



Deferred tax

Produced by Tax Training Ltd.

www.taxtrainingltd.co

020 8224 5695.

March 2018

Introduction

Deferred tax is an accounting adjustment. It is a figure that appears on a business's balance sheet.

The figure for deferred tax has no impact whatsoever on the amount of tax payable by an entity. It is not reported to HMRC. The figure is of no interest to HMRC (except possibly in checking the veracity of a tax return).

What deferred tax represents

The amount of deferred tax represents the difference between:

- the corporation tax or income tax payable by the entity for the accounting period, and
- the corporation tax or income tax that would have been payable had the tax been calculated on the figures per the accounts without timing adjustments.

This is best illustrated by a simple example. A business spends £100,000 on plant that it expects to last for 10 years. So it accounts for £10,000 depreciation in each of ten years. Its turnover is £200,000 and its costs and expenses other than depreciation are £50,000.

Its profit and loss account will (very simplified) show:

Turnover		£200,000
less depreciation	£10,000	
other costs and expenses	<u>£50,000</u>	
		<u>£60,000</u>
Net profit		<u>£140,000</u>

If that net profit were to be subject to corporation tax at 19%, the tax would be £26,600.

But that net profit is not subject to corporation tax. The annual investment allowance allows the business to claim the whole £100,000 cost in the first year against tax.

The tax computation will show:

Profit per accounts:	£140,000
add back depreciation	<u>£10,000</u>
	£150,000

less annual investment allowance	<u>£100,000</u>
adjusted profit	<u>£50,000</u>

If this is taxed at 19%, the corporation tax for the accounting period is just £9,500. And that is what is paid to HMRC.

This is a tax saving £17,100. This represents 19% of £90,000, the additional amount of tax relief given in the first year.

But accounts must be prepared on the **matching basis** or accruals concept. This means that income and expenditure must be matched for the same accounting period. In this case, tax law in effect has allowed the business to claim ten years' worth of tax relief in one year.

An accounting adjustment is therefore made as a journal entry. The sum of £17,100 is debited to "tax" in the profit and loss account. It is added to the £9,500 paid. The profit and loss account will usually show the total tax figure of £26,600 split between these two elements. The corresponding credit of £17,100 is posted to deferred tax. It appears on the balance sheet as a long-term liability. In effect, it represents money payable to HMRC in more than a year's time.

The amount of deferred tax is a credit balance, and is therefore shown as a liability.

What happens in year 2

We assume that no further plant is bought in year 2 and that, otherwise, the figures are the same as for year 1.

The profit and loss account will therefore again show £140,000 net profit and tax of £26,600.

However, the tax computation will show:

Profit per accounts	£140,000
add back depreciation	<u>£10,000</u>
Adjusted profit	<u>£150,000</u>

The tax on this sum at 19% is £28,500. That is what is paid to HMRC. This is £1,900 more than the £26,600 per the accounts. The sum of £1,900 represents the additional £10,000 subject to corporation tax.

This time the journal entry is to debit deferred tax on the balance sheet by £1,900 and credit £1,900 to tax on the profit and loss account. The journal is the opposite way round to that in year 1.

The profit and loss account will show:

Tax paid	£28,500
less deferred tax	<u>£1,900</u>

Tax charge	<u>£26,600</u>
------------	----------------

The balance sheet will show as the long-term liability of deferred tax:

Deferred tax b/fwd	£17,100
less deferred tax for year	<u>£1,900</u>
Deferred tax c/fwd	<u>£15,200</u>

The tax charge shown in the accounts is again £26,600. The balance sheet figure has reduced from £17,100 to £15,200. The passing of another year has meant that the delayed payment to HMRC has reduced.

If these accounts were to be repeated for another eight years, the deferred tax credit balance on the balance sheet would reduce by £1,900 each year until it fell to zero at the end of those eight years, or ten years after the asset was acquired.

But life is not so simple

The example above is deliberately simple to understand the principle involved. In real life, there are some other factors which can complicate matters.

In the example above, we have used a corporation tax rate of 19% for all years. But **rates** of tax change. We know that the rate is due to fall to 17% in 2020. We do not know what the rates will be for the next ten years. So what rates do we use?

The answer is found in accounting standard FRS 102 para 29.12 which states that the rates of tax to be used are “the tax rates and laws that have been enacted or substantially enacted”. As rates are usually known for perhaps a maximum of two or three years hence, there is usually an assumption that the last rate will continue.

Sometimes different rates of corporation tax can apply. Since April 2015, there has been just one rate of corporation tax as the previous small profits rate has been subsumed into the main rate. Even so, there are some differences in corporation tax rates for such areas as banking, oil industry, merchant shipping and patent box.

Deferred tax is not confined to UK tax. A company that operates in other jurisdictions needs to allow for deferred tax under those laws. In some jurisdictions there are different rates according to size of business and how much profit has been distributed as dividends. These must be factored into the deferred tax calculation.

Deferred tax should only be taken to accounts to the extent that it will be **reversed** in a later year. If there is reason to believe that subsequent events will prevent reversal, deferred tax should not be calculated.

If a company has **subsidiaries** or associated companies, their deferred tax may need to be included, wholly or partly, in the consolidated accounts.

There are some special accounting provisions in relation to deferred tax as it applies to non-depreciable assets and to investment properties.

As deferred tax represents a future liability payable several years hence, the value will be less than the figure shown in the accounts. