EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

29 August 2014

Eurostat Guidance Note

TREATMENT OF DEFERRED TAX ASSETS (DTAs) AND RECORDING OF TAX CREDITS RELATED TO DTAs IN ESA2010

Executive summary

This note provides guidance on the treatment of deferred tax assets (DTAs) in the framework of national accounts and on the recording under ESA2010 of tax credits related to DTAs.

In 2014, Basel III has introduced changes for the calculation of the Core Tier 1 capital ratio of financial institutions and DTAs that rely on future profitability are to be gradually deducted for the calculation of such ratio. This has induced some countries to enact specific changes in legislation allowing the conversion of DTAs into tax credits that constitute a direct claim on government and that would not need to be deducted for the calculation of the Core Tier 1 capital ratio. At the same time, ESA 2010 has introduced clear provisions for the recording of tax credits. Given that there is no guidance concerning DTAs in national accounts, Eurostat and the Member States (MS) agreed that specific guidance should be provided on the recording under ESA2010 for tax credits related to DTAs.

Deferred tax assets are defined as amounts of income tax recoverable by corporations in future periods, provided that there will be sufficient future taxable profits. DTAs are related to past transactions, which, according to International Accounting Standard 12 (IAS12), can be grouped in the following 3 categories:

a) Deductible temporary differences;

b) Carry forward of past losses;

c) Carry forward of unused tax credits.

DTAs represent a potential claim of corporations against government, as they may possibly reduce the taxes to be paid by corporations on their future profits. The reasons for creation and use of DTAs vary across countries and are normally defined in national legislations in the context of income taxes. The recognition and use of DTAs is conditional on a number of factors, such as the existence of likely sufficient future profits or the possible reversal of deductible temporary differences (for instance, the reversal of provisions).

DTAs on the balance sheet of a corporation may give the right to pay less tax, but a DTA is not a tax credit until such a right effectively exists and can be used up to a certain amount.

From a practical point of view, it should be considered that a DTA becomes a claim with the features of a tax credit at the time in which an amount can be established with certainty and can be used to reduce taxes to be paid, as the right to pay less tax would become at some stage effective and not only theoretical.

In national accounts, DTAs are only contingent assets for corporations and therefore no liabilities are recorded for government in the financial accounts. DTAs would be recorded in national accounts only in case they give rise to claims with the features of a tax credit and, in this case, ESA2010 rules for the recording of tax credits are to be applied for both payable and non-payable tax credits.

DTAs could give rise to a claim with the nature of a tax credit in the following cases:

a) Normal offsetting of taxes because the corporation is profitable and deductible temporary differences are reverted, etc.,

b) Tax credits that were carried forward,

c) Changes in legislation allowing the conversion of certain DTAs with little likelihood of recovery into fully recoverable tax credits, under specific circumstances (for instance in case a corporation reports losses, in case of liquidation, etc.).

A recording for each of the three cases is provided in this note and a detailed analysis is undertaken for case c), which is more complex than the others. A flowchart trying to summarise the recording for all possible cases is provided in annex at the end of the note.

In case a) the claim originated from a normal offsetting of taxes would be assimilated to a non-payable tax credit, with no possibilities for amounts exceeding the tax liability to be paid to the corporation. Therefore, under ESA2010, these tax credits would have to be netted from tax revenue.

In case b) the recording of payable and non-payable tax credits, as detailed in ESA2010, should be followed. If the tax credit carried forward is payable, it would be recorded only once, at the time of recognition by the tax authorities and no amounts would be subsequently recorded if the amounts not used in each period to pay less tax are carried forward, even if in business accounts a deferred tax asset would be recorded in the balance sheet. On the contrary, if the tax credit carried forward is non-payable, the amount effectively used to pay less tax in each accounting period would be recorded as reducing tax revenue, the remaining amounts being carried forward and recorded as reducing tax revenue in subsequent accounting periods.

In case c), the tax credits originated will be payable by definition and the rules set in ESA2010 for payable tax credits should apply. This would imply the recording of government expenditure every time an amount of DTAs is converted into a tax credit, at the time the tax authorities recognise the liability and for the full amount converted. These payable tax credits are to be recorded under the expenditure category of other capital transfers (D.99). The recording for such cases should be clarified on a case by case basis and bilaterally discussed with Eurostat on the basis of this guidance note.

It is to be underlined that other national accounts rules (such as those for capital injections) might also be applicable in cases of legislations concerning DTAs with features different from the ones examined and described in this guidance note.

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1. Introduction

Following the changes to national tax legislations that allow the conversion of DTAs into payable tax credits, enacted in some Member States as a consequence of Basel III, Eurostat raised the issue of tax credits originated from DTAs in the Financial Accounts Working Group (FAWG) in December 2013 and discussions followed since then in the framework of Eurostat's Task Force on methodological issues. The issue was finally agreed between Eurostat and the Member States in the FAWG in June 2014.

Given the new provisions established in ESA2010 for the recording of payable tax credits[1], and the absence of reference to DTAs in national accounts manuals, it was widely agreed that guidance was necessary as regards the recording of payable tax credits originated from the conversion of DTAs.

This note provides guidance on the treatment of deferred tax assets in the framework of national accounts and the practical recording to be implemented for tax credits related to DTAs, under ESA2010.

