



TECHNICAL
DEPARTMENT

THE EFFECTIVE TAX RATE IN CONSOLIDATED
INTERIM FINANCIAL STATEMENTS

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THE EFFECTIVE TAX RATE IN CONSOLIDATED INTERIM FINANCIAL STATEMENTS

In consolidated interim financial statements under IFRS, reference is usually made to the effective tax rate. But what is it exactly, what purpose does it serve and how should it be used? With the 30 June closings fast approaching, we thought it would be useful to set out the applicable requirements and how to apply them in practice.

REQUIREMENTS OF THE STANDARD

Paragraph 30.c of IAS 34 – Interim Financial Reporting provides that « *income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.* » IAS 34 thus introduces a difference in the recognition of the tax expense in interim financial statements compared with the full year. In the annual closing, a comprehensive calculation is used based on restating income for tax purposes and recognising temporary differences when calculating the actual and deferred tax amounts, which are then justified in the tax “proof” schedule. Interim calculations, however, need be based simply on the « *best estimate of the weighted average annual income tax rate expected for the full financial year.* »

Whilst it may appear easy to forego the comprehensive collection of data and the tax “proof” and replace it with an interim tax rate, estimating the “*weighted average annual income tax rate expected for the full financial year*” (known as the “effective tax rate”) may prove complex in practice.

Paragraphs B12 to B22 of IAS 34 give illustrative examples of how to estimate the interim tax rate based on the following principles:

PRINCIPLE	IN PRACTICE
The interim tax expense should be recognised by applying the tax rate expected for the full financial year to the first-half income before tax (§B12).	Full-year results forecasts will be required. The effective tax rate is calculated based on the entity's budget and forecast data.
To the extent possible, determine an average annual effective tax rate for each tax jurisdiction and apply it to the first-half income before tax for the jurisdiction concerned (§B14).	Actual and forecast results taking into account each tax jurisdiction and modelled on the same scope should preferably be available. In a tax group, the effective tax rate is calculated at the level of the consolidated tax group rather than for each member of the group.
Timing differences between accounting and tax years, tax credits and particular income tax rates applied to specific transactions should be taken into account in calculating the effective tax rate (§B17 and B19).	It may be necessary to calculate different effective tax rates: a specific rate for particular transactions in any given period and a “normal” rate applicable to more standard transactions.
The benefits of any carry-backs should be reflected in the period during which the loss that may be carried back arises (§B20). The probability of being able to utilise losses should be taken into account in calculating the effective tax rate (§B21).	Forecasts of the use of losses should be considered in determining the effective tax rate and incorporated into the “normal” or specific tax rates as appropriate.

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ILLUSTRATIVE EXAMPLE

By way of illustration, take the example of the following group:

- A parent company (P) subject to tax at 20% and with nil income for the year.
- A foreign subsidiary (F) subject to tax at 20% up to income of €20,000 and at 30% above that figure, and which generates income in the second-half year of €5,000 taxed at a reduced rate of 10%. For this subsidiary, it will be necessary to calculate both a normal and a reduced effective tax rate.
- A member of the tax group (TGM) subject to tax at 40%, which receives tax credits and is forecast to use losses for which no deferred tax asset had been recognised in prior years. It is assumed that the expenses giving rise to the tax credits are incurred in a straight-line fashion throughout the year.
- A subsidiary with income (I) subject to tax at 40%, which is forecast to utilise deferred tax assets recognised in prior years.
- A loss-making subsidiary (L) subject to tax at 30%, which sets its loss for the year against profits from the prior year.

1. FORECAST DATA

Calculation of the effective tax rates based on forecast data for the year gives the following results:

Budget data	Calculation	P	F	TGM	I	L	Total
Normal tax rate	TIN	20%	20% up to 20000 then 30%	40%	40%	30%	
Reduced tax rate	TIR		10%				
Budgeted income before tax	RCAI	0	45 000	42 000	40 000	-10 000	117 000
Particular transactions budgeted	EP	0	5 000	-8 000	-10 000	7 000	-6 000
Tax credit	EP1			2 000			2 000
Transaction at reduced rate	EP2		5 000				5 000
Change in accumulated losses	EP3			-10 000	-10 000	10 000	-10 000
Carry-back	EP4					-3 000	-3 000
Budgeted taxable income at normal rate	RF1=RCAI-EP1-EP2+EP3	0	40 000	30 000	30 000	0	100 000
Budgeted actual tax charge at normal rate	ISN=RF1*TIN	0	-10 000	-12 000	-12 000	0	-34 000
Budgeted taxable income at reduced rate	EP2	0	5 000	0	0	0	5 000
Budgeted actual tax charge at reduced rate	ISR=EP2*TIR	0	-500	0	0	0	-500
Change in deferred tax assets	IDA				-4000		-4000
Budgeted actual + deferred tax charge	IS=EP1+ISN+ISR+IDA	0	-10 500	-10 000	-16 000	3 000	-33 500
Forecast annual effective tax rate (ETR)	ETR=IS/RCAI	#DIV/0!	-23%	-24%	-40%	-30%	-29%
Forecast annual normal ETR	ETRN=(ISN+IDA)/(RCAI-EP2)		-25%				-34%
Forecast annual reduced ETR	ETRR=ISR/EP2		-10%				-10%

As the TGM had not previously recognised a deferred tax asset, its tax charge is reduced to reflect the losses used. Its effective tax rate is therefore lower than I's rate, which had deferred tax assets brought forward from last year and which are reversed during the year as the losses are taken into account.

