



CHARTERED CERTIFIED ACCOUNTANTS

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Deferred Tax

As accountants, we are all familiar with accounting for taxes. A UK resident company is chargeable to corporate tax on its profits wherever they arise, other than dividends received from other UK companies and this liability is accounted for as a current liability – very straight forward.

The complexities seem to arise when deferred tax appears on the scene and with more and more companies taking advantage of HMRC's £50,000 Annual Investment Allowance, deferred tax issues may become a material component of a company's financial statements.

This article looks at the concept of deferred tax and the inherent complexities and addresses some of the more common concerns practitioners often have with deferred tax.

Some view deferred tax as a meaningless accounting exercise and in some cases preparer's of financial statements often ignore the concept completely. However, by ignoring the effects of deferred tax, preparer's may be in breach of FRS 19 'Deferred Tax' and the recognition of deferred tax assets and / or deferred tax liabilities.

Timing differences

FRS 19 provides the definition of timing differences as:

'Differences between an entity's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in financial statements. Timing differences originate in one period and are capable of reversal in one or more subsequent periods.'

An example of the above could be where a company accrues income in 2008 which is subsequently taxable in 2009 on receipt. Conversely, a company could make a provision for restructuring costs in 2009 which will attract tax relief when the expenditure has been incurred in 2010.

It follows, therefore, that a timing difference is said to originate when a transaction is accounted for in the financial statements of an entity, but has not yet been accounted for in the tax computation. Timing differences are said to reverse when the transaction is accounted for in the tax computation or financial statements, whichever the case may be.

There are instances where timing differences arise and then reverse, but are never, in fact, reflected in the tax computation. Such an example could be a provision for bad debts done in, say, 2008 and written back in 2009 as the provision has been deemed unnecessary. Admittedly, these cases (especially for clients in the SME sector) are quite rare.

Other examples of timing differences to illustrate the concept are:

- Accelerated capital allowances in respect of fixed assets.
- Accrued pension liabilities in the financial statements which are subsequently granted tax relief when they are paid at a later date.
- Assets subject to revaluation, where the revaluation gain only crystallises for tax purposes when the asset is sold.
- Intra-group profits in stock which are unrealised at group level, but are reversed on consolidation.

Deferred tax assets

In practice, the most common transaction giving rise to a deferred tax asset are unutilised tax losses. In today's 'climate' these are particularly common. A deferred tax asset is recognised in respect of unutilised tax losses because less tax will be payable in the future as the losses can be offset against future profits.

Care must be taken in recognising a deferred tax asset. A deferred tax asset should only be recognised when it is regarded that it will be recoverable. Such an asset can only therefore be recognised as a deferred tax asset where it is more likely than not that there will be sufficient taxable profits generated by the entity in future periods from which the future reversal of the underlying timing differences can be deducted.

The term 'more likely than not' is not defined in FRS 19 but FRS 12 at paragraph 23 suggests that it should be taken to mean that *"the probability that the event will occur is greater than the probability that it will not"*. US GAAP at SFAS 109 'Income Taxes' suggests that something is 'more likely than not' if its likelihood of occurring is more than 50%.

For example, if a company has tax losses in 2008, but the directors consider that 2009 will yield profits, for example because they have won a lucrative contract, then the directors can recognise a deferred tax asset.

Conversely, if a company is producing losses year on year then, not only will doubt be cast on the company's going concern, but the chances are that there will not be suitable taxable profits generated in the future and as a consequence, a deferred tax asset should not be recognised. However, the mere existence of unrelieved tax losses should be taken as evidence that there will

not be suitable future profits generated to offset the deferred tax asset and evidence to the contrary would normally be identifying the cause of the unrelieved tax losses and the fact that the company has previously been profitable and past losses have also been able to be utilised against future profits.

Deferred tax liabilities

The most frequent transactions giving rise to a deferred tax liability in the financial statements – especially those of SMEs – is accelerated capital allowances.

Figure 1

Company A purchases an item of plant for £45,000. The company's year-end is 31 July 2009 and it has been trading for a full twelve months. The company's accounting policy in respect of plant and machinery is to write the cost of the asset off over the useful economic life of the plant using depreciated historic cost with a full year's depreciation charge in the year of acquisition and no depreciation in the year of disposal. In respect of the new item purchased, this machine is deemed to have a useful economic life of 5 years with no residual value. The company has also taken advantage of HMRC 'Annual Investment Allowance' and pays tax at 21%.

