

CHAPTER 14

Taxation in company accounts

14.1 Introduction

The main purpose of this chapter is to explain the corporation tax system and the accounting treatment of deferred tax.

Objectives

By the end of the chapter, you should be able to:

- discuss the theoretical background to corporation tax systems;
- critically discuss tax avoidance and tax evasion;
- prepare deferred tax calculations;
- critically discuss deferred tax provisions.

14.2 Corporation tax

Limited companies, and indeed all corporate bodies, are treated for tax purposes as being legally separate from their proprietors. Thus, a limited company is itself liable to pay tax on its profits. This tax is known as **corporation tax**. The shareholders are only accountable for tax on the income they receive by way of any dividends distributed by the company. If the shareholder is an individual, then **income tax** becomes due on their dividend income received.

This is in contrast to the position in a partnership, where each partner is individually liable for the tax on that share of the pre-tax profit that has been allocated. A partner is taxed on the profit and not simply on drawings. Note that it is different from the treatment of an employee who is charged tax on the amount of salary that is paid.

In this chapter we consider the different types of company taxation and their accounting treatment. The International Accounting Standard that applies specifically to taxation is IAS 12 *Income Taxes*. The standard was last modified radically in 1996, further modified in part by IAS 10 in 1999 and revised by the IASB in 2000. Those UK unquoted companies that choose not to follow international standards will follow FRS 16 *Current Tax* and FRS 19 *Deferred Tax*.

Corporation tax is calculated under rules set by Parliament each year in the Finance Act. The Finance Act may alter the existing rules; it also sets the rate of tax payable. Because of this annual review of the rules, circumstances may change year by year, which makes comparability difficult and forecasting uncertain.

The reason for the need to adjust accounting profits for tax purposes is that although the tax payable is based on the accounting profits as disclosed in the profit and loss account, the tax rules may differ from the accounting rules which apply prudence to income recognition. For example, the tax rules may not accept that all the expenses which are recognised by the accountant under the IASB's *Framework for the Preparation and Presentation of Financial Statements* and the IAS 1 *Presentation of Financial Statements* accrual concept are deductible when arriving at the taxable profit. An example of this might be a bonus, payable to an employee (based on profits), which is payable in arrear but which is deducted from accounting profit as an accrual under IAS 1. This expense is only allowed in calculating taxable profit on a cash basis when it is paid in order to ensure that one taxpayer does not reduce his potential tax liability before another becomes liable to tax on the income received.

The accounting profit may therefore be lower or higher than the taxable profit. For example, the Companies Acts require that the formation expenses of a company, which are the costs of establishing it on incorporation, must be written off in its first accounting period; the rules of corporation tax, however, state that these are a capital expense and cannot be deducted from the profit for tax purposes. This means that more tax will be assessed as payable than one would assume from an inspection of the published profit and loss account.

Similarly, although most businesses would consider that entertaining customers and other business associates was a normal commercial trading expense, it is not allowed as a deduction for tax purposes.

A more complicated situation arises in the case of depreciation. Because the directors have the choice of method of depreciation to use, the legislators have decided to require all companies to use the same method when calculating taxable profits. If one thinks about this, then it would seem to be the equitable practice. Each company is allowed to deduct a uniform percentage from its profits in respect of the depreciation that has arisen from the wear and tear and diminution in value of fixed assets.

The substituted depreciation that the tax rules allow is known as a **capital allowance**. The capital allowance is calculated in the same way as depreciation; the only difference is that the rates are those set out in the Finance Acts. At the time of writing, some commercial fixed assets (excluding land and buildings) qualify for a capital allowance far in excess of depreciation in the accounts. There are restricted allowances, called industrial buildings allowances, for certain categories of buildings used in manufacturing. Just as the depreciation that is charged by the company under accrual accounting is substituted by a capital allowance, profits or losses arising on the sale of fixed assets are not used for tax purposes.

14.3 Corporation tax systems – the theoretical background

It might be useful to explain that there are three possible systems of company taxation (classical, imputation and partial imputation).¹ These systems differ solely in their tax treatment of the relationship between the limited company and those shareholders who have invested in it.

14.3.1 The classical system

In the classical system, a company pays tax on its profits, and then the shareholders suffer a second and separate tax liability when their share of the profits is distributed to them. In effect, the dividend income of the shareholder is regarded as a second and separate source of income from that of the profits of the company. The payment of a dividend creates an

additional tax liability which falls directly on the shareholders. It could be argued that this double taxation is inequitable when compared to the taxation system on unincorporated bodies where the rate of taxation suffered overall remains the same whether or not profits are withdrawn from the business. It is suggested that this classical system discourages the distribution of profits to shareholders since the second tranche of taxation (the tax on dividend income of the shareholders) only becomes payable on payment of the dividend, although some argue that the effect of the burden of double taxation on the economy is less serious than it might seem.² Austria, Belgium, Denmark, the Netherlands and Sweden have classical systems.

14.3.2 The imputation system

In an imputation system, the dividend is regarded merely as a flow of the profits on each sale to the individual shareholders, as there is considered to be merely one source of income which could either be retained in the company or distributed to the shareholders. It is certainly correct that the payment of a dividend results from the flow of monies into the company from trading profits, and that the choice between retaining profits to fund future growth and the payment of a dividend to investing shareholders is merely a strategic choice unrelated to a view as to the nature of taxable profits. In an imputation system the total of the tax paid by the company and by the shareholder is unaffected by the payment of dividends and the tax paid by the company is treated as if it were also a payment of the individual shareholders' liabilities on dividends received. It is this principle of the flow of net profits from particular sales to individual shareholders that has justified the repayment of tax to shareholders with low incomes or to non-taxable shareholders of tax paid by the limited company, even though that tax credit has represented a reduction in the overall tax revenue of the state because the tax credit repaid also represented a payment of the company's own corporation tax liability. If the dividend had not been distributed to such a low-income or non-taxable shareholder who was entitled to repayment, the tax revenue collected would have been higher overall. France and Germany have such an imputation system. The UK modified its imputation system in 1999, so that a low-income or non-taxable shareholder (such as a charity) could no longer recover any tax credit.

14.3.3 The partial imputation system

In a partial imputation system only part of the underlying corporation tax paid is treated as a tax credit.

14.3.4 Common basis

All three systems are based on the taxation of profits earned as shown under the same basic principles used in the preparation of financial statements.

14.4 Corporation tax systems – avoidance and evasion

Governments have to follow the same basic principles of management as individuals. To spend money, there has to be a source of funds. The sources of funds are borrowing and income. With governments, the source of income is taxation. As with individuals, there is a practical limit as to how much they can borrow; to spend for the benefit of the populace, taxation has to be collected. In a democracy, the tax system is set up to ensure

that the more prosperous tend to pay a greater proportion of their income in order to fund the needs of the poorer; this is called a progressive system. As Franklin Roosevelt, the American politician, stated, ‘taxes, after all, are the dues that we pay for the privileges of membership in an organised society’.³ Corporation tax on company profits represents 10% of the taxation collected by HM Revenue & Customs in the UK from taxes on income and wages.

It appears to be a general rule that taxpayers do not enjoy paying taxation (despite the fact that they may well understand the theory underpinning the collection of taxation). This fact of human nature applies just as much to company directors handling company resources as it does to individuals. Every extra pound paid in taxation by a company reduces the resources available for retention for funding future growth.

14.4.1 Tax evasion

Politicians often complain about tax evasion. Evasion is the illegal (and immoral) manipulation of business affairs to escape taxation. An example could be the directors of a family-owned company taking cash sales for their own expenditure. Another example might be the payment of a low salary (below the threshold of income tax) to a family member not working in the company, thus reducing profits in an attempt to reduce corporation tax. It is easy to understand the illegality and immorality of such practices. Increasingly the distinction between tax avoidance and tax evasion has been blurred.⁴ When politicians complain of tax evasion, they tend not to distinguish between evasion and avoidance.

14.4.2 Tax avoidance

Tax avoidance could initially be defined as a manipulation of one’s affairs, within the law, so as to reduce liability; indeed, as it is legal, it can be argued that it is not immoral. There is a well established tradition within the UK that ‘every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be’.⁵

Indeed the government deliberately sets up special provisions to reduce taxes in order to encourage certain behaviours. The more that employers and employees save for employee retirement, the less social security benefits will be paid out in the future. Thus both companies and individuals obtain full relief against taxation for pension contributions. Another example might be increased tax depreciation (capital allowances) on capital investment, in order to increase industrial investment and improve productivity within the UK economy.

The use of such provisions, as intended by the legislators, is not criticised by anyone, and might better be termed ‘tax planning’. The problem area lies between the proper use of such tax planning, and illegal activities. This ‘grey area’ could best be called ‘tax avoidance’.

The Institute for Fiscal Studies has stated:

We think it is impossible to define the expression ‘tax avoidance’ in any truly satisfactory manner. People routinely alter their behaviour to reduce or defer their taxation liabilities. In doing so, commentators regard some actions as legitimate tax planning and others as tax avoidance. We have regarded tax avoidance (in contra-indication to legitimate . . . tax planning) as action taken to reduce or defer tax liabilities in a way Parliament plainly did not intend. . . .⁶

The law tends to define tax avoidance as an artificial element in the manipulation of one’s affairs, within the law, so as to reduce liability.⁷

14.4.3 The problem of distinguishing between avoidance and evasion

The problem lies in distinguishing clearly between legal avoidance and illegal evasion. It can be difficult for accountants to walk the careful line between helping clients (in tax avoidance) and colluding with them against HM Revenue and Customs.⁸

When clients seek advice, accountants have to be careful to ensure that they have integrity in all professional and business relationships. Integrity implies not merely honesty but fair dealing and truthfulness. ‘In all dealings relating to the tax authorities, a member must act honestly and do nothing that might mislead the authorities.’⁹

As an example to illustrate the problems that could arise, a client company has carried out a transaction to avoid taxation, but failed to minute the details as discussed at a directors’ meeting. If the accountant were to correct this act of omission in arrears, this would be a move from tax avoidance towards tax evasion. Another example of such a move from tax avoidance to tax evasion might be where an accountant in informing the Inland Revenue of a tax-avoiding transaction fails to detail aspects of the transaction which might show it in a disadvantageous light.

Companies can move profit centres from high-taxation countries to low-taxation countries by setting up subsidiaries therein. These areas, known in extreme cases as tax havens, are disliked by governments.

Tax havens are countries with very low or nil tax rates on some or all forms of income. They could be classified into two groups:

- 1 the zero rate and low tax havens,
- 2 the tax haven that imposes tax at normal rates but grants preferential treatment to certain activities.

Group 1 countries tend to be small economies that make up for the absence of taxation on profits and earnings by the use of taxes on sales. This group of tax havens is disliked by governments of larger economies. Gibraltar¹⁰ took the European Commission to court over its ruling that it should not run a tax regime more favourable than that in the UK, and succeeded in its claim in the Court of the First Instance. Both Spain and the European Commission are appealing against this decision on numerous points of law, and it is clear that the policies of Gibraltar remain under attack. In February 2009 the European Union proposed an attack on the secrecy of banking in such tax havens.

Ireland is an example of the second group, with its manufacturing incentives under which a special low rate of tax applies to manufacturing operations located there.

The use of zero rate and low-tax havens could be considered a form of tax avoidance, although sometimes they are used by tax evaders for their lack of regulation.

Companies can make use of government approved investment schemes to reduce (or ‘shelter’) their tax liability, although there have recently been examples of improper (or abusive) schemes where short-term transactions were taken solely for taxation purposes. On 26 August 2005 the US Justice Department obtained an admission by and penalties of \$456 million from the USA KPMG accounting firm over such a scheme.¹¹ The agreement reached with the Justice Department requires permanent restrictions on KPMG tax practice in the USA.¹² A few partners in the firm had set up a scheme for clients and misled the US Internal Revenue Service. Whilst the schemes may or may not have been legal, the misleading information certainly resulted in tax evasion. The dangers of starting to act improperly were illustrated in an e-mail obtained by the Senate Committee in which a senior KPMG tax adviser told his colleagues that even if regulators took action against their sales strategies for a tax shelter known as OPIS the potential profits from these deals would still greatly exceed the possible court penalties.¹³

14.5 Corporation tax – the system from 6 April 1999

A company pays corporation tax on its income. When that company pays a dividend to its shareholders it is distributing some of its taxed income among the proprietors. In an imputation system the tax paid by the company is ‘imputed’ to the shareholders who therefore receive a dividend which has already been taxed.

This means that, from the paying company’s point of view, the concept of gross dividends does not exist. From the paying company’s point of view, the amount of dividend paid shown in the profit and loss account will equal the cash that the company will have paid.

However, from the shareholder’s point of view, the cash received from the company is treated as a net payment after deduction of tax. The shareholders will have received, with the cash dividend, a note of a tax credit, which is regarded as equal to basic rate income tax on the total of the dividend plus the tax credit. For example:

	£
Dividend being the cash paid by the company and disclosed in the company’s profit and loss account	400.00
Imputed tax credit of 1/9 of dividend paid (being the rate from 6 April 1999)	<u>44.44</u>
Gross dividend	<u><u>444.44</u></u>

The imputed tax credit calculation (as shown above) has been based on a basic tax rate of 10% for dividends paid, being the basic rate of income tax on dividend income from 6 April 1999. This means that an individual shareholder who only pays basic rate income tax has no further liability in that the assumption is that the basic rate tax has been paid by the company. A non-taxpayer cannot obtain a repayment of tax.

Although a company pays corporation tax on its income, when that company pays a dividend to its shareholders it is still considered to be distributing some of its taxed income among the proprietors. In this system the tax payable by the company is ‘imputed’ to the shareholders who therefore receive a dividend which has already been taxed. This means that, from the paying company’s point of view, the concept of ‘gross’ dividends does not exist. From the paying company’s point of view, the amount of dividends paid shown in the profit and loss account will equal the cash that the company will have paid to the shareholders.

The essential point is that the dividend paying company makes absolutely no deduction from the dividend **nor is any payment made by the company to the HM Revenue and Customs**. The addition of 1/9 of the dividend paid as an imputed tax credit is purely nominal. A tax credit of 1/9 of the dividend will be deemed to be attached to that dividend (in effect an income tax rate of 10%). That credit is notional in that no payment of the 10% will be made to the HM Revenue and Customs.¹⁴ The payment of taxation is not associated with dividends.

Large companies (those with taxable profits of over £1,500,000) pay their corporation tax liability in quarterly instalments starting within the year of account, rather than paying their corporation tax liability nine months thereafter. The payment of taxation is not associated with the payment of dividends. Smaller companies pay their corporation tax nine months after the year-end.

It has been argued that the imputation system has encouraged the payment of dividends, and consequently discourages firms from reinvesting earnings. Since 1985, both investment and the ratio of dividend payments to GDP had soared in Britain relative to the USA, but it is not obvious that such trends are largely attributable to tax policy.¹⁵ It has been suggested that the corporation tax system (from 5 April 1999) would tend to discourage companies from paying ‘excessive’ dividends because the major pressure for dividends has

come in the past from pension fund investors who previously could reclaim the tax paid, and that the decrease in cash flow to the company caused by payment of quarterly corporation tax payments might tend to assist company directors in resisting dividend increases to compensate for this loss.

14.5.1 Advance corporation tax – the system until 5 April 1999

A company pays corporation tax on its income. Statute previously required that when a company paid a dividend it was required to make a payment to the Inland Revenue equal to the total tax credit associated with that dividend. This payment was called ‘advance corporation tax’ (ACT) because it was a payment on account of the corporation’s tax liability that would be paid on the profits of the accounting period. When the company eventually made its payment of the corporation tax liability, it was allowed to reduce the amount paid by the amount already paid as ACT. The net amount of corporation tax that was paid after offsetting the ACT was known as **mainstream corporation tax**. The total amount of corporation tax was no greater than that assessed on the taxable profits of the company; there was merely a change in the timing of the amount of tax paid by paying it in two parts – the ACT element and the mainstream corporation tax element.

What would have been the position if the company had declared a dividend but had not paid it out to the shareholders by the date of the statement of financial position? In such a case the ACT could only have been offset against the corporation tax in the accounting period during which the tax was actually paid. The offset of ACT against corporation tax was effectively restricted to the ACT rate multiplied by the company’s profits chargeable to corporation tax. A further refinement was that for offset purposes the ACT rate was multiplied by the UK profit – this does not include profits generated overseas. Should a distribution have exceeded the chargeable profits for that period, then the ACT could not be recovered immediately. Under tax law, such unrelieved ACT could be carried back against corporation tax payments in the preceding six years or forward against future liabilities indefinitely.

Unrecovered ACT would have appeared in the statement of financial position as an asset. At this point the accountant must have considered the prudence concept. In order for it to have remained as such on the statement of financial position it must have been (a) reasonably certain and (b) foreseeable that it would be recoverable at a future date. If the ACT could be reasonably seen as recoverable then it should have been shown on the statement of financial position as a deferred asset. If, for any reason, it seemed improbable that there would be sufficient future tax liabilities to ‘cover’ the ACT, then it had to be written off as irrecoverable. This payment of ACT stopped on 5 April 1999 with a change in the imputation system. Companies which had paid tax for which they had not yet had relief against mainstream corporation tax at 5 April 1999 are permitted to carry it forward against future corporation tax liabilities – this carry-forward is called **shadow ACT**.

14.6 IFRS and taxation

European Union law requires listed companies to draw up their consolidated accounts according to IFRS for accounting periods beginning after 1 January 2005 (with adjusted comparative figures for the previous year). United Kingdom law has been amended to allow the Inland Revenue to accept accounts drawn up in accordance with GAAP (‘generally accepted accounting practice’), which is defined as IFRS or UK GAAP (UK Generally Accepted Accounting Practice).¹⁶

Although the Accounting Standards Board (ASB) intends to bring its standards into accordance with IFRS (but not necessarily identical with them), it will take several years

to do this. Consequently two different standards will be acceptable for some years. The move towards IFRS is leading to a detailed study of accounting theory and principles, so that the accounting treatment may eventually become the benchmark standard for taxation purposes, although this will take several years to reach fruition (if it proves to be attainable).

The Inland Revenue and the professional bodies have anticipated the potential impact of the move to IFRS. For some years at least, the legislation will have to provide for different treatment of specific items under UK GAAP and IFRS.

The Finance Act 2004 included legislation which ensured that companies that adopted IFRS to draw up their accounts would receive broadly equivalent tax treatment to companies that continue to use UK GAAP.¹⁷ The intention of these provisions is to defer the major tax effects of most transitional adjustments until the tax impact becomes clearer.

The Pre-Budget Report of 2 December 2004 proposed further tax changes to ensure this policy of deferring tax effects of these accounting changes, for which the Chancellor of the Exchequer further confirmed his support in his Budget of 16 March 2005.

The clearest intimation of the intention to defer major tax effects is shown by the proposals for special purpose securitisation companies. These are certain companies where borrowing is located in a separate company in order to protect from insolvency. Under the proposed provisions, these companies would continue to use the previous accounting practice for taxation purposes for a further year, thus avoiding a significant tax charge on items that would not have been treated as income under UK GAAP. Another example is that there will be difficulties under IAS 39 where hedging profits are taken into account before they are realised, and tax law will ignore these volatile items.

A deliberate decision had already been made during the discussion of the Finance Act 2003 not to follow the changes in the treatment of share-based payments to employees that would not only follow from IFRS 2 but also from FRS 20 (under UK GAAP).¹⁸

IAS 8 includes adjustments for fundamental errors in the statement of changes in equity, but the legislation specifically excludes the tax effects of these.

Further provisions have been introduced to mitigate the tax liabilities that could arise from the adoption of IFRS. It remains to be seen whether the taxation effects of any significant changes in profit resulting from the change from UK GAAP to IFRS will be deferred until UK GAAP becomes truly aligned with IFRS.

IFRS will not remain static. The IASB Project on the 'Financial Reporting of all Profit-Oriented Entities' (for under consideration is the development of a standard 'performance statement') will lead to further significant changes from UK GAAP. Such a move from the present Profit and Loss Account would lead to the need for a decision whether it could be used for tax purposes and what further adjustments would be needed for tax assessment purposes.

At least for the time being, any significant effects of the change to IFRS will be deferred for tax purposes.

14.7 IAS 12 – accounting for current taxation

The essence of IAS 12 is that it requires an enterprise to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in the statement of comprehensive income, any related tax effects are also recognised in the statement of comprehensive income.

The details of how IAS 12 requires an enterprise to account for the tax consequences of transactions and other events follow below.

Statement of comprehensive income disclosure

The standard (para. 77) states that the tax expense related to profit or loss from ordinary activities should be presented on the face of the statement of comprehensive income. It also provides that the major components of the tax expense should be disclosed separately. These separate components of the tax expense may include (para. 80):

- (a) current tax expense for the period of account;
- (b) any adjustments recognised in the current period of account for prior periods (such as where the charge in a past year was underprovided);
- (c) the amount of any benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce the current tax expense; and
- (d) the amount of tax expense (income) relating to those changes in accounting policies and fundamental errors which are included in the determination of net profit or loss for the period in accordance with the allowed alternative treatment in IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*.

Statement of financial position disclosure

The standard states that current tax for current and prior periods should, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess should be recognised as an asset.

The treatment of tax losses

As regards losses for tax purposes, the standard states that the benefit relating to a tax loss that can be carried back to recover current tax of a previous period should be recognised as an asset. Tax assets and tax liabilities should be presented separately from other assets and liabilities in the statement of financial position. An enterprise should offset (para. 71) current tax assets and current tax liabilities if, and only if, the enterprise:

- (a) has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

The standard provides (para. 81) that the following should also be disclosed separately:

- (a) tax expense (income) relating to extraordinary items recognised during the period,
- (b) an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:
 - (i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
 - (ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed,
- (c) an explanation of changes in the applicable tax rate(s) compared to the previous accounting period.

The relationship between tax expense and accounting profit

The standard sets out the following example in Appendix B of an explanation of the relationship between tax expense (income) and accounting profit:

Current Tax Expense	X5	X6
Accounting profit	8,775	8,740
<i>Add</i>		
Depreciation for accounting purposes	4,800	8,250
Charitable donations	500	350
Fine for environmental pollution	700	—
Product development costs	250	250
Health care benefits	<u>2,000</u>	<u>1,000</u>
	17,025	18,590
<i>Deduct</i>		
Depreciation for tax purposes	<u>(8,100)</u>	<u>(11,850)</u>
Taxable profit	<u>8,925</u>	<u>6,740</u>
Current tax expense at 40%	<u>3,570</u>	
Current tax expense at 35%		<u>2,359</u>

IAS 12 and FRS 16

IAS 12 is similar to FRS 16 *Current Tax*, which UK non-quoted companies that choose not to follow international standards can choose to adopt.

There are very few rules for calculating current tax in UK GAAP, although in practice the calculation will be largely similar to that under IAS 12. FRS 16 does not go into the detail of calculating current tax, but it does, however, clarify the treatment of withholding taxes and the effect they have on the statement of comprehensive income.

14.8 Deferred tax

14.8.1 IAS 12 – background to deferred taxation

The profit on which tax is paid may differ from that shown in the published profit and loss account. This is caused by two separate factors.

Permanent differences

One factor that we looked at above is that certain items of expenditure may not be legitimate deductions from profit for tax purposes under the tax legislation. These differences are referred to as **permanent** differences because they will not be allowed at a different time and will be permanently disallowed, even in future accounting periods.

Timing differences

Another factor is that there are some other expenses that are legitimate deductions in arriving at the taxable profit which are allowed as a deduction for tax purposes at a later date. These might be simply **timing** differences in that tax relief and charges to the profit and loss account occur in different accounting periods. The accounting profit is prepared on an accruals basis but the taxable profit might require certain of the items to be dealt with on a cash basis. Examples of this might include bonuses payable to senior management, properly

included in the financial statements under the accruals concept but not eligible for tax relief until actually paid some considerable time later, thus giving tax relief in a later period.

Temporary differences

The original IAS 12 allowed an enterprise to account for deferred tax using the statement of comprehensive income liability method which focused on timing differences. IAS 12 (revised) requires the statement of financial position liability method, which focuses on temporary differences, to be used. Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the statement of financial position. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. All timing differences are temporary differences.

The most significant temporary difference is depreciation. The depreciation charge made in the financial statements must be added back in the tax calculations and replaced by the official tax allowance for such an expense. The substituted expense calculated in accordance with the tax rules is rarely the same amount as the depreciation charge computed in accordance with IAS 16 *Property, Plant and Equipment*.

Capital investment incentive effect

It is common for legislation to provide for higher rates of tax depreciation than are used for accounting purposes, for it is believed that the consequent deferral of taxation liabilities serves as an incentive to capital investment (this incentive is not forbidden by European Union law or the OECD rules). The classic effect of this is for tax to be payable on a lower figure than the accounting profit in the earlier years of an asset's life because the tax allowances usually exceed depreciation in the earlier years of an asset's life. In later accounting periods, the tax allowances will be lower than the depreciation charges and the taxable profit will then be higher than the accounting profit that appears in the published profit and loss account.

Deferred tax provisions

The process whereby the company pays tax on a profit that is lower than the reported profit in the early years and on a profit that is higher than reported profit in later years is known as **reversal**. Given the knowledge that, ultimately, these timing differences will reverse, the accruals concept requires that consideration be given to making provision for the future liability in those early years in which the tax payable is calculated on a lower figure. The provision that is made is known as a **deferred tax provision**.

Alternative methods for calculating deferred tax provisions

As you might expect, there has been a history of disagreement within the accounting profession over the method to use to calculate the provision. There have been, historically, two methods of calculating the provision for this future liability – the **deferral** method and the **liability** method.

The deferral method

The deferral method, which used to be favoured in the USA, involves the calculation each year of the tax effects of the timing differences that have arisen in that year. The tax effect is then debited or credited to the profit and loss account as part of the tax charge; the double entry is effected by making an entry to the deferred tax account. This deferral method of

Figure 14.1 Deferred tax provision using deferral method

		ACCOUNTS (depreciation)	TAX (allowances)	DIFFERENCE (temporary)	TAX (rate)
		£	£	£	
01.0.1.1996	Cost of asset	10,000	10,000		
31.12.1996	Depreciation/tax	<u>1,000</u>	<u>2,500</u>	<u>1,500</u>	25%
	Allowance	9,000	7,500	1,500	
31.12.1997	Depreciation/tax	<u>1,000</u>	<u>1,875</u>	<u>875</u>	25%
	Allowance	8,000	5,625	2,375	
31.12.1998	Depreciation/tax	<u>1,000</u>	<u>1,406</u>	<u>406</u>	25%
	Allowance	7,000	4,219	2,781	
31.12.1999	Depreciation/tax	<u>1,000</u>	<u>1,055</u>	<u>55</u>	24%
	Allowance	6,000	3,164	2,836	
31.12.2000	Depreciation/tax	<u>1,000</u>	<u>791</u>	<u>(209)</u>	24%
	Allowance	<u>5,000</u>	<u>2,373</u>	<u>2,627</u>	

calculating the tax effect ignores the effect of changing tax rates on the timing differences that arose in earlier periods. This means that the total provision may consist of differences calculated at the rate of tax in force in the year when the entry was made to the provision.

The liability method

The liability method requires the calculation of the total amount of potential liability each year at current rates of tax, increasing or reducing the provision accordingly. This means that the company keeps a record of the timing differences and then recalculates at the end of each new accounting period using the rate of corporation tax in force as at the date of the current statement of financial position.

To illustrate the two methods we will take the example of a single asset, costing £10,000, depreciated at 10% using the straight-line method, but subject to a tax allowance of 25% on the reducing balance method. The workings are shown in Figure 14.1. This shows, that, if there were no other adjustments, for the first four years the profits subject to tax would be lower than those shown in the accounts, but afterwards the situation would reverse.

Charge to statement of comprehensive income under the deferral method

The deferral method would charge to the profit and loss account each year the variation multiplied by the current tax rate, e.g. 1996 at 25% on £1,500 giving £375.00, and 1999 at 24% on £55 giving £13.20. This is in accordance with the accruals concept which matches the tax expense against the income that gave rise to it. Under this method the deferred tax provision will be credited with £375 in 1997 and this amount will not be altered in 1999 when the tax rate changes to 24%. In the example, the calculation for the five years would be as in Figure 14.2.

Charge to statement of comprehensive income under the liability method

The liability method would make a charge so that the total balance on deferred tax equalled the cumulative variation multiplied by the current tax rate. The intention is that the statement of financial position liability should be stated at a figure which represents the tax effect as at

Figure 14.2 Summary of deferred tax provision using the deferral method

Year ended	Timing difference £	Basic rate %	Deferred tax charge in year £	Deferred tax provision (deferral method) £
31.12.1996	1,500	25%	375.00	375.00
31.12.1997	875	25%	218.75	593.75
31.12.1998	406	25%	101.50	695.25
31.12.1999	55	24%	13.20	708.45
31.12.2000	(209)	24%	(50.16)	658.29

the end of each new accounting period. This means that there would be an adjustment made in 1999 to recalculate the tax effect of the timing difference that was provided for in earlier years. For example, the provision for 1997 would be recalculated at 24%, giving a figure of £360 instead of the £375 that was calculated and charged in 1997. The decrease in the expected liability will be reflected in the amount charged against the profit and loss account in 1997. The £15 will in effect be credited to the 1997 profit statement.

The effect on the charge to the 2000 profit statement (Figures 14.2 and 14.3) is that there will be a charge of £13.20 using the deferral method and a credit of £14.61 using the liability method. The £14.61 is the reduction in the amount provided from £695.25 at the end of 1999 to the £680.64 that is required at the end of 2000.

World trend towards the liability method

There has been a move in national standards away from the deferral method towards the liability method, which is a change of emphasis from the statement of comprehensive income to the statement of financial position because the deferred tax liability is shown at current rates of tax in the liability method. This is in accordance with the IASB's conceptual framework which requires that all items in the statement of financial position, other than shareholders' equity, must be either assets or liabilities as defined in the framework. Deferred tax as it is calculated under the traditional deferral method is not in fact a calculation of a liability, but is better characterised as deferred income or expenditure. This is illustrated by the fact that the sum calculated under the deferral method is not recalculated to take account of changes in the rate of tax charged, whereas it is recalculated under the liability method.

Figure 14.3 Deferral tax provision using the liability method

Year ended	Temporary difference £	Basic rate	Deferred tax charge in year £	Deferred tax provision (deferral method) £	Rate in 2000	Deferred tax provision (liability method) £
31.12.1997	1,500	25%	375.00	375.00	24%	360.00
31.12.1998	875	25%	218.75	593.75	24%	210.00
31.12.1999	406	25%	101.50	695.25	24%	97.44
31.12.2000	55	24%	13.20	708.45	24%	13.20
				<u>708.45</u>		<u>680.64</u>

The world trend towards using the liability method also results in a change from accounting only for timing differences to accounting for temporary differences.

Temporary versus timing: conceptual difference

These temporary differences are defined in the IASB standard as ‘differences between the carrying amount of an asset or liability in the statement of financial position and its tax base’.¹⁹ The conceptual difference between these two views is that under the liability method provision is made for only the future reversal of these timing differences whereas the temporary difference approach provides for the tax that would be payable if the company were to be liquidated at statement of financial position values (i.e. if the company were to sell all assets at statement of financial position values).

The US standard SFAS 109 argues the theoretical basis for these temporary differences to be accounted for on the following grounds:

A government levies taxes on net taxable income. Temporary differences will become taxable amounts in future years, thereby increasing taxable income and taxes payable, upon recovery or settlement of the recognised and reported amounts of an enterprise’s assets or liabilities . . . A contention that those temporary differences will never result in taxable amounts . . . would contradict the accounting assumption inherent in the statement of financial position that the reported amounts of assets and liabilities will be recovered and settled, respectively; thereby making that statement internally inconsistent.²⁰

A consequence of accepting this conceptual argument in IAS 12 is that provision must also be made for the potential taxation effects of asset revaluations.

14.8.2 IAS 12 – deferred taxation

The standard requires that the financial statements are prepared using the liability method described above (which is sometimes known as the statement of financial position liability method).

An example of how deferred taxation operates follows.

EXAMPLE ● An asset which cost £150 has a carrying amount of £100. Cumulative depreciation for tax purposes is £90 and the tax rate is 25% as shown in Figure 14.4.

The tax base of the asset is £60 (cost of £150 less cumulative tax depreciation of £90). To recover the carrying amount of £100, the enterprise must earn taxable income of £100, but will only be able to deduct tax depreciation of £60. Consequently, the enterprise will pay taxes of £10 (£40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of £100 and the tax base of £60 is a taxable temporary difference of £40. Therefore, the enterprise recognises a deferred tax liability of £10 (£40 at 25%)

Figure 14.4 Cumulative depreciation

	<i>In accounts</i>	<i>For tax</i>
Cost	150	150
Depreciation	50	90
Carrying amount	100	60

Figure 14.5 Deferred tax liability

Income to recover	
Carrying amount	£100
Carrying amount for tax	£60
Temporary difference	£40
Tax rate	25%
Deferred tax	£10

representing the income taxes that it will pay when it recovers the carrying amount of the asset as shown in Figure 14.5.

The accounting treatment over the life of an asset

The following example, taken from IAS 12,²¹ illustrates the accounting treatment over the life of an asset.

EXAMPLE • An enterprise buys equipment for £10,000 and depreciates it on a straight-line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% per annum on a straight-line basis. Tax losses may be carried back against taxable profit of the previous five years. In year 0, the enterprise's taxable profit was £5,000. The tax rate is 40%. The enterprise will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the enterprise's current tax computation is as follows:

Year	1	2	3	4	5
Taxable income (£)	2,000	2,000	2,000	2,000	2,000
Depreciation for tax purposes	2,500	2,500	2,500	2,500	0
Tax profit (loss)	(500)	(500)	(500)	(500)	2,000
Current tax expense (income) at 40%	(200)	(200)	(200)	(200)	800

The enterprise recognises a current tax asset at the end of years 1 to 4 because it recovers the benefit of the tax loss against the taxable profit of year 0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows:

Year	1	2	3	4	5
Carrying amount (£)	8,000	6,000	4,000	2,000	0
Tax base	7,500	5,000	2,500	0	0
Taxable temporary difference	500	1,000	1,500	2,000	0
Opening deferred tax liability	0	200	400	600	800
Deferred tax expense (income)	200	200	200	200	(800)
Closing deferred tax liability	200	400	600	800	0

The enterprise recognises the deferred tax liability in years 1 to 4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The enterprise's statement of comprehensive income is as follows:

<i>Year</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Income (£)	2,000	2,000	2,000	2,000	2,000
Depreciation	2,000	2,000	2,000	2,000	2,000
Profit before tax	0	0	0	0	0
Current tax expense (income)	(200)	(200)	(200)	(200)	800
Deferred tax expense (income)	200	200	200	200	(800)
Total tax expense (income)	0	0	0	0	0
Net profit for the period	0	0	0	0	0

Further examples of items that could give rise to temporary differences are:

- Retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the enterprise or when retirement benefits are paid by the enterprise. A temporary difference exists between the carrying amount of the liability (in the financial statements) and its tax base (the carrying amount of the liability for tax purposes); the tax base of the liability is usually nil.
- Research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base (the carrying amount of the liability for tax purposes) of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.

Treatment of asset revaluations

The original IAS 12 permitted, but did not require, an enterprise to recognise a deferred tax liability in respect of asset revaluations. If such assets were sold at the revalued sum then a profit would arise that could be subject to tax. IAS 12 as currently written requires an enterprise to recognise a deferred tax liability in respect of asset revaluations.

Such a deferred tax liability on a revalued asset might not arise for many years, for there might be no intention to sell the asset. Many would argue that IAS 12 should allow for such timing differences by discounting the deferred liability (for a sum due many years in advance is certainly recognised in the business community as a lesser liability than the sum due immediately, for the sum could be invested and produce income until the liability would become due; this is termed the time value of money). The standard does not allow such discounting.²² Indeed, it could be argued that in reality most businesses tend to have a policy of continuous asset replacement, with the effect that any deferred liability will be further deferred by these future acquisitions, so that the deferred tax liability would only become payable on a future cessation of trade. Not only does the standard preclude discounting, it also does not permit any account being made for future acquisitions by making a partial provision for the deferred tax.

Accounting treatment of deferred tax following a business combination

In a business combination that is an acquisition, the cost of the acquisition is allocated to the identifiable assets and liabilities acquired by reference to their fair values at the date of the exchange transaction. Temporary differences arise when the tax bases of the identifiable assets and liabilities acquired are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary

difference arises which results in a deferred tax liability. Paragraph B16(i) of IFRS 3 *Business Combinations* prohibits discounting of deferred tax assets acquired and deferred tax liabilities assumed in a business combination as does IAS 12 (revised). IAS 12 states that deferred tax should not be provided on goodwill if amortisation of it is not allowable for tax purposes (as is the case in many states). Deferred tax arising on a business combination that is an acquisition is an exception to the rule that changes in deferred tax should be recognised in the statement of comprehensive income (rather than as an adjustment by way of a note to the financial statements).

Another exception to this rule relates to items charged (or credited) directly to equity. Examples of such items are:

- a change in the carrying amount arising from the revaluation of property, plant and equipment (IAS 16 *Property, Plant and Equipment*);
- an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*);
- exchange differences arising on the translation of the financial statements of a foreign entity (IAS 21 *The Effects of Changes in Foreign Exchange Rates*);
- amounts arising on initial recognition of the equity component of a compound financial instrument.

Deferred tax asset

A deferred tax asset should be recognised for the carry-forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

At each statement of financial position date, an enterprise should reassess unrecognised deferred tax assets. The enterprise recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered. For example, an improvement in trading conditions may make it more probable that the enterprise will be able to generate sufficient taxable profit in the future for the deferred tax asset.

The International Accounting Standards Board (IASB), as part of the convergence project with the United States Financial Accounting Standards Board (FASB), proposed to amend IAS 12 with a new IFRS.

The published Exposure Draft (ED/2009/2) was similar to IAS 12, although it would seem that deferred tax liabilities net of deferred tax assets under the changes would be altered. This led to considerable discussion. It would be instructive to look at the points raised.

Two particular issues arose from the papers. Firstly it was proposed that the tax base of an asset used to calculate any deferred tax would be the tax base on disposal and not that on its final use. Many assets held in the United Kingdom, particularly buildings, have no tax base whilst in use because they do not have any form of tax deduction, whereas on disposal there will be one because of a calculations of tax liability on capital profits. Many deferred tax calculations would have to be reworked. It could be argued that the revised deferred tax charge would represent tax on future profits arising on sale rather than a reversal of past differences between book and tax depreciation.

Secondly the new IFRS would consider the recognition and measurement of differences in interpretation of the law between tax authorities and companies (termed ‘uncertain tax positions’), where both current and deferred tax liabilities will be adjusted for the weighted

average of possible outcomes of tax in dispute. Apart from the difficulty in assessing such probabilities, company directors may well prove averse to accounting for their opinions proving to be incorrect.

The proposals proved contentious. At one extreme was the argument that at a time when there are many other issues to deal with relating to the financial crisis, it was not the right time to pursue this project. Amongst the proponents of this point was the CIMA (the Chartered Institute of Management Accountants). Although it might seem improper to take such a pragmatic (and indeed ‘political’) approach, it must be remembered that in order for changes in policy to be accepted generally the view of company management must accept the logic and mechanism of proposed changes.

A more fundamental view was that the theoretical background to the proposals had not been fully considered, and the proposals represented minor changes to a ‘weak standard’ rather than seeking a fundamental review of tax accounting. Amongst those putting forward this view was the ICAEW – the Institute of Chartered Accountants in England and Wales.

At the October 2009 joint meeting of the IASB and the FASB, both boards indicated that they would consider undertaking a fundamental review of accounting for income taxes at some time in the future. In the meantime, the IASB is considering which issues it should address in a limited-scope project to amend IAS 12.

14.9 FRS 19 (the UK standard on deferred taxation)

Those UK unquoted companies that choose not to follow international standards will follow FRS 19 *Deferred Tax*.

Accounting for deferred tax in the UK pre-dates the issue of accounting standards.

Prior to the issue of standards, companies applied an accounting practice known as ‘tax equalisation accounting’, whereby they recognised that accounting periods should each be allocated an amount of income tax expense that bears a ‘normal relationship to the income shown in the statement of comprehensive income’, and to let reported income taxes follow reported income has been the objective of accounting for income taxes ever since.²³ There is also an economic consequence that flows from the practice of tax equalisation in that the trend of reported after-tax income is smoothed, and there is less likelihood of pressure for a cash dividend distribution based on the crediting of the tax benefit of capital investment expenditure to the early years of the fixed assets.

There followed a period of very high rates of capital allowances and, with a naive belief that this situation would continue and allow permanent deferral, companies complained that to provide full provision was unrealistic and so in 1977 the concept of **partial provision** was introduced in which deferred tax was only provided in respect of timing differences that were likely to be reversed. The argument was that if the company continued with the replacement of fixed assets, and if the capital allowances were reasonably certain to exceed the depreciation in the foreseeable future, it was unrealistic to make charges against the profit and create provisions that would not crystallise. This would merely lead to the appearance of an ever-increasing provision on the statement of financial position.

The *Foreword to Accounting Standards* published in June 1993 by the Accounting Standards Board (ASB) states that ‘FRSs are formulated with due regard to international developments . . . the Board supports the IASC in its aim to harmonise’ and that ‘where the requirements of an accounting standard and an IAS differ, the accounting standard should be followed’.

Professor Andrew Lennard, then Assistant Technical Director of the ASB, confirmed during a lecture on 17 March 1999 that this was a matter where there was a divergence of view between the ASB and international regulators, where the ASB was unhappy to account

in full for deferred tax where there was no discounting for long delays until the anticipated payment; indeed he expressed his exasperation with the topic in stating that ‘he wished deferred tax accounting would go away’.²⁴ Applying the full provision method is more consistent with both international practice and the ASB’s draft *Statement of Principles* (as modified in March 1999). However, a criticism of the full provision method in the past was that it could, if the company had a continuous capital expenditure programme, lead to a build-up of large liabilities that may fall due only far into the future, if at all.

The significant differences between FRS 19 and IAS 12 are:

- 1 Under FRS 19 there is a general requirement that a deferred tax charge **should not be recognised on revaluation gains** on non-monetary assets which are revalued to fair values on the acquisition of a business. IAS 12 requires tax on revaluations.
- 2 Under FRS 19 **discounting of deferred taxation liabilities is made optional**. The ASB had stated its belief that, in principle, deferred tax should be discounted, but has taken the view that discounting should be optional so as to give a choice to the preparer of the accounts. However, although discounting appears to be an attractive method for allowing for the delay in payment of the liability, it has been pointed out that in some cases where capital expenditure is uneven, then an unexpected effect of discounting both the initial and final cash flow effects could be to turn an eventual liability into an initial asset.²⁵ IAS 12 does not allow such discounting.²⁶

The ASB is aware that the break with international standards is undesirable. Indeed it has been suggested that the ASB developed and implemented FRS 19 with a view that it would ‘encourage the International Accounting Standards Committee to think again’ about IAS 12.²⁷

The ASB is considering the diverging views as to whether UK GAAP should be aligned with IFRS.

14.10 A critique of deferred taxation

It could be argued that deferred tax is not a legal liability until it accrues. The consequence of this argument would be that deferred tax should not appear in the financial statements, and financial statements should:

- present the tax expense for the year equal to the amount of income taxes that has been levied based on the income tax return for the year;
- accrue as a receivable any income refunds that are due from taxing authorities or as a payable any unpaid current or past income taxes;
- disclose in the notes to the financial statements differences between the income tax bases of assets and liabilities and the amounts at which they appear in the statement of financial position.

The argument is that the process of accounting for deferred tax is confusing what **did** happen to a company, i.e. the agreed tax payable for the year, and what **did not** happen to the company, which is the tax that would have been payable if the adjustments required by the tax law for timing differences had not occurred. It is felt that the investor should be provided with details of the tax charge levied on the profits for the year and an explanation of factors that might lead to a different rate of tax charge appearing in future financial statements. The argument against adjusting the tax charge for deferred tax and the creation of a deferred tax provision holds that shareholders are accustomed to giving consideration to many other imponderables concerning the amount, timing and uncertainty of future cash

receipts and payments, and the treatment of tax should be considered in the same way. This view has received support from others,²⁸ who have held that tax attaches to taxable income and not to the reported accounting income and that there is no legal requirement for the tax to bear any relationship to the reported accounting income. Indeed it has been argued that ‘deferred tax means income smoothing’.²⁹

Before discussing the arguments it is appropriate to consider the economic reality of deferred taxation.

Those industries which are capital-intensive tend to have benefited from tax deferral by way of accelerated tax depreciation on plant investment, and it could be suggested that their accounts do not truly reflect the economic reality without provision for deferred taxation. Studies in the UK certainly support this view.

In the UK it has not been the practice to make full provision for deferred taxation. ‘Full provision’ refers to the fact that **the potential liability to deferred taxation has not been reduced** to allow for the view of management that the entire liability will not be paid in the future as a result of timing differences because the taxation benefits of future capital investments will result in a further deferral of taxation liability. In the UK, the deferred taxation liability has been reduced to allow for the effects of these anticipated future investments.

Terry Smith points out in Table 17.2 of his *Accounting for Growth*³⁰ that according to the companies’ own figures their estimated EPS would fall as follows if full provision for deferred tax were made:

British Airways	36.4%
Severn Trent	25.3%
British Gas	20.5% (based on CCA earnings of 15.1p per share adjusted to exclude restructuring costs)
TI Group	13.8%

In his Table 17.3 he lists companies which expected an EPS fall of over 10% and with more than 10% of shareholders’ funds in unprovided deferred tax:

	<i>Estimated impact on historic gearing of full provision</i>	
	<i>From</i>	<i>To</i>
	%	%
British Airways	148	214
BP	67	78
British Gas	56	68

He points out in his Table 17.4 that five of the companies he lists without any exposure to an increase in deferred tax charge are some of the UK’s most successful and conservatively financed large companies.

	<i>Tax rate (%)</i>
General Electric	32
Marks & Spencer	32
Reuters	32
GUS	33
Wolseley	33

In the light of such economic facts, it is possible to understand why business managers might oppose deferred tax accounting, for it would lower their company stock valuation, whereas investment advisers might support deferred tax accounting as enabling them to form a better view of future prospects. Academic research has shown the extent of corporate lobbying against the full provision of deferred taxation liabilities.³¹ IAS 12 is believed to be deeply unpopular with company directors. Whilst IASB believes the standard makes tax more transparent, the ICAEW suggests that the deferred tax charge will act as a disincentive to the adoption of IFRS (particularly because the adoption of IFRS will force companies to create a deferred tax liability on the revaluation of assets or subsidiaries).³² In the change from the use of UK GAAP to IFRS, UK companies have started³³ to provide for deferred taxation on valuation gains. The following companies showed a deferred tax charge on these gains and a decrease in Shareholder's Equity as follows:

	£ million
Slough Estates plc	30.5
Brixton plc	68.1
Great Portland Estates plc	34.8

It has been argued³⁴ that IAS 12 uses definitions of assets and liabilities that are different to those otherwise used in IFRS and consequently require an entry to record taxes on future income. This argument, whilst initially attractive, ignores the fact that additional asset value has been created on the statement of financial position.

It is suggested that the arguments for and against deferred taxation accounting must be based solely on the theory underpinning accounting, and unaffected by commercial considerations.

It is also suggested that the above arguments against the use of deferred tax accounting are unconvincing if one considers the IASB's underlying assumption about accrual accounting, as stated in the *Framework*:

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting . . . Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.³⁵

This underlying assumption confirms that deferred tax accounting makes the fullest possible use of accrual accounting.

Pursuing this argument further the *Framework* states:

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise.³⁶

If a statement of financial position includes current market valuations based on this view of an asset, it is difficult to argue logically that the implicit taxation arising on this future economic benefit should not be provided for at the same time. The previous argument for excluding the deferred tax liability cannot therefore be considered persuasive on this basis.

On the other hand, it is stated in the *Framework* that 'An essential characteristic of a liability is that the enterprise has a present obligation.'³⁷ One could argue solely from these words that deferred tax is not a liability, but this conflicts with the argument based on the

definition of an asset; consequently when considered in context this does not provide a sustainable argument against a deferred tax provision. The fact is that accounting practice has moved definitively towards making such a provision for deferred taxation.

The legal argument that deferred tax is not a legal liability until it accrues runs counter to the criterion of substance over form which gives weight to the economic aspects of the event rather than the strict legal aspects. The *Framework* states:

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form.³⁸

It is an interesting fact that substance over form has achieved a growing importance since the 1980s and the legal arguments are receiving less recognition. Investments are made on economic criteria, investors make their choices on the basis of anticipated cash flows, and such flows would be subject to the effects of deferred taxation.

14.11 Examples of companies following IAS 12

Figure 14.6 is from the Roche Group 2009 Annual Report. Figure 14.7 is from the Bayer Group 2008 Annual Report. It should be noted that these published examples do not always comply in full with all aspects of IAS 12 (revised).

14.12 Value added tax (VAT)

VAT is one other tax that affects most companies and for which there is an accounting standard (SSAP 5 *Accounting for Value Added Tax*), which was established on its introduction. This standard was issued in 1974 when the introduction of value added tax was imminent and

Figure 14.6 Extract from Roche Group 2009 Annual Accounts

6. Income taxes

Income tax expenses | in millions of CHF

	2009	2008
Current income taxes	(3,701)	(3,617)
Adjustments recognised for current tax of prior periods	160	35
Deferred income taxes	671	277
Total income (expense)	(2,870)	(3,305)

Since the Group operates internationally, it is subject to income taxes in many different tax jurisdictions. The Group calculates its average expected tax rate as a weighted average of the tax rates in the tax jurisdictions in which the Group operates. This rate changes from year to year due to changes in the mix of the Group's taxable income and changes in local tax rates. The Group's effective tax rate can be reconciled to the Group's average expected tax rate as follows:

continued

Figure 14.6 (continued)

Reconciliation of the Group's effective tax rate		
	2009	2008
Average expected tax rate	22.1%	23.0%
Tax effect of		
— Utilisation of previously unrecognised tax losses	-0.1%	-0.2%
— Non-taxable income/non-deductible expenses	+0.7%	+1.2%
— Genentech equity compensation plans	+0.1%	+0.5%
— Other differences	-1.3%	-1.1%
Group's effective tax rate before exceptional items	21.5%	23.4%

Income tax assets (liabilities) in millions of CHF			
	2009	2008	2007
Current income taxes			
— Assets	244	268	263
— Liabilities	(2,478)	(2,193)	(2,215)
Net current income tax assets (liabilities)	(2,234)	(1,925)	(1,952)

Deferred income taxes			
	2009	2008	2007
— Assets	2,573	1,829	1,317
— Liabilities	(1,099)	(1,409)	(1,527)
Net deferred income tax assets (liabilities)	1,474	420	(210)

Deferred income tax assets are recognised for tax loss carry forwards only to the extent that realisation of the related tax benefit is probable. The Group has unrecognised tax losses, including valuation allowances, as follows:

Unrecognised tax losses: expiry

	2009		2008	
	Amount (mCHF)	Applicable tax rate	Amount (mCHF)	Applicable tax rate
Within one year	—	—	—	—
Between one and five years	90	24%	68	22%
More than five years	480	19%	223	31%
Total unrecognised tax losses	570	20%	291	29%

Deferred income tax liabilities have not been established for the withholding tax and other taxes that would be payable on the unremitted earnings of certain foreign subsidiaries, as such amounts are currently regarded as permanently reinvested. These unremitted earnings totalled 26.5 billion Swiss francs at 31 December 2009 (2008: 41.7 billion Swiss francs).

there was considerable worry within the business community on its accounting treatment. We can now look back, having lived with VAT for well over two decades, and wonder, perhaps, why an SSAP was needed. VAT is essentially a tax on consumers collected by traders and is accounted for in a similar way to PAYE income tax, which is a tax on employees collected by employers.

Figure 14.7 Extract from Bayer Group 2009 Annual Accounts

14. Income taxes					
The breakdown of income taxes by origin is as follows:					
Income Tax Expense by Origin					
		2008	2009		
		€ million	€ million		
Income taxes paid or accrued					
Germany		(161)	(186)		
other countries		(651)	(476)		
		(812)	(662)		
Deferred taxes					
from temporary differences		323	430		
from interest carryforwards		11	(11)		
from tax loss carryforwards		(168)	(291)		
from tax credits		10	23		
		176	151		
Total		(636)	(511)		
Expiration of Unusable Tax Credits and Tax Loss Carryforwards					
		Tax credits		Tax loss carryforwards	
		Dec. 31, 2008	Dec. 31, 2009	Dec. 31, 2008	Dec. 31, 2009
		€ million	€ million	€ million	€ million
One year		—	—	2	—
Two years		—	—	9	23
Three years		—	—	58	28
Four years		—	—	51	39
Five years		—	—	111	123
Thereafter		—	32	170	255
Total		—	32	401	468

IAS 18 (para. 8) makes clear that the same principles are followed:

Revenue includes only the gross inflows of economic benefits received and receivable by the enterprise on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the enterprise and do not result in increases in equity. Therefore, they are excluded from revenue.³⁹

14.12.1 The effects of the standard

The effects of the standard vary depending on the status of the accounting entity under the VAT legislation. The term ‘trader’ appears in the legislation and is the terminology for a business entity. The ‘traders’ or companies, as we would normally refer to them, are classified under the following headings:

(a) Registered trader

For a registered trader, accounts should only include figures net of VAT. This means that the VAT on the sales will be deducted from the invoice amount. The VAT will be payable to the government and the net amount of the sales invoice will appear in the profit and loss account in arriving at the sales turnover figure. The VAT on purchases will be deducted from the purchase invoice. The VAT will then be reclaimed from the government and the net amount of the purchases invoice will appear in the profit and loss account in arriving at the purchases figure.

The only exception to the use of amounts net of VAT is when the input tax is not recoverable, e.g. on entertaining and on 'private' motor cars.

(b) Non-registered or exempt trader

For a company that is classified as non-registered or exempt, the VAT that it has to pay on its purchases and expenses is not reclaimable from the government. Because the company cannot recover the VAT, it means that the expense that appears in the profit and loss account must be inclusive of VAT. It is treated as part of each item of expenditure and the costs treated accordingly. It will be included, where relevant, with each item of expense (including capital expenditure) rather than being shown as a separate item.

(c) Partially exempt trader

An entity which is partially exempt can only recover a proportion of input VAT, and the proportion of non-recoverable VAT should be treated as part of the costs on the same lines as with an exempt trader. The VAT rules are complex but, for the purpose of understanding the figures that appear in published accounts of public companies, treatment as a registered trader would normally apply.

Summary

The major impact on reported post-tax profits will be the adoption of IAS 12 which will remove the possibility for the discounting of deferred tax on the adoption of the full provisioning method.

There may be significant increase in the deferred tax charge, with the earnings per share correspondingly reduced.

REVIEW QUESTIONS

- 1 Why does the charge to taxation in a company's accounts not equal the profit multiplied by the current rate of corporation tax?
- 2 Explain clearly how advance corporation tax arose and its effect on the profit and loss account and the year-end statement of financial position figures. (Use a simple example to illustrate.)
- 3 Explain how the corporation tax system changed as from April 1999.
- 4 Deferred tax accounting may be seen as an income-smoothing device which distorts the true and fair view. Explain the impact of deferred tax on reported income and justify its continued use.
- 5 Explain how dividends received and paid are shown in the accounts.

- 6 Distinguish between (a) the deferral and (b) the liability methods of company deferred tax.
- 7 Explain the criteria that a deferred tax provision needs to satisfy under IAS 12 in order to be accepted as a liability in the statement of financial position.
- 8 Explain the effect of SSAP 5 *Accounting for Value Added Tax*.

EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

Question 1

In your capacity as chief assistant to the financial controller, your managing director has asked you to explain to him the differences between tax planning, tax avoidance and tax evasion.

He has also asked you to explain to him your feelings as a professional accountant about these topics.

Write some notes to assist you in answering these questions.

* Question 2

A fixed asset (a machine) was purchased by Adjourn plc on 1 July 20X2 at a cost of £25,000.

The company prepares its annual accounts to 31 March in each year. The policy of the company is to depreciate such assets at the rate of 15% straight line (with depreciation being charged *pro rata* on a time apportionment basis in the year of purchase). The company was granted capital allowances at 25% per annum on the reducing balance method (such capital allowances are apportioned *pro rata* on a time apportionment basis in the year of purchase).

The rate of corporation tax has been as follows:

Year ended	31 Mar 20X3	20%
	31 Mar 20X4	30%
	31 Mar 20X5	20%
	31 Mar 20X6	19%
	31 Mar 20X7	19%

Required:

- (a) Calculate the deferred tax provision using both the deferred method and the liability method.
- (b) Explain why the liability method is considered by commentators to place the emphasis on the statement of financial position, whereas the deferred method is considered to place the emphasis on the profit and loss account.

Question 3

The move from the preparation of accounts under UK GAAP to the users of IFRS by United Kingdom quoted companies for years beginning 1 January 2005 had an effect on the level of profits reported. How will those profits arising from the change in accounting standards be treated for taxation purposes?

Question 4

Discuss the arguments for and against discounting the deferred tax charge.

Question 5

Austin Mitchell MP proposed an Early Day Motion in the House of Commons on 17 May 2005 as follows:

That this House urges the Government to clamp down on artificial tax avoidance schemes and end the ... tax avoidance loop-holes that enable millionaires and numerous companies trading in the UK to avoid UK taxes; and further urges the Government to ... so that transactions lacking normal commercial substance and solely entered into for the purpose of tax avoidance are ignored for tax purposes, thereby providing certainty, fairness and clarity, which the UK's taxation system requires to prevent abusive tax avoidance, to protect the interests of ordinary citizens who are committed to making their contribution to society, to avoid an unnecessary burden of tax of individual taxpayers and to ensure that companies pay fair taxes on profits generated in this country.

Required:

- (a) The Motion refers to tax avoidance. In your opinion, does the Early Day Motion tend to confuse the boundaries between tax avoidance and tax evasion?
- (b) The Motion refers to nullifying the effects of tax avoidance to protect the interests of ordinary citizens who are making their contribution to society, to avoid an unnecessary burden of tax on individual taxpayers. If ordinary citizens require such protection, would it be possible to argue that even if tax avoidance were legal, it might well be immoral?

Question 6

Dee For has recently qualified as a pilot and is now intending to set up a private company in the near future to run small charter passenger flights from her home town. Most of her business plan has been written but she has recently learned that the company's forecast statement of comprehensive income and statement of financial position may be incorrect as she has not taken into account the likely impact of deferred tax on those financial statements. She has therefore asked you for help and, following a meeting, the following facts come to light:

- (i) The aircraft would cost \$1m. It would have a life of five years after which, it would have no residual value and will then be scrapped. Depreciation will be on a straight-line basis.
- (ii) The government of the country in which she lives has recently introduced a scheme for new entrepreneurs which provides a tax allowance on capital expenditure of this type of 25% per annum using the reducing balance method. In this country, depreciation is not a deductible expense for tax purposes. Also in this country, a balancing adjustment is allowed whenever the asset is sold or scrapped.
- (iii) Corporate income tax is currently set at 30%. It has remained unchanged for many years now and the government has indicated there are no plans to change it.
- (iv) The company's forecast annual accounting profit before tax is \$2m per annum over the next five years.

Required:

- (a) Demonstrate the impact of the above on the company's forecast profit and loss accounts and balance sheets for each of the next five years by comparing the 'nil provision' method with the 'full provision method'.
- (b) Explain the 'partial provision' method and whether it could apply to Dee For's company.
- (c) Explain how your answer to (a) would be affected by a government announcement that it intends to increase the corporate income tax rate in the near future.

(The Association of International Accountants)

Question 7

The following information is given in respect of Unambitious plc:

- Non-current assets consist entirely of plant and machinery. The net book value of these assets as at 30 June 2010 is £100,000 in excess of their tax written-down value.
- The provision for deferred tax (all of which relates to fixed asset timing differences) as at 30 June 2010 was £21,000.
- The company's capital expenditure forecasts indicate that capital allowances and depreciation in future years will be:

Year ended 30 June	Depreciation charge for year	Capital allowances for year
£	£	£
2011	12,000	53,000
2012	14,000	49,000
2013	20,000	36,000
2014	40,000	32,000
2015	44,000	32,000
2016	46,000	36,000

For the following years, capital allowances are likely to continue to be in excess of depreciation for the foreseeable future.

- Corporation tax is to be taken at 21%.

Required:

Calculate the deferred tax charges or credits for the next six years, commencing with the year ended 30 June 2011, in accordance with the provisions of IAS 12.

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