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Chapter 10

Accounting for Tax

10.1 The majority of this book is concerned with the adjustment of accounting profit to taxable profit, thus enabling the computation of the tax charge and liability. This chapter, however, is primarily concerned with how to reflect that tax charge and liability in the financial statements. The general principle of accounting for tax is fairly straightforward. The tax expense follows the accounting profit, regardless of the nature of the profit, or of the tax. Therefore, the tax on those profits which are included in the profit and loss account (or income statement) is itself included in the profit and loss account. Similarly, tax on profits which are included within other comprehensive income (OCI) is included in OCI. For the first time, *FRS 102* includes the option of including tax directly within equity if that is where the related income or expense is recorded. However, this simple approach is complicated by the need in accounting to take account of future tax implications of past events.

10.2 For example, a company with tax losses which makes future taxable profits will most likely be able to offset the losses against those profits such that a reduced tax liability arises. From the point of view of HMRC, these losses are irrelevant in the current year; they are only relevant when the taxpayer wishes to use them. In the financial statements of the taxpayer, however, we need to consider whether the availability of these losses creates an asset which should be recognised.

10.3 Consider, again, another situation where the timing of the tax allowances does not coincide with the accounting treatment. An entity spends £100,000 on an item of plant and equipment which is depreciated on a straight line basis over five years. The company is, however, able to claim a 100% deduction in the tax computation in the year of acquisition as part of its annual investment allowance. In the year of acquisition, there is a profit and loss charge for depreciation of £20,000 but in the tax computation a deduction of £100,000. This gives rise to a timing difference of £80,000. In each of the next four years the entity will charge £20,000 for depreciation, which will be added back in the tax computation and no further allowance will be available for that asset. Effectively, therefore, the entity will pay tax on that £20,000 for each of the next four years. Should this be recognised as a liability at the end of the year of acquisition? Since at the end of the life of the asset the entity will have

had a deduction in the profit and loss account and in the tax computation of £100,000, the effect of capital allowances has been one of timing only, hence the use of the term 'timing differences'.

10.4 The question for the standard setters, is how, if at all, the financial statements should reflect these future tax consequences of past events. In summary, and as will be expanded in the chapter below, *FRS 102, Section 29* follows previous accounting standards in requiring the tax effects of timing differences to be recognised in financial statements, as they arise and as they reverse. This is known as deferred taxation. There have been differences over the years in terms of defining which timing differences to recognise, and how the calculation should be prepared, but the principle has been consistent throughout.

10.5 As a consequence of this approach, there is now a requirement to segregate a company's tax charge in the profit and loss accounts (and OCI) and the liability in the financial statements into two components:

(*a*) current tax which is defined as 'the amount of tax estimated to be payable (refundable) in respect of the taxable profit (tax loss) for the current period or past reporting periods, along with adjustments to estimates in respect of previous periods'; and

(*b*) deferred tax which is defined as 'income tax payable (recoverable) in respect of the taxable profit (tax loss) for future reporting periods as a result of past transactions or events'.

THE POLITICISATION OF THE RELATIONSHIP BETWEEN TAX AND ACCOUNTING PROFITS

10.6 In recent years, there has been a major outcry over the apparently low level of taxation being paid, particularly by multi-national companies on apparently high levels of profit. It has always been the case that taxation does not equal accounting profit multiplied by the relevant tax rate. As will be discussed further below, this is primarily because there are differences between the treatment of items in computing accounting profit and taxable profit. Some of these differences are due to timing differences, as in the case of the differences between capital allowances and depreciation referred to above. Others arise from tax law which is often based on public policy issues, or other government action. It is against public policy to provide tax relief on what government may regard as inappropriate behaviour such as business entertaining, fines and expenses not wholly and exclusively for the business. The adjustments required in the tax computation for such items give rise to what are known as permanent differences (see **10.38** *et seq* below). Accounting standards have for many years required a reconciliation explaining the reason why tax is not accounting profit multiplied by the tax rate. Given the public interest in this area, it is important that the tax practitioner, auditor and client get the calculations and disclosures right.

ACCOUNTING FOR VAT

10.7 Accounting for VAT is straightforward. Prior to the introduction of *FRS 102*, VAT was covered by one of the longest-standing SSAPs, *SSAP 5*. Under *FRS 102*, it is covered by a single paragraph in *FRS 102, para 29.20*.