2. Definitions

2.1. Tax credits: definition and recording

Definition of tax credit

According to national accounts manuals, a tax credit is a form of tax relief that is subtracted directly from the tax liability[2] due by the beneficiary after the liability has been computed. In tax legislation, a tax credit is any credit of the beneficiary *vis a vis* the tax administration.

As any form of tax relief, tax credits are normally intended to reduce the amount of taxes paid by households or corporations. As tax credits can reduce the tax liability of taxpayers, they are normally linked to final tax settlements.

Tax credits are normally foreseen in national tax legislation and can vary considerably among countries according to types and amounts.

They may be aimed simply at redistribution among sectors of the economy, but they may also be designed to encourage certain activities, such as participation in the labour force or investment in research and development.

SNA1993 and ESA1995 did not explicitly address the treatment of tax credits. However, the treatment of tax credits is described in SNA08 (22.95-22.98) and ESA2010 (20.167-20.168 and 4.81).

Two categories of tax credits are defined in SNA08 and ESA2010: payable and non-payable[3].

In order to classify a tax credit as payable, the following condition must be fulfilled: *the full amount of the tax credit will be paid out to the beneficiary* (it is an obligation for government and therefore a non-contingent government liability).

Any tax credit not fulfilling the above condition is a non-payable tax credit. This includes tax credits where some amount could not be paid out to the beneficiary (regardless of whether the tax credit is limited or not to the size of the tax liability).

[1] See ESA2010 20.167-20.168 and 4.81.

[2] It is deducted from the tax liability and not from the tax base as other forms of tax relief such as deductions.

[3] They are sometimes referred to as non-wastable and wastable respectively.

Recording of tax credits in national accounts

As concerns their recording, under ESA1995, no explicit guidance was provided on the recording of tax credits. In the absence of this, non-payable tax credits were normally recorded as reducing tax revenue. For the recording of payable tax credits, many countries followed guidance from OECD revenue statistics to record the amounts exceeding the tax payers' liabilities as expenditure, while netting other amounts from tax revenue. However, a few MS followed a gross approach and recorded the full amount of the payable tax credit as expenditure.

ESA2010 introduces explicit rules for the recording of tax credits and establishes two different recordings depending on their payable or non-payable nature. While non-payable tax credits are to be recorded as a reduction of tax revenue (the same treatment followed in practice, in the absence of guidance, under ESA1995), payable tax credits have to be recorded as expenditure, in the appropriate expenditure category, for their full amount. This treatment for payable tax credits introduces a difference as compared to the recording previously followed by most MS in the absence of clear guidance in ESA1995.

As regards their time of recording, non-payable tax credits are normally recorded at the time they are used to reduce the taxes due. On the contrary, the time of recording of payable tax credits should be when the tax claim of the tax payer is recognized by government as an obligation to pay in the future, as, before that moment, no actual liability exists for government[4]. This time of recording should be implemented regardless of the expenditure category applied (D.3, D.62, D.75, D.92, D.99, etc.)

Tax credits are amounts that can be used by corporations to pay less tax. However, the right to pay less tax must always be assessed, controlled, certified or approved by government after tax declarations are submitted. This time of recording when there is a formal recognition of the liability by the tax authorities, is an acceptable approximation of the accrual principle in the case of payable tax credits. A pure accrual time of recording for payable tax credits (before tax declarations are submitted) would not be acceptable as it would raise a number of problems, such as the need to make estimates on the amounts involved, a high likelihood of subsequent revisions in the accounts and the recording of amounts before they are determined with certainty.

The recording of the expenditure at the time government recognises the claim has to be made for its whole amount, regardless of the exact time in which the payable tax credit will be used in order to decrease the amount of taxes to be paid and regardless of the exact time the tax credit could be paid back in its totality to the beneficiary.

2.2 DTAs: definition and general considerations

2.2.1 Definition of DTAs

DTAs are defined and explained in IAS12 (related to income taxes) and in US GAAP (Generally Accepted Accounting Principles). Also, the conditions in which DTAs can be generated and used are normally set in the national legislation for income taxes, leading to differences among MS.

[4] This time of recording was discussed and agreed in the FAWG in December 2013.

However, at present, there is no reference to DTAs in national accounts manuals. DTAs are neither mentioned in ESA, nor in SNA.

In this context, it is worth to make a remark on one of the differences between International Financing Reporting Standards (IFRS) and the national accounts framework. While in IFRS future events may be recorded in the accounting system, this is not the case in national accounts.

Deferred tax assets are defined as amounts of income tax[5] recoverable by corporations in future periods, provided that there will be sufficient future taxable profits. DTAs are related to past transactions, which, according to IAS12, can be grouped in the following 3 categories:

a) Deductible temporary differences,

b) Carry forward of past losses,

c) Carry forward of unused tax credits.

The number of years that deductible temporary differences, losses or tax credits can be carried forward varies among MS. While in some MS the carry forward is limited to a specific number of years set in legislation, in other MS there is no limit to the carry forward, which can be done at any time in the future.

According to IAS12, deferred tax assets shall be measured at the tax rate that is expected to apply to the period when the asset will be realised, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

On the other hand, current tax assets/liabilities are defined as amounts of income tax recoverable/payable by the beneficiary in the current period.

