting	Tax
Initial recognition of the property, plant and equipment	30 000	30 000
Initial recognition of the grant	(3 000)	-
Therefore, deferred tax is based on	27 000	30 000

The difference that arises between the accounting and tax values of the asset on initial recognition adjusts the temporary differences on which deferred tax is recognised at each reporting date. This adjustment is based on the realisation of the tax deductions attributable to the excess between the accounting and tax values of the asset on initial rcognition. In this example, 40% of the tax deductions on the asset are realised in the year the assets are brought into use and 20% thereafter. Therefore, the 40% of the initial recognition difference is realised in the year the assets are brought into use and 20% is realised in the three subsequent years.

We note that the realisation of the initial recognition difference will be based on the facts and circumstances of the incentive claimed by the entity and other approaches may be acceptable.

The tables below illustrate the accounting implications of the tax deductions claimed in each financial year and the impact of the tax deductions on the effective tax rate.

Policy 1: Grant adjusted to carrying amount of the asset					
	Initial recognition	2012	2013	2014	2015
Depreciation		6 750	6 750	6 750	6 750
Tax deductions		12 000	6 000	6 000	6 000
Carrying value [A]	27 000	20 250	13 500	6 750	-
Tax base [B]	30 000	18 000	12 000	6 000	-
Temporary difference [A - B]	(3 000)	2 250	1 500	750	-
Initial recognition exemption [C]	3 000	-	-	-	-
Unrecognised initial recognition exemption [C]		1 800[1]	1 200[2]	600[3]	-
Temporary difference adjusted by initial recognition exemption [A - B - C]	-	4 050	2 700	1 350	-
Deferred tax liability @ 28%	-	1 134	756	378	-
Income statement					
Net profit before depreciation (no temporary differences)		100 000	105 000	110 000	115 000
Depreciation		6 750	6 750	6 750	6 750
Net profit before tax		93 150	98 250	103 250	108 250
Current tax @ 28%		24 640	27 720	29 120	30 520
Deferred tax		1 134	(378)	(378)	(378)
Effective tax rate		27.7%	27.8%	27.8%	27.8%
Balance sheet					
Property, plant and equipment		20 250	13 500	6 750	-
Deferred tax liability		(1 134)	(756)	(378)	-

[1] 3 000 x (1 - 40%), [2] 3 000 x (1 - 60%), [3] 3 000 x (1 - 80%).

On initial recognition of the grant, a temporary difference arises between accounting and tax values.

Policy 2: Grant reflected as deferred income					
	Initial recognition	**2012**	**2013**	**2014**	**2015**
Depreciation		7 500	7 500	7 500	7 500
Grant income		750	750	750	750
Tax deductions		12 000	6 000	6 000	6 000
Carrying value - property, plant and equipment [A]	30 000	22 500	15 000	7 500	-
Carrying value - deferred income [B]	(3 000)	(2 250)	(1 500)	(750)	-
Tax base [C]	30 000	18 000	12 000	6 000	-
Temporary difference [A + B - C]	(3 000)	2 250	1 500	750	-
Initial recognition exemption [D]	3 000	-	-	-	-
Unrecognised initial recognition exemption [D]		1 800[1]	1 200[2]	600[3]	-
Temporary difference adjusted by initial recognition exemption [A + B - C + D]	-	4 050	2 700	1 350	-
Deferred tax liability @ 28%	-	1 134	756	378	-
Income statement					
Net profit before depreciation and grant income (no temporary differences)		100 000	105 000	110 000	115 000
Depreciation		7 500	7 500	7 500	7 500
Grant income		750	750	750	750
Net profit before tax		93 150	98 250	103 250	108 250
Current tax @ 28%		24 640	27 720	29 120	30 520
Deferred tax		1 134	(378)	(378)	(378)
Effective tax rate		27.7%	27.8%	27.8%	27.8%
Balance sheet					
Property, plant and equipment		20 250	13 500	6 750	-
Deferred tax liability		(1 134)	(756)	(378)	(1 134)
Deferred income		(2 250)	(1 500)	(750)	-

[1] 3 000 x (1 - 40%), [2] 3 000 x (1 - 60%), [3] 3 000 x (1 - 80%).

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