10.8 Turnover should be reported net of recoverable VAT and similar sales taxes and VAT imputed under the flat rate VAT scheme (*FRS 102, para 29.20*). This last part is important for the smallest businesses which use the flat rate scheme. They charge clients at the standard rate, do not reclaim input tax and then pay VAT at a fixed rate appropriate to their business. This gives rise to a gain, being the difference between the amount of VAT which has been charged to customers and the flat rate payable to HMRC. The question is how should this gain be recorded? Should it be part of turnover or is it more appropriate to include it in other operating income? We would suggest that other operating income is the more appropriate in the light of *FRS 102, para 29.20* and also in the light of *FRS 102, Section 23* 'Revenue'.

10.9 Irrecoverable input VAT should be attributed to the relevant expenditure and included as part of its cost. Amounts owing to or from HMRC should be included in the balance sheet under the heading of creditors ('other creditors including taxation and social security') or debtors, as appropriate.

10.10 The only real problems arise in relation to those companies which are partially exempt for VAT purposes. This arises because of the difficulty in identifying which VAT is irrecoverable. Where an expense can be uniquely attributed to an exempt supply, its related VAT is irrecoverable. However, where the expenditure, and hence the input VAT, is not directly attributable to a specific supply, it is necessary to apportion the expenditure (and VAT) between standard- (or zero-) rated supplies, on the one hand, and exempt supplies on the other. That part attributed to exempt supplies will be irrecoverable and accounted for under the relevant expense heading.

10.11 The attribution described above is in relation not only to revenue or expense items, but also to capital items. For example, an insurance broker may have a computer system which services both his normal commission-based work (basically exempt) and also his advisory work, for which he renders a charge (basically standard-rated). It is necessary in this case to agree an apportionment with HMRC, and only a proportion of the input tax on acquisition is reclaimable. The non-reclaimable VAT should be treated as an additional part of the cost price of (in this case) the computer, and depreciated in the normal way.

ACCOUNTING FOR INCOME TAX

10.12 It is important to note at this point that there are many entities which do not account for income tax at all. Sole traders, partnerships and limited liability partnerships do not, traditionally, account for income tax, since the tax charge and liabilities are those of the individual sole trader, partners or members of

the LLP, and not of the business. Other entities, such as charities and pension schemes may be tax exempt and therefore there may be no tax to account for. If, however, a partnership wished to account for income tax, or a charity or pension scheme did have a liability to tax, the principles of this chapter would apply.

10.13 Initially there were two UK standards that dealt with accounting for income tax. Most recently, *FRS 16* was concerned with current tax, that is the tax attributable to the current year's profit, and *FRS 19* dealt with deferred tax. Under *FRS 102*, both elements are dealt with in a single section, *FRS 102, Section 29* 'Income Tax'.

10.14 Income tax includes all domestic and foreign taxes that are based on taxable profit. Income tax also includes taxes, such as withholding taxes, that are payable by subsidiaries, associates and joint ventures on distributions to the reporting entity. In the UK this therefore includes corporation tax, capital gains tax, and property taxes, etc which are levied on taxable profit. It excludes taxes such as VAT, PAYE, etc which are not.

Current tax

10.15 Accounting for current tax is relatively straightforward. The charge is based on the taxable profit for the current and past periods. The taxable profit is based on the accounting profit adjusted for tax purposes. The liability is therefore the charge for the period, less any payments made on account, plus any current tax of previous years not yet paid. If the amount of tax paid for the current and past periods exceeds the amount of tax payable for those periods, the entity shall recognise the excess as a current tax asset. Where an entity has made a tax loss that can be carried back to recover tax paid in a previous period, the tax attributable to the loss shall be recognised in the profit and loss account and an asset of tax recoverable recognised.

10.16 Measurement of the liability is based on taxable profit assessed at what *FRS 102* defines as 'the tax rates and laws that have been enacted or substantively enacted by the reporting date'. This expression means the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so. A UK tax rate is regarded as having been substantively enacted if it is included in either:

(*a*) a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent; or

(*b*) a resolution having statutory effect that has been passed under the *Provisional Collection of Taxes Act 1968*. (Such a resolution could be used to collect taxes at a new rate before that rate has been enacted. In practice, corporation tax rates are now set a year ahead to avoid having to invoke the Provisional Collection of Taxes Act for the quarterly payment system.)

10.17 One issue that arises in accounting for current tax is how to deal with income that carries tax credits, for example dividends received, on which