The three categories giving rise to deferred tax assets, described in IAS12, are analysed in detail below:

a) Deductible temporary differences

Provisions for credit insolvency and provisions for future pension expenditure are examples of deductible temporary differences. The related DTAs are calculated as follows:

DTA = tax rate * deductible temporary difference

Deductible temporary differences are originated because the “accounting rules” (general accounting plans, IAS, etc.) that determine the profit or loss of a corporation, differ from the “fiscal rules” (legislation for the CIT) that determine the tax base.

The differences between the profit/loss before tax (accounting profit) and the tax base (or taxable profit) are called deductible temporary differences and give rise to assets (if the profit before tax is lower than the tax base, i.e., if accounting profit < taxable profit) or liabilities (if the profit before tax is higher than the tax base, i.e., if accounting profit > taxable profit) in the balance sheets of corporations. Therefore:

Accounting profit < Taxable profit → Deferred tax asset in balance sheet of corporation
→ Government contingent liability

Accounting profit > Taxable profit → Deferred tax liability in balance sheet of corporation
→ Government contingent asset

[5] Generally, DTAs are linked to corporate income tax (CIT) and are held by corporations. However, in some countries, DTAs can also be held by self-employed and be linked to personal income tax (PIT).

These differences can be due to various reasons:

1) Items considered revenue (or expenditure) in the profit and loss account which are not considered revenue (or expenditure) for fiscal purposes and are not fiscally deductible in the same year in which they impact the profit and loss account.

For instance, a provision to cover the risk of credit insolvency is considered an expenditure impacting the profit and loss account, but it is not fiscally deductible until the loss has actually materialised. Therefore, it will not be considered an expenditure for fiscal purposes (it is not a realized loss) and will, thus, not be deductible from the tax base until the loss materialises and becomes a realised loss, which will normally happen at a later period.

2) Differences between the valuation of assets/liabilities in the financial statements and the valuation for fiscal purposes. For instance, differences in the depreciation method or in the years of life of an asset.

b) The carry forward[6] of past losses

Negative tax bases (normally due to materialised or real losses) generate DTAs that may reduce the tax liability of future years. The related DTAs are calculated as follows:

DTA = tax rate * ((-) negative tax base)

c) The carry forward of "unused" tax credits from previous periods

Tax credits not used in previous periods, that can be carried forward, generate DTAs. Tax credits carried forward can be non-payable or payable. Clarification as concerns this third category is provided in section 2.3.

2.2.2 General considerations on DTAs

- DTAs arise from past events (deductible temporary differences, unused tax losses or unused tax credits).
- DTAs are always forward looking.
- DTAs represent a potential (and not unconditional) claim of corporations against government, as they may possibly reduce the taxes to be paid by corporations on their future profits.
- The origin and use of DTAs vary across countries and is normally set in national legislations in the context of the corporate income tax (CIT).
- The recognition and use of DTAs is conditional on a number of factors, such as the existence of likely sufficient future profits or the possible reversal of deductible temporary differences (for instance, reversal of provisions).
- A number of assumptions are needed for the calculation that corporations undertake of their stock of DTAs and these assumptions may change from one year to the other, leading to changes in the stock of DTAs reported by corporations on their financial statements. For instance, DTAs shall be measured at the tax rate expected to be applied at the time the DTA is used[7]. In case of changes in the tax rates (which is likely to happen in periods of economic and financial crisis), the stock of DTAs is revised. In addition, the future profitability of the corporation should also be estimated in order to

[6] The carry back of present losses is also possible in some MS. See point 3.3 of this note.

[7] As stated in IAS12, deferred tax assets shall be measured at the tax rates that are expected to apply to the period when the asset is realised, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

determine the exact stock of DTAs. In case the estimation was not correct, the stock of DTAs would need to be revised at a later stage. The stock of DTAs will also be revised in case some shares of the corporation are sold to a non-resident unit (it will completely disappear if 100% of the shares are sold to a unit not subject to taxes in the original country).

- Therefore, the stock of DTAs of a corporation may be subject to continuous revisions from one year to the other.
- The use of DTAs as set in national legislations can be limited to a determined period of time since their creation. In this case, the remaining amounts will be lost[8] if not used at the end of the given period. However, in some MS, such limitation does not exist.
- In most cases, DTAs are not immediately recoverable/usable in their entirety to reduce taxes (i.e., they are only potential claims). From an initial stock of DTAs, it could happen that only part of the stock will finally be recovered. As stated above, the recoverability is conditional on the existence of future profits and, in case of temporary differences (provisions, etc.), their reversal is mandatory for the recoverability. Also, they can normally be recovered over a given period of time, at the end of which the amount not "used" could simply be lost. Because of this uncertainty on their recoverability and the fact that they depend on future events, most DTAs are contingent liabilities for government.
- DTAs can be offset against deferred tax liabilities (DTLs). IAS 12 requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities. The analysis undertaken in this note will only refer to DTAs.

2.3 Are DTAs tax credits?

Before discussing the recording of DTAs, it is essential to clarify whether all DTAs on the balance sheets of corporations can indeed be considered as tax credits. If not, an additional issue to be clarified would be whether all DTAs on the balance sheet of a corporation will give rise claims with the features of tax credits.

