CHAPTER 33

TAX AND PROVISIONS

33.1 Provisions

A **provision is effectively an estimate of expenditure** which may have been incurred or losses which may have been sustained. They do not necessarily reflect actual expenditure but are a reliable estimate in working out the cost of a particular item to a business.

The problem is that HMRC don't like them. This is given by the very old case of ***Southern Railways of Peru Limited*** whereby HMRC only accepted a provision provided it had been specifically calculated. HMRC do not like companies simply putting through a provision in the accounts and wiping out substantial amounts of taxable profit. Where a company can show a fundamental basis for the figures computed then the provision would be allowed. So this case set the principle that provisions are only allowable where they are specific.

33.2 Tax Bulletin 44

HMRC's bi-monthly publication, Tax Bulletin, issue number 44 (now incorporated into the Revenue manuals), which was released in December 1999, set out HMRC's views on the deductibility of provisions. Tax Bulletin 44 basically says that **HMRC will accept provisions as deductible if:**

(i) They **relate to allowable revenue expenditure**;

(ii) They **follow GAAP** which nowadays means the application of FRS 12, cemented by the Herbert Smith case; HMRC BIM46510

(iii) They **do not conflict with any specific tax rule** given by statutory provisions or case law; and

(iv) They can be **estimated with sufficient accuracy**.

The entity must prove that all four of these criteria have been met before a provision will be deductible for tax purposes.

33.3 FRS 12 and IAS 37

FRS 12 and IAS 37 were developed at the same time hence there are no major differences between them.

As **FRS 12** is the **accounting standard which specifically deals with provisions** it is important, given HMRC's view in Tax Bulletin 44, that we understand exactly when FRS 12 enables us to make a provision.

Under FRS 12, a provision is permitted if it meets all **three** of the following **conditions:**

(i) The entity has a **present obligation resulting from a past event**. In other words this event has taken place by the balance sheet date;

(ii) It is probable that **economic benefits will be required to settle this obligation.** In other words, the event has caused us to spend money or is likely to cause us to spend money; and

(iii) **A reliable estimate can be made**.

33.4 Obligations

The whole issue of whether a provision is allowable under FRS 12 centres on whether the entity has an obligation. These obligations fall into two main categories.

Legal obligations

These may be given by some form of contract such as a lease, a service agreement or warranties issued to customers. By signing a lease or providing a warranty the entity has basically committed itself to incur expenditure in the future.

A legal obligation could also arise by the operation of legislation, such as the Sale of Goods Act (which requires a retailer to provide one year guarantees on certain types of product), Consumer law or the **Financial Services and Markets Act of 2000.**

Where an entity can prove that it has an obligation under a particular statutory provision which requires it to spend money and which it can reliably estimate, then a provision will be required under FRS 12.

Constructive obligations

If an entity has established a past practice or published policies indicating it will accept certain responsibilities and there is a valid expectation that those responsibilities will be discharged then a provision will be required under FRS 12.

For instance under the **Sale of Goods Act**, a business is required to give certain statutory guarantees on products, but if the business in its consumer policies or other business practices provides warranties over and above the statutory requirements, then provisions should be made in the accounts to reflect the cost of those provisions.

33.5 Existence of obligations

The importance of identifying obligations is not just an accounting one. If we can find more provisions we can actually reduce the accounting profit, in some cases substantially, which as a result of **Tax Bulletin 44** will naturally be allowed for tax purposes.

So, if we can show that an obligation actually exists, not only is the entity recommended to make a provision under FRS 12, it is also actually required to make such a provision and it naturally follows that tax relief will be allowed as cemented in the decision in ***Herbert Smith v Honour***, covered in the previous chapter.

33.6 Anticipation of losses

Some provisions do anticipate losses. **In the past, HMRC firmly believed that losses could not be anticipated for tax purposes** - a view that was published in **SP 3/90**.

However, **in the case of Herbert Smith the firm anticipated losses on sub-letting of properties which were allowed for tax purposes** on the basis that they followed generally accepted accounting principles.

As a result **SP 3/90 was withdrawn** by HMRC as it no longer has a valid basis. Consequently there is no general rule anymore that losses cannot be anticipated for tax purposes, what we must look at clearly is whether the provision for the loss accords with FRS 12.

33.7 The Jenners case

Jenners is a department store on Princes Street in Edinburgh. It needed to undergo a refurbishment so a provision was put through the accounts. The company argued that the repairs were necessary under the terms of the lease. HMRC argued that s.74(d) ICTA 1988 (as was) required amounts relating to repairs to have actually been expended. As far as HMRC were concerned, expended meant spent and consequently the repair provision was not allowable.

It was held that expended did not mean spent out in cash, but could also include amounts accrued under accounting principles.

33.8 IAS

IAS's allow the recognition of future profits and losses. In general, income is recognised when there is an increase in future economic benefits, and that increase relates to either an increase in an asset or a decrease in a liability which can be measured reliably.

The use of fair value accounting and subsequent year end revaluations may cause problems. This is because such adjustments are not normally represented by cash movements, whereas a tax liability does have a cash impact.

HMRC is moving towards IAS as part of GAAP. HMRC has the power to issue regulations requiring amounts included in the accounts not to be recognised for tax purposes.