P's effective tax rate cannot be calculated because it has no income; the enacted tax rate is therefore used as its effective tax rate.

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2. APPLICATION OF EFFECTIVE INCOME TAX RATE TO THE FIRST HALF-YEAR PERIOD

Applied to the interim results, the first-half tax charge is as follows for each entity and for the group:

H1 half-year data	Calculation	P	F	TGM	I	L	Total
Normal tax rate	TIN	20%	20% up to 20000 then 30%	40%	40%	30%	
Reduced tax rate	TIR		10%				
Half-year income before tax	RCAI	10 000	20 000	21 000	20 000	-6 000	65 000
Particular transactions in the period	EP	0	0	1 000	0	-1 800	-800
Tax credit	EP1			1 000			1 000
Transaction at reduced rate	EP2						0
Change in accumulated losses	EP3						0
Carry-back	EP4					-1 800	-1 800
Actual + deferred tax charge at effective tax rate (ETR)	$=(RCAI-EP2)*ETR_N + EP2*ETR_R$	-2 000	-5 000	-5 000	-8 000	1 800	-18 200
Forecast annual ETR	ETR	20%	-23%	-24%	-40%	-30%	-28%
Forecast annual normal ETR	ETR_N		-25%				-34%
Forecast annual reduced ETR	ETR_R		-10%				-10%

Provided that the forecasts for the utilisation of losses have not changed, there is no need in the interim financial statements to revise the deferred tax calculations, nor is it necessary to distinguish between the current and the deferred tax charges as both are taken into account in the effective tax rate.

P's tax charge is calculated by applying the enacted tax rate to its income before tax. Thus, although P's forecast tax charge for the full year is nil, its interim tax charge would not be nil if it posts positive or negative income before tax for the period. The philosophy underlying the effective tax rate method is to achieve consistency in the tax charge by using the effective tax rate, rather than a linear projection of the forecast full-year tax charge.

In F, the transaction subject to the reduced tax rate did not take place in the first half year. Accordingly, the normal annual effective tax rate should be applied to F's income before tax at the interim stage.

For the same reasons of consistency sought in the effective tax rate, a carry-back tax credit to reflect the loss posted by L in the first half year should be recognised, even if the tax credit does not represent a linear projection of the annual forecast figure.

If the group had applied an average group tax rate, rather than the more detailed calculation by tax jurisdiction, it would have recognised a tax charge of €22,100 (€65,000 x 34%) rather than €18,200, because P's income would have been subject to tax at 34% rather than at 20%.

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3. APPLICATION OF EFFECTIVE INCOME TAX RATE TO THE SECOND HALF-YEAR PERIOD

On a half-year basis, the tax charge for the second half of the year would be as follows, by entity and for the group:

H2 half-year data	Calculation	P	F	TGM	I	L	Total
Normal tax rate	TIN	20%	20% up to 20000 then 30%	40%	40%	30%	
Reduced tax rate	TIR		10%				
Half-year income before tax	RCAI	-10 000	25 000	21 000	20 000	-4 000	52 000
Particular transactions in the period	EP	0	5 000	1 000	0	-1 200	4 800
Tax credit	EP1			1 000			1 000
Transaction at reduced rate	EP2		5 000				5 000
Change in accumulated losses	EP3						0
Carry-back	EP4					-1 200	-1 200
Actual + deferred tax charge at effective tax rate (ETR)	$=(RCAI-EP2)*ETR_N + EP2*ETR_R$	2 000	-5 500	-5 000	-8 000	1 200	-15 300
Forecast annual ETR	ETR	20%	-23%	-24%	-40%	-30%	-29%
Forecast annual normal ETR	ETR _N		-25%				-34%
Forecast annual reduced ETR	ETR _R		-10%				-10%

As in H1, P's tax charge is calculated by applying the enacted tax rate to its income before tax for the period. Although P posted a loss, a tax credit must be shown in the half-year accounts, indicating that the tax charge in the first half has been reversed in the second half.

As the transaction subject to the reduced tax rate took place in the second half, F's income before tax is split into a "normal" part, taxed at the "normal" effective tax rate, and the income from the reduced-rate transaction, taxed at the corresponding reduced effective tax rate.

For the same reasons of consistency sought in the effective tax rate, a carry-back tax credit must be recognised for L's loss posted in the second half, even though the tax credit does not represent a linear projection of the annual forecast figure.

In conclusion, application of the effective tax rate requires educating the public, since the interim tax charge (or credit!) reflects neither a tax calculation as at that date nor a linear reflection of the annual tax charge. Although the income before tax for the half year may be negative, there may well be a tax credit for the period if a charge is forecast for the year end.

A philosophy based on the consistent application of the same tax rate for all periods of the year is not intuitive for those who reason in figures.

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