Although DTAs and tax credits belong to different frameworks[9], from a theoretical point of view there might be an analogy between them, to the extent that some DTAs could be considered as tax credits.[10] However, it is important to understand the difference between them, as not all DTAs can be assimilated to tax credits in practice.

Tax credits are amounts that can normally be established with certainty and are not subject to revisions once they are known. They may be fixed for one single amount[11], fixed for different amounts set by tranches[12] or they may depend on a variable[13] or a group of variables. They can be fully recovered (or not) according to their payable (or non-payable) nature, but, regardless of the effective use of the tax credit to reduce taxes, the initial amount

[8] Except for DTAs originating from payable tax credits.

[9] DTAs are a concept used in business accounting while tax credits are mostly used in national accounts.

[10] In practice, the carry forward of a tax credit is the same tax credit (maybe for a lower amount). From a theoretical point of view it is considered to give rise to a DTA in the balance sheet. In this case the DTA is from the beginning an actual claim (a tax credit). This is further explained later in the document.

[11] Example: if a child tax credit grants €500 per year to each family with an annual income below €20.000

[12] Example: if a child tax credit grants €500 per year to families with annual income below €20.000, €300 if the annual family income is between €20.000 and €30.000 and €100 if the annual family income is between €30.000 and €40.000.

[13] Example: tax credit granting 5% of the compensation of employees paid by a corporation in a given year.

can be fixed. Tax credits are not based on assumptions, but on facts. This implies that the amounts related to tax credits reported by tax payers in their tax declarations and the amounts effectively recognised by the tax authorities, should normally be more or less close.

On the contrary, there is uncertainty[14] on the stock of DTAs on the balance sheet of a corporation, as it is based on a number of assumptions and not only on facts known at the time the accounts are drawn up (see general considerations on DTAs above). In addition, such stocks may be subject to continuous revisions. This does not seem to fit with the features of a tax credit. In addition, because of this uncertainty, the amounts related to DTAs reported by corporations on their balance sheets and on their annual reports could differ considerably from the amounts that would be finally recognised by the tax authorities.

The total stock of DTAs on the balance sheet of a corporation may give the right to pay less taxes, but a DTA is not a tax credit until such a right exists and is applicable for a certain amount. DTAs can give rise to tax credits at some stage, for certain amounts and under certain conditions. However, DTAs are not tax credits per se and the fact that they could be converted into tax credits does not imply that all of them will in practice be converted.

In general, all DTAs on the balance sheet of corporations cannot be immediately considered as tax credits.[15] However, it can be considered that a DTA can give rise to a claim with the features of a tax credit in national accounts at the time in which the amount can be established with certainty and can be used to reduce the taxes to be paid. Nevertheless, not all DTAs will give rise to a tax credit at some stage.

Following the above, it could be considered that DTAs on the balance sheet of a corporation could be split as follows, according to the likelihood of becoming a claim with the features of a tax credit at some stage:

> 1) DTAs that presumably will not become a claim with the features of a tax credit. This part of the stock will not constitute a liability for government and no recording will be needed in national accounts.
>
> 2) DTAs that will most likely become claims with the features of a tax credits at some stage, either because taxes can be normally offset against profits or because of specific legislations allowing the conversion of DTAs from the above category into payable tax credits.

From a practical point of view, it should be considered that a DTA becomes a claim with the features of a tax credit at the time in which an amount can be established with certainty and can be used to reduce the taxes to be paid, as the right to pay less tax would become effective and not only theoretical. This does not however mean that it is a payable tax credit at that point.

Clarification concerning DTAs related to the carry forward of tax credits as described in IAS12

It should be noted that DTAs linked to the carry forward of tax credits are in fact tax credits. No new claim is generated in the case of these DTAs, as the claim already exists.

The carry forward of a payable tax credit is the same payable tax credit. These DTAs linked to payable tax credits are government non-contingent liabilities. The payable tax credit is recorded (once) at the time the liability is recognized by government.

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[14] It is not definitively and irreversibly measured.

[15] This refers basically to DTAs originated from the carry forward of negative tax bases or from deductible temporary differences. However, the carry forward of tax credits also gives rise to DTAs and, in this case, the statement is not applicable. Further clarification is provided below.

Symmetrically, the carry forward of a non-payable tax credit is the same non-payable tax credit. These DTAs linked to non-payable tax credits are government contingent liabilities until the tax credits are effectively used to reduce the tax liability.

3. Treatment of DTAs in national accounts (ESA2010)

3.1 General considerations

In business accounting, DTAs are usually recorded as assets in the balance sheets of corporations. However, in national accounts, DTAs are only contingent assets and, therefore, no liabilities are recorded for government in the financial accounts (and, by symmetry, no assets for corporations).

In terms of national accounts, we refer to the recording of a tax credit, but DTAs as such are not recorded. Before the introduction of ESA2010, DTAs were recorded only when they were effectively used to reduce the amount of taxes to be collected by government (i.e., the claims are recorded in all cases as non-payable tax credits).

As stated in the previous section, DTAs would be recorded in national accounts only if they become claims with the features of tax credits. At that time, ESA2010 rules for the recording of tax credits are to be applied for both payable and non-payable tax credits.

Under ESA2010, the recording for non-payable tax credits is likely not to change for most MS. However, for payable tax credits, the new provisions in ESA2010 would imply, to record the payable tax credit as expenditure for its full amount at the time government is recognizing the liability.

The next paragraphs will provide guidance on how to implement in practice the recording, following ESA2010 on a case by case basis.

3.2 Recording of tax credits related to DTAs under ESA2010. Case by case analysis

Case 1 → Recording of a DTA before it gives rise to a claim with the features of a tax credit

In this case, the DTA is only a contingent liability for government; there is no claim with the features of a tax credit, and therefore nothing should be recorded in national accounts.[16]

Case 2 → Recording of a DTA once it becomes a claim with the features of a tax credit

A DTA can give rise to a claim with the nature of a tax credit in the following cases:

a) normal offsetting of taxes because the corporation is profitable and deductible temporary differences are reverted, etc.

b) tax credits that were carried forward (in this case the DTA is a tax credit itself).

c) specific changes in legislation allowing the conversion of DTAs, with little likelihood of recovery,[17] into fully recoverable tax credits.

The recording of each of these cases will be analysed separately. A flowchart summarising the recording of the different tax credits related to DTAs is provided in the annex to this document.

[16] Even if total amounts of deferred tax assets are provided explicitly in the balance sheets of corporations in business accounting, in national accounts such amounts are government contingent liabilities and are not recognized by the tax authorities.

[17] For instance, in case of losses or liquidation or in case the DTAs are not offset during the period established in legislation.

In case 2a), the claim originated from a natural offsetting of taxes would be assimilated to a non-payable tax credit. Therefore, under ESA2010, these tax credits have to be reduced from tax revenue (i.e., no change should apply as compared to the treatment followed under ESA1995). This recording should pose no problem as the amounts in this case can be clearly identified.

In case 2b), the recording of payable and non-payable tax credits, as detailed in ESA2010, should be followed. Also in this case the amounts are identified, not constituting therefore a problem for the recording. The fact that the carry forward gives rise to DTAs, does not change anything as concerns the recording, which remains the same as if DTAs did not exist (the tax credit already existed).

If the tax credit carried forward is payable, it would be recorded once at the time of recognition by the tax authorities, and no amounts would be subsequently recorded if the amounts not used in each period to pay less tax would be carried forward, even if in business accounting a deferred tax asset is recorded in the balance sheet.

On the contrary, if the tax credit carried forward is non-payable, the amount effectively used to pay less tax in each accounting period would be recorded as reducing tax revenue, the remaining amounts being carried forward and recorded as reducing tax revenue in subsequent accounting periods.

Case 2c) is however more complex and will be treated separately in section 4 of this note.

As mentioned in the general considerations on DTAs (section 2.2.2), in some MS there is no time limit for the carry forward. As far as the recording is concerned, this would not change anything. An unlimited carry forward would not automatically give rise to a claim with the features of a tax credit. Identically to cases where there is a given limited period for the carry forward, tax credits will arise either because of natural offsetting of taxes or in the cases defined by the specific legislations enacted for the conversion of DTAs. Therefore, the provisions above are equally applicable to unlimited and limited carry forward.

3.3 Recording of current tax assets and carry back under ESA2010

Even though current tax assets and the carry back of present losses are not DTAs, it is worth commenting briefly on their recording in the framework of this guidance note.

Current tax assets

Current tax assets/liabilities are defined as amounts of income tax recoverable/payable by the beneficiary in the current period. Contrary to DTAs, current tax assets are non-contingent and, according to the accrual principle, they would be recorded in national accounts as government liabilities/assets under the form of other accounts payable/receivable (F.89) when recognised by government, and under the form of expenditure/revenue in the non-financial account.

Carry back

When defining DTAs, it was previously explained how the carry forward of past losses gives rise to DTAs to be used against future taxes. In addition, in some MS, it is also possible to carry back current losses against past taxes already paid in relation to profits. This increases the possibility of corporations to benefit from tax relief measures. In general, if there were profits in the year(s)[18] prior to the loss, the carry back generates an immediate right (for an

[18] Although the carry back is normally limited to one year, in some MS this time limit may be longer.

amount known) of the corporation against government. Generally, this right does not meet the definition of a deferred tax asset, but of a current tax asset instead[19].

In general, the corporation may be entitled to get a refund at once and, in this case, it should be recorded as a tax refund.

In some MS, the corporation is not entitled to an immediate refund, but it may have the possibility to offset this claim (of a known amount) against taxes over a number of years, giving rise to a tax credit.

The tax credit will be non-payable in case the amount not recovered after the given period is lost. However, it could be payable if it is established that the amount not offset after the given period will be recovered by the corporation in any case. The rules for tax credits set in ESA2010 should apply. Therefore, in case of a payable tax credit, the full amount should be recorded as expenditure at the time government recognize the liability (normally at the time the corresponding tax declaration is submitted), regardless of the time in which the amount will be recovered by the corporation.

Whether direct refund or right to offset future taxes, the claim is generated the year when the losses are incurred (although it may be recognised when the declaration is submitted) and should impact the non-financial accounts at this time and not in the previous year(s) to which the loss is carried back. The accounts of the previous year(s) should not be revised because of amounts carried back.

4. Analysis of a specific case. Recording under ESA2010 of DTAs converted into tax credits because of specific legislations

4.1 Background

Basel III[20] is a set of measures implemented to strengthen the regulation of the banking sector and which aims, among others, at improving the quality of capital in the banking system, defined as "core Tier 1 capital". It has entered into force in January 2014.

According to Basel III, DTAs that rely on future profitability are to be gradually[21] deducted for the calculation of the Tier 1 capital ratio of financial institutions. However, Article 39 of the Capital Requirements Regulation implementing Basel III (CRR) sets a list of items that shall not be deducted for this calculation (see below). Paragraph 2 of this article specifies the conditions that DTAs should meet in order not to be deducted for the calculation: *DTAs arising from deductible temporary differences shall not be deducted for the calculation of the Tier 1 capital ratio if they are automatically replaced with a tax credit under certain conditions*.

According to Basel III, DTAs should be deducted for the calculation of the core Tier 1 capital ratio. However, this is not the case for tax credits that constitute a direct claim on government.

Article 39 1(b) states that claims originated by the carry back of tax losses are not to be deducted for the calculation of the Tier 1 capital ratio. However, the carry back of tax losses does not give rise to DTAs and the case has already been explained in the previous section.

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[19] Especially if a refund is immediate or with a small time gap.

[20] In Europe, the Basel III framework is implemented by:

- CRR → Capital Requirements Regulation (Regulation No 575/2013 of 26 June)
- CRD IV → Capital Requirements Directive (Directive 2013/36/EU)

http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm#maincontentSec1.

[21] They are to be deducted by 10% each year starting from 2015.

In some MS, the stock of DTAs held by financial institutions has increased considerably over the past years as a consequence of the financial crisis (either because of losses or provisions). In addition, most of the existing DTAs held by financial institutions rely on future profitability. Thus, the introduction of Basel III would lead to a non-negligible decrease in the Tier 1 capital ratios of financial institutions if these DTAs would be deducted.

To avoid this situation, following the exceptions foreseen in Article 39 of CRR, some MS have implemented changes in their national income tax legislations, so that financial institutions would not have to deduct significant amounts of DTAs for the calculation of their Tier 1 capital ratios. Such changes set the conditions for the conversion of DTAs into tax credits as defined in Article 39 above. By definition, these tax credits would be payable and would constitute a liability for government and an unconditional claim of financial institutions with positive impact on their own funds.

Although there are some differences between countries in the changes to legislation enacted so far (as concerns the entities covered by the changes in the law, the origin of the DTAs to be converted, the circumstances of the conversion and the way in which the conversion will be done), the conversion of DTAs into payable tax credits is common to all cases. Moreover, although in some cases the specific change in national legislation may theoretically apply to all corporations; in practice it could be applicable only to financial corporations.

Article 39 (CRR)

Tax overpayments, tax loss carry backs and deferred tax assets that do not rely on future profitability

1. The following items shall not be deducted from own funds and shall be subject to a risk weight in accordance with Chapter 2 or 3 of Title II of Part Three, as applicable:

(a) overpayments of tax by the institution for the current year;

(b) current year tax losses of the institution carried back to previous years that give rise to a claim on, or a receivable from, a central government, regional government or local tax authority.

2. Deferred tax assets that do not rely on future profitability shall be limited to deferred tax assets arising from temporary differences, where all the following conditions are met:

(a) they are **automatically and mandatorily replaced without delay with a tax credit in the event that the institution reports a loss** when the annual financial statements of the institution are formally approved, or in the event of liquidation or insolvency of the institution;

(b) **an institution shall be able under the applicable national tax law to offset a tax credit referred to in point (a) against any tax liability** of the institution or any other undertaking included in the same consolidation as the institution for tax purposes under that law or any other undertaking subject to the supervision on a consolidated basis in accordance with Chapter 2 of Title II of Part One;

(c) **where the amount of tax credits referred to in point (b) exceeds the tax liabilities referred to in that point, any such excess is replaced without delay with a direct claim on the central government** of the Member State in which the institution is incorporated.

Institutions shall apply a risk weight of 100 % to deferred tax assets where the conditions laid down in points (a), (b) and c) are met.

4.2 Recording under ESA2010

Tax credits originated from the conversion of DTAs, as defined in Article 39 of CRR, will be payable and as such; the rules set in ESA2010 for payable tax credits should apply. This would imply the recording of their whole amount as expenditure at the time government recognizes the liability. However, it is to be underlined that other national accounts rules could be applicable in combination to this guidance, depending on the particular feature of the legislation enacted for DTAs.

In this framework, some issues need to be analysed, such as: under what circumstances will the DTA be converted into a tax credit? For which amount? When? How? At what time will government recognize the liability? What information is available?

The analysis of the issues above is at first undertaken. Subsequently, Eurostat's proposal for the recording is described, followed by some considerations on other alternative recording options.

4.2.1 Issues to be analysed

- Under what circumstances? For which amount?

  According to the legislations enacted so far in some MS and already analysed by Eurostat, the conversion of certain DTAs into non-contingent tax credits will always be done if the corporation realises losses over the accounting period or in case of liquidation. In case of losses, the amount of DTAs converted would be limited to the ratio of losses/own funds applied to the losses incurred by the corporation. In case of liquidation, there would be no cap for the amount to be converted into a tax credit.

  The conversion could also be done in other circumstances depending on the country (in case of negative value of net output in the tax on productive activities, in case a corporation was not able to naturally offset the DTAs during the period set in the legislation, etc.).

- When?

  As concerns the time of the conversion, this is set in the legislations enacted in some MS at the time the tax declaration is submitted[22]. Normally, income tax declarations corresponding to year T are submitted in year T+1.

- How will the tax credit resulting from the conversion be effectively used in practice?

  The tax credit can be offset against other taxes or can be refunded. It could also be sold/transferred to other entities. In some cases, corporations can choose whether to use the tax credit to offset taxes or whether to get a refund. In other cases, there is no choice and the refund is obtained only if there are remaining amounts after a previous offsetting of taxes.

- Recognition of the liability by government

  The time when government will recognize the liability should be in line with the accrual principle, adapted by using an acceptable proxy if needed, in order to take into account the moment in which the amounts will be certain[23], so to avoid possible unreliable estimations and continuous revisions of data. In practice, this might be at different moments across MS, according to the system currently in place for tax reimbursements

[22] In some cases, the conversion could be done at the time when the financial statements of the corporation are approved in the shareholder's meeting. This should not make any difference, as this moment is normally very close to the time when the declaration is submitted. The gap would be of a few months and always within the same year.

[23] Or very close to certain.

and the accounting rules chosen for recording such amounts (whether time adjusted cash or assessments and declarations).

- Availability of information

  As mentioned before, corporations show the total stocks of DTAs in their balance sheet and provide in their annual reports information of such amounts and even of the stock of DTAs that could possibly be converted into tax credits according to their calculations. This information for year T is normally available during the first half of year T+1. However, these stocks of DTAs are not payable tax credits unless they are effectively converted. They are only contingent liabilities for government and, thus, they are not recorded in national accounts. As stated above, in case the corporation realises losses in year T, the conversion, from a legal point of view, would normally be done at the time the tax declaration is submitted, which is normally in T+1.

  There are two issues to be analysed:

  - what information is reported by corporations in the corporate income tax declaration?
  - what amount will government recognise as a liability?

  The information reported by corporations in their tax declaration is not standardised and varies across countries. While in some MS corporations could report information on both total stock of DTAs and the amounts of DTAs that are actually converted in a payable tax credit in the current year, in other MS corporations would only report the latter, which constitute a claim of the corporation towards government.

  Notwithstanding the above, even if the total stock of DTAs would be reported in the tax declaration, this would not imply the recognition of such stock by government. It does not seem likely that government would recognise, as a liability, claims that are only contingent and where no actual claims assimilated to tax credits have been generated. Instead, it seems more likely that government would recognise a liability only for the "flow" of DTAs that is actually converted into a payable tax credits in the current year.

4.2.1 Eurostat's proposed recording

All the above would imply the recording of government expenditure every time an amount of DTAs is converted into a (payable) tax credit. For instance, according to the legislations enacted up to date[24], this means recording government expenditure in the possible following cases:

- Every time a financial institution reports losses;

- In case a corporation is liquidated;

- If a corporation reports negative net output in the tax on productive activities;

- If a corporation is not able to offset existing DTAs originated from certain deductible temporary differences after the period set in legislation.

Such recording is to be done at the time the tax authorities recognise the liability in public accounts.

As concerns the financial accounts, a liability for the same amount will be recorded under the corresponding instrument: decrease in F.2 (assets) if the amount is paid in cash, increase in F.3 (liabilities) if paid in government bonds or increase in other accounts payable (F.89) in case there is a time lag between the recognition of the liability and the actual payment.

[24] 3 June 2014

It is to be underlined that, according to ESA2010, an expenditure will always have to be recorded for payable tax credits, regardless of the accrual method used for the recording of taxes (time adjusted cash (TAC) or assessments and declarations (AD)). This shall be the case also in those circumstances where taxes were previously recorded on a net basis.

The expenditure category to be used for the recording is analysed below.

At the time of preparation of this guidance, Eurostat analysed two existing cases in Member States. Other legislations are in preparation in other countries and have not yet been analysed by Eurostat. It should be noted that other national accounts rules (such as those for capital injections) might also be applicable in cases of future legislations to be enacted regarding DTAs with features different from the ones examined and described in this guidance note.

Expenditure category to be used for the recording of the payable tax credits originated from the conversion of DTAs

Eurostat's view is that payable tax credits originated from the conversion of DTAs are to be recorded as other capital transfers (D.99) payable for government. The rationale for this treatment is that the conversion of DTAs, as described in national legislations, would be normally undertaken in case a corporation reports losses or in case of liquidation.

Moreover, from ESA 4.165 (b) and SNA 2008 (11.91 and 22.145), it can be concluded that payments intended to cover accumulated or exceptional losses and payments by government to units in financial distress are to be recorded as capital transfers.

As the conversion of DTAs into payable tax credits would normally be related to losses or liquidation reported in the same accounting period of the conversion, it could be argued whether to apply a recording as current expenditure. However, DTAs are normally linked to losses or provisions incurred in previous periods. DTAs are generated from past events and the generation and the use of DTAs occur always in different periods.

4.3 Alternative recording options

The above changes in national tax legislation have converted certain DTAs, which are contingent by definition, into payable tax credits, which have a non-contingent nature. It is to be underlined that such legislations had the effect of avoiding that certain DTAs would be excluded from the core Tier 1 capital ratio of financial institutions. By definition of Core Tier 1 capital, this would imply that the nature of such DTAs is non-contingent.

Therefore, the issue could be raised of why expenditure would not be recorded at inception for the whole amount of the stock of DTAs to which the specific legislations recently enacted could apply. Eurostat considers that this option would not be possible both for theoretical and practical reasons.

From a theoretical point of view, it has already been explained that DTAs are not recorded unless they give rise to a claim with the features of a tax credit). When this is the case, the tax credit (and not the DTA) will be recorded. However, recording at inception the whole stock of DTAs to which the legislation is applicable, would imply to record DTAs (to recognise government liabilities) before the tax credits for specific amounts are generated. (Please note that the conversion of DTAs into tax credits is done in case of losses, liquidation or in case the DTAs were not naturally offset after a number of years, and always at the time the tax declaration is submitted).

In addition, from a practical point of view, a detailed analysis of this alternative recording has pointed out the following problems:

1) Uncertainty on the initial stock

First of all, there is uncertainty on the total stock of DTAs and, consequently, on the total stock of DTAs to which the changes in legislations could apply. Even though financial corporations provide an estimation of such stock of DTAs in their annual financial statements, this stock is not recognized by the tax authorities. The recognition by government (if any) would be undertaken at different moments in time and most probably, (when considering the sum) by different amounts to those shown in the balance sheets of corporations.

Recording as expenditure in one year the whole stock reported by corporations in their financial statements may have as a consequence that this initial stock imputed would be wrong.

2) Continuous follow-up and revisions of the stock needed

For the calculation of the stock of DTAs, a number of assumptions are needed. The stock will depend on the tax rates, on the rules in place to determine the tax base and on the likelihood and estimation of future profitability, amongst other. As these may vary from one year to the other, the stock of DTAs would be variable and possibly subject to continuous changes, leading to revisions in the accounts.

For instance, in case of a decrease in the tax rate, the stock of DTAs will be reduced as compared to the previous year. In case expenditure had been recorded, a decrease in the stock would imply to make a correction either by recording revenue or other volume changes.

Also, the stock should be corrected in case the estimations on future profitability turned out not to be correct.

Finally, if some shares of the corporation would be sold to a non-resident unit, the stock of DTAs would need to be decreased and corrected. The complete stock would need to be excluded in case 100% of the shares were sold.

3) Continuous imputations will be needed in the accounts

If the full stock of DTAs is recorded as expenditure at inception, imputations would be needed in the accounts in all the following years in order to avoid a double impact on the deficit.

This approach seems difficult to apply in practice and, if applicable, could lead to a number of problems concerning data availability, data quality and systematic sizeable revisions in the accounts. It is a key principle in national accounts that, in order to record amounts, full certainty (or a very reliable estimation) would be needed. The recording proposed by Eurostat, while compliant with ESA2010, would minimise this problem and would reduce revisions as compared to the alternative approach.

5. Conclusions

This guidance note clarifies the treatment on DTAs in national accounts and proposes guidance on the recording of tax credits related to DTAs under ESA2010. The text is based on actual legislation recently enacted in a few Member States; however the guidance is of a general nature and a wide range of cases with different features are intended to be covered as well.

The guidance proposed in this note is based on an analysis of ESA2010 and offers practical approaches for the implementation. A flowchart summarising the recording of the different tax credits related to DTAs, as elaborated on in this note, is provided in the annex to this document.

Based on the examination of the various DTAs issues, it is concluded that DTAs are not to be recorded in national accounts unless they give rise to a claim with the features of a tax credit, which is to be recorded in line with the provisions of ESA2010 (paragraphs 20.167-20.168 and 4.81).

The note also provides a detailed analysis for a specific case of tax credits originated from the conversion of DTAs due to specific changes in legislation enacted in some MS, which need further consideration. As these tax credits would be payable and in line with the provisions for payable tax credits in ESA2010, Eurostat's proposal foresees the recording of government expenditure under other capital transfers (D.99) every time an amount of DTAs is converted into a tax credit, at the time the tax authorities recognise the liability.

For such cases, Eurostat will clarify on a case by case basis what is to be reported in the April and October EDP Notifications at T+1, as there might be different possibilities linked to the two methods for the recording of taxes in national accounts (time adjusted cash method and methods based on assessments and declarations).

Eurostat will closely follow future legal developments referring to DTAs in all Member States and bilaterally discuss all national accounts recording issues on the basis of the guidance proposed in this note.

It is to be underlined that other national accounts rules (such as those for capital injections) might also be applicable in cases of legislations concerning DTAs with features different from the ones examined and described in this guidance note.

Eurostat Directorate D, Government Finance Statistics (GFS) and quality

(Lourdes Prado Ureña, Unit D2 Excessive Deficit Procedure 1)

ANNEX
FLOWCHART FOR THE RECORDING OF TAX CREDITS RELATED TO DTAs