CHAPTER 32

TAX LAW AND ACCOUNTING PRACTICE

32.1 General principle

In general the tax treatment of a particular item will follow the accounting treatment, i.e. income shown in the P & L Account is taxable and expenses are deductible. This principle applies unless tax legislation or case law dictates otherwise. This principle has been around for years as the starting point for the measure of profit taxable as Trade profit (formerly known as Schedule D Case I). However, recent legislative changes have actually made the accounting rules apply for tax purposes in many cases.

In Finance Act 1993 the foreign exchange gains and loss rules for tax purposes were aligned with the accounting treatment. Finance Act 1994 required the recognition of gains and losses under the financial instruments rules to follow the accounting treatment. This was followed by Finance Act 1996 which applied the accounting treatment to all loan relationships for tax purposes.

More recently we have seen many changes in the rules to deal with the adoption of international accounting standards (IAS). The terminology used in statute has been amended to follow that used in IAS. For example, references to bad debt relief have been replaced with references to impairment losses.

The Government has gone virtually the whole way towards aligning tax and accounting in CTA 2009, s.46 which requires all accounts to be prepared using the true and fair basis.

CTA 2009, s.46 removes many of the prescriptive rules relating to debits and credits for loan relationships and derivatives, replacing them with a general rule that the amounts to be taxed are those recognised in calculating the accounting profit and loss for the period.

32.2 Accounting standards

As the tax treatment, in many cases, is dictated by the accounting treatment, it is important to ensure the proper adoption of **accounting standards.** The tax treatment should follow generally accepted accounting principles or **GAAP** as it is commonly shortened to. For accounting periods beginning on or after 1 January 2005 the definition of GAAP is extended to include adherence with International Accounting Standards (IAS) where required. The need to follow GAAP has been developed both in legislation **by CTA 2009, s.46** and in **case law**.

In the case of ***Gallagher v Jones***, a company entered into a four year finance lease with lease rentals payable over this four year period. The rent actually paid was £397 in year 1 and a peppercorn rent of £1 p.a. for the remainder of the lease. This was the treatment which was adopted in the accounts.

However, under **SSAP21** the correct accounting treatment should recognise the economic reality of the transaction. The asset is being leased for a four year period at an overall cost of £400, so therefore the correct accounting treatment is to recognise the cost evenly over the period of the lease as £100 per annum.

HMRC disputed the accounting treatment and put forward the view that there is no rule in tax law stating that expenses are deductible when they are paid. The company was, through the accounting treatment, giving itself an up-front tax deduction to which HMRC objected.

It was held in this case that the tax treatment should follow GAAP. Consequently HMRC can successfully request that proper accounting principles are applied, at least in the tax computations, even if the item is not material to the accounts.

The decision in the ***Gallagher v Jones*** case reinforced SP 3/91 which requires the tax treatment of finance leased assets to follow correct accounting treatment.

32.3 Importance of GAAP

Generally accepted accounting principles are very important when it comes to calculating taxable profits. If the correct accounting principles have been followed HMRC cannot dispute the treatment unless statute or case law states otherwise.

This particular principle was established in the case of ***Johnston v Britannia Airways.*** Britannia Airways fly a fleet of aeroplanes. Britannia matched the costs of overhauling the jet engines to the actual flying hours the fleet had flown during the year.

HMRC disputed this provision, basically saying it did not relate to the costs actually incurred, but to costs which may have been theoretically incurred. They wanted the company to follow the accruals method of accounting by bringing forward an accrual from the previous year, accounting for the expenses actually incurred during the accounting period and accruing for expenditure committed to by the end of the year.

However, in the judgement to this case it was held that what Britannia was doing was perfectly acceptable under generally accepted accounting principles. The Court did not follow the argument put forward by HMRC that something else might have been more acceptable.

Therefore, the conclusion that we can draw from this case is where there is a **choice as to how we apply a particular standard**, the **choice rests with the tax paying company**. We only need to prove what we have done is acceptable. It is not for HMRC to argue that something else might be more acceptable.

Unfortunately **FRS 12** and **IAS 37** which specifically deal with accounting for provisions, have **effectively prohibited a "Britannia style" provision in the future.** Britannia would now need to show that they have a present day obligation that is either contractual or legal, before they could provide for the future overhaul costs in this way. This is examined in the next chapter.