In Company A's financial statements, the new item of plant will have a carrying value of (£45,000 – (£45,000 / 5) £9,000) = £36,000. The company has taken advantage of HMRC's AIA and has chosen to write off the whole of this cost off in the 2009 tax computation. This results in the item of plant having a value of £nil for tax purposes.

The fact that HMRC have granted AIA against the full cost of the asset in 2009 has resulted in a disparity between the value of the asset for tax purposes and the book value of the same asset. As a result, the company will pay more tax in future periods, representing an obligation for the entity to refund a temporary cash flow advantage obtained by claiming the AIA. The deferred tax liability is calculated as follows:

Net book value of plant and machinery	£36,000
Tax written down value	<u>£ nil</u>
Difference	£36,000

$$\text{Deferred tax liability} = £36,000 \times 21\% = \mathbf{£7,560}$$

Industrial buildings allowance

Prior to the Chancellor's announcement to change the IBA regime, the original rules on factories, warehouses, hotels and commercial buildings in enterprise zones meant that IBA's did not need to be repaid if they were retained in the business for a qualifying holding period of 25 years following the date of purchase. After the 25 year period had elapsed, then no balancing charge arose even if an industrial building was subsequently sold for more than its tax written down value.

Under the old rules, deferred tax which was attributable to capital allowances of this type should be recognised until the conditions for retaining IBAs have been met. Once the conditions were met and there was no possibility that the Revenue could claw back the allowances, then the differences

became permanent and any deferred tax liability previously recognised was reversed – usually at the end of year 25.

In the Chancellor's 2007 budget, he announced two fundamental changes:

- Balancing adjustment provisions and those that recalculate writing-down allowances for purchasers were withdrawn for balancing events occurring on or after 21 March 2007.
- IBAs were to be phased out gradually from 2008/9 onwards by reducing the allowances from 4% to 3% to 2% to 1% with allowances being eliminated thereafter.

The Chancellor's budget in 2007 resulted in the fact that balancing adjustments will no longer arise and as a result, any deferred tax liability would never be reclaimed by HMRC. The removal of the balancing adjustment (and the qualifying period for retaining allowances) means that allowances received prior to the removal will become a permanent difference. As a consequence, no deferred tax liability should be made and any such deferred tax should be released. During the phasing out of IBAs, the allowance should be treated as a permanent difference as it arises.

Government grants

Accounting for government grants is accounted for under the provisions laid down in SSAP 4 '*Accounting for government grants*'.

Non-taxable revenue-based grants do not have any deferred tax issues attached to them because the amortised credit to the profit and loss account is a permanent difference. This also applies to non-taxable capital-based grants, except to the extent that accelerated capital allowances apply.

Taxable revenue-based grants that are taxed when the company receives the grant, but recognised in the profit and loss account over a period of time for financial reporting purposes will give rise to a timing difference on which a deferred tax asset may be required to be recognised on the unamortised balance carried forward to future periods. This is because the deferred tax asset will be recoverable in future accounting periods when the deferred credit unwinds.

Where the grant is received in respect of a fixed asset then the nature of the deferred tax will depend on both the accounting treatment and tax treatment of the grant. FRS 15 allows the grant to be deducted from the cost of fixed assets. It is worth mentioning at this point that companies are prohibited from deducting government grants from the purchase/production price of assets under the Companies Act 2006 (paragraphs 17 and 27 Schedule 1 (SI 2008/410) and FRSSE (April 2008) at paragraph 6.54) despite SSAP 4 deeming this treatment acceptable. The standard does refer to companies only that are governed by the accounting and financial reporting requirements of UK companies legislation. This suggests that an unincorporated business, however, can deduct the grant from the cost of the asset (IAS 20 – the international equivalent of SSAP 4 – also permits this treatment).

If the grant is deducted from the cost of the asset then the deferred tax implications are simply accelerated capital allowances. If the grant is treated as deferred income for financial reporting

purposes but deducted from the cost of the asset for tax calculation purposes, then a deferred tax asset will arise on the unamortised grant which will then be offset against the deferred tax liability arising on the accelerated capital allowances.

Discounting deferred tax

Undoubtedly, the discounting of deferred tax assets and liabilities is quite rare in the UK – particularly amongst those who prepare financial statements for SME clients. However, FRS 19 does allow deferred tax assets and liabilities to be discounted to present day monetary values and this is where there are notable differences between FRS 19 and its international equivalent, IAS 12, which specifically prohibits the discounting of deferred tax assets and liabilities.

This article has provided a brief ‘refresher’ of deferred tax and the considerations practitioners and preparer’s of financial statements for companies should address when determining if there are material amounts of deferred tax that need to be provided in a set of financial statements in order that financial statements will give a true and fair view.

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