32.4 Herbert Smith v Honour (1999)

Herbert Smith is a solicitors practice. They opened up office number one in central London and soon expanded their operations to a second site. They expanded again and opened up a third and a fourth office, all in central London.

It was becoming logistically difficult to run the practice from four separate locations and consequently they made the decision to take out a lease on new larger premises, office five and moved everything under the same roof. All this happened back in December 1990, this date being very important for what was happening in the economy at the time.

The leases on offices one, two, three and four were taken out by the firm in the late 1980s when land prices, particularly in central London, were very high and therefore they had committed themselves to onerous rental payments. In December 1990 when they moved into site five, rental values on these properties had fallen considerably. As their landlords would not let them relinquish the leases, the only option that they had was to sub-let the premises until the head leases expired. As a result of this sub-letting, losses in excess of £5½ million would be created and the firm provided for the full amount in the 1990 accounts.

HMRC sought to disallow this provision. They quoted **SP 3/90** which basically says that we are not allowed to anticipate losses for tax purposes. Their argument was that the firm should have accrued for the rental losses over the period that the head leases expired. The firm disagreed as they argued that what they had done was consistent with the concept of prudence. **SSAP 2** specifically says that the prudence concept overrides the accruals concept.

Consequently when the case came before the **High Court** the Judge **ruled in favour of the firm** on the basis that they could prove what they had done was acceptable on accounting grounds. As a result HMRC were forced to withdraw SP 3/90.

32.5 Materiality

For accounting purposes, only material items are required to adhere to accounting standards (in other words only items which affect the users' view of the accounts).

The concept of materiality is not recognised by HMRC. For tax purposes all the figures in the accounts must be examined, not just the material ones, as the failure to apply generally accepted accounting principles is likely to lead to an adjustment being required.

For instance, let us say that we received a letter from HMRC asking us to confirm whether a particular provision meets the requirements of **FRS 12.** When we open up the audit file we realise that we did not make any comments during the audit on this particular provision as it is immaterial to the accounts. Unless we can put forward sufficient evidence to show that we have applied **FRS12** correctly, HMRC have every right to ask for an adjustment to be made in the tax computation.

32.6 GAAP and the FRSSE

HMRC will accept accounts prepared under the Financial Reporting Standards for Small Enterprises (FRSSE) because the accounts submitted for that size of organisation have followed the correct accounting treatment. HMRC cannot insist that a non-FRSSE standard is applied in a particular situation.

A company may choose not to adopt FRSSE, in other words to adopt the full array of standards. HMRC's view on this is that if a company chooses to apply one particular standard which is not applicable to the FRSSE, they must apply all of the other standards and must do so in full. This view is yet to be challenged.

32.7 Capital and revenue

HMRC believe that the **accounting treatment of an item cannot change its nature,** be it **capital** or **revenue.** This view is expressed in their bi-monthly publication **Tax Bulletin, issue 39**.

CTA 2009 s.53 disallows capital expenditure unless it is mentioned elsewhere in CTA 2009 as being specifically allowable.

Therefore even if the correct accounting principles have been followed, HMRC can rely on separate statutory rules which disallow capital expenditure.

32.8 Income recognition

The critical area for tax purposes is the recognition of income. There is currently no accounting standard dealing with the recognition of income for accounting or indeed therefore tax purposes.

However, where HMRC can show that GAAP has not been followed in recognising income in the accounts, they can successfully request the appropriate adjustment. This was given in the decision in the ***Gardner Mountain*** case.

In this particular case, agents sold insurance policies and were entitled to an amount of commission per policy sold. The commission was paid to the agents at the time the policy was sold. However, if the policyholder cashed in the policy within the first two years, some of the commission might have to be refunded to the insurance company.

The insurance company, Gardner Mountain, advised all of their agents to account for their commission income to HMRC as follows:

50% in Year 1,
25% in Year 2, and
25% in Year 3.

The argument behind this income recognition pattern was, that at the time the commission was paid to the agent, there was a risk that some of it would have to be refunded to the insurance company and therefore it would be wrong to recognise all of the commission up front for tax purposes.

However, HMRC successfully argued that this accounting treatment did not accord with the underlying economic reality of the transaction. For tax purposes, HMRC were of the view that all of the commission should be brought into charge in the accounting period in which it was received, as it was this accounting period in which the work had been done to sell the policy.

In the second and third years HMRC would accept as an expense any commissions which the agent subsequently had to refund. In some situations, a provision might be acceptable, but of course nowadays we would need to follow **FRS 12.**

32.9 Moving towards IAS

As stated earlier, for accounting periods beginning on or after 1 January 2005, compliance with GAAP includes compliance with International Accounting Standards (IAS). The main difference between GAAP and IAS is the tendency towards fair value accounting.

IAS concentrate more on the balance sheet and recognising movements in the opening and closing balance sheets within the profit and loss account. IAS provide for recognition of anticipated profits. Accruals and prudence are still the basis for accounting however there is greater use of fair value accounting.

Where there is a conflict between prudence and fair value, fair value will prevail.

In amending the legislation, in particular that relating to loan relationships and derivatives, to deal with IAS HMRC has left themselves the right to issue regulations requiring that amounts recognised under GAAP are not brought in for tax and vice versa giving specific rules on how these amounts will be dealt with for tax.

We have seen an example of these rules in the chapter on loan relationships.

For accounting periods beginning on or after 1 January 2005, where in a group of companies one company uses IAS and another UK GAAP, then if there are transactions between the two and a tax advantage would arise as a result of the different accounting policies, they are both to be treated as using UK GAAP. FA 2004, s.51

A group for these purposes is as defined for capital gains tax.

32.10 Deferred tax

Deferred taxation is an accounting term. It in no way impacts on a company's taxation liability.

The aim of the rules on deferred taxation is to recognise the impact of the **difference between the accounting treatment of items and the taxation treatment**. We have seen that the amounts allowed for tax purposes do not always coincide with the amounts shown in the profit and loss account.

Permanent differences arise when certain types of income and expenditure are recognised in the accounts but will never appear in the tax computation as an item of taxable income or an allowable expense.

The classic example of this is business entertaining – in the accounts it is a legitimate business expense, but it is never an allowable deduction for tax purposes.

Another example would be a dividend received from a UK company – it is an item of income in the accounts but not in the tax computation.

Timing differences arise when certain types of income and expenditure are recognised in different periods for the purpose of financial statements on the one hand and taxation on the other.

An example of a timing difference is that depreciation charges appear in the financial statements, but are not allowed as an expense for tax purposes. Instead, capital allowances reduce taxable profits. Over the lifetime of a fixed asset, total depreciation charges will equal (roughly) total capital allowances. However, in any particular accounting period the two amounts will differ – this is a timing difference.

Illustration 1

Ride Ltd has annual pre tax profits (after deducting depreciation) of £240,000. The company buys an asset for £180,000 in the year ended 31 March 2011 and claims a 20% writing down allowance each year. The asset is depreciated on a straight line basis over 10 years. The corporation tax rate is 28%.

Here the company buys an asset in the year for which it is entitled to a writing down allowance of 20% each year on the reducing balance basis. However its depreciation charge is straight line at 10% per annum over 10 years.

First we need to work out our actual corporation tax charge. To calculate our taxable profits we start with the profit before tax in the accounts of £240,000 but we then have to add back the depreciation of £18,000 and deduct capital allowances of £36,000. This gives us taxable profits of £222,000 and a corporation tax charge of £62,160.

	£
Profit before tax	240,000
Add back: Depreciation	18,000
Less: Capital allowances	(36,000)
Taxable profits	222,000
CT charge (£222,000 x 28%)	£62,160

This sometimes confuses shareholders who expect the corporation tax charge to be 28% of the profit before tax figure. The expected tax charge is therefore £67,200 (28% x £240,000).

Deferred tax is an accounting adjustment which, provided there are only timing differences, makes the total tax charge in the profit and loss account equal the expected tax charge (corporation tax rate x profit before tax).

	£
Actual CT charge	62,160
Deferred tax charge (balancing figure)	5,040
Expected tax charge	67,200

The deferred tax charge will therefore be £5,040 in the year ended 31 March 2011. The double entry will be to debit the deferred tax charge (otherwise referred to as the deferred tax expense) T account and to credit the deferred tax provision T account (which is a balance sheet creditor).

	£
Dr Deferred tax charge	5,040
Cr Deferred tax creditor	5,040

In the next year, year ended 31 March 2012, Ride Ltd again has annual pre tax profits (after deducting depreciation) of £240,000. We follow the same approach as before.

First we need to calculate our actual corporation tax charge for the year ended 31 March 2012. The depreciation charge that we add back to the profit before tax in the accounts is again £18,000 because using the straight line method of depreciation will give us the same expense for each of the asset's ten year life.

However, the capital allowances which are deducted for tax purposes are calculated on a reducing balance basis. The capital allowances will therefore be 20% x £144,000 (being the asset's cost of £180,000 less the writing down allowance of £36,000 claimed in year one), giving capital allowances of £28,800.

This gives us taxable profits of £229,200 and a corporation tax charge of £61,884 in the year ended 31 March 2012.

	£
Profit before tax	240,000
Add back: Depreciation	18,000
Less: Capital allowances	(28,800)
Taxable profits	229,200
CT charge (£229,200 x 27%)	£61,884

The profit before tax figure however is unchanged at £240,000 and so the expected tax charge is still £64,800 (27% x £240,000).

	£
Actual CT charge	61,884
Deferred tax charge (balancing figure)	2,916
Expected tax charge	64,800

The deferred tax charge will therefore be £2,916 in the year ended 31 March 2012 and the double entry will be:

	£
Dr Deferred tax charge	2,916
Cr Deferred tax creditor	2,916

The reason that this **deferred tax charge** has arisen in our example is **due to the timing difference** between the depreciation expense in the accounts and capital allowances that are deducted for tax purposes.

Timing differences:

	Y/e 31 March 2011	Y/e 31 March 2012
	£	£
Capital allowances	36,000	28,800
Depreciation	(18,000)	(18,000)
Timing difference	18,000	10,800
Deferred tax @ 28%/27%	£5,040	£2,916

Eventually the total £180,000 cost of the asset will have been deducted both as depreciation expense in the accounts and as capital allowances in arriving at the taxable profits.

The purpose of deferred tax is to smooth out the inconsistency between the rate at which relief is given in the accounts and the rate at which relief is given for tax purposes.

Deferred tax impacts the profit and loss account as follows. Our profit before tax is £240,000 each year. From this we deduct the actual corporation tax charge each year (based on the taxable profits each year). We then also deduct our deferred tax charge each year.

Our total tax charge for the years in question come to £67,200 and £64,800 which is 28% and 27% respectively of profit before tax. This is the figure the shareholders would expect to see.

Profit and Loss Account

	Y/e 31 March 2011	Y/e 31 March 2012
	£	£
Profit before tax	240,000	240,000
Corporation tax	(62,160)	(61,884)
Deferred tax	(5,040)	(2,916)
Profit after tax	£172,800	£175,200

In years where the actual corporation tax liability is greater than the expected tax charge there will be a decrease in the deferred tax creditor because the timing differences are being smoothed out.

The double entry will therefore be to debit the deferred tax creditor and to credit the deferred tax charge (which is a decrease in the deferred tax expense):

	£
Dr Deferred tax creditor	X
Cr Deferred tax charge	X

Timing differences can also arise in respect of:

- accruals for pension costs and other post-retirement benefits that will be deductible for tax purposes only when paid;
- elimination of unrealised intragroup profits on consolidation;
- unrelieved tax losses.

FRS 19 is the relevant accounting standard on deferred tax under UK GAAP. It requires **full provision** to be made for deferred tax assets and liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in a tax computation. The illustration above shows the amount that would be required to be provided for on a full provision basis.

IAS 12 is the international accounting standard for income tax which also deals with deferred tax. Like FRS 19 it requires full provision for deferred tax on most types of timing differences. However IAS 12 uses a different conceptual framework looking at what it calls "temporary differences". The provision under IAS 12 for Illustration 1 would be as shown above.

There are some differences between FRS 19 and IAS 12. For example FRS 19 does not require a provision where non monetary assets are revalued, also FRS 19 allows discounting for the time value of money which is not permitted by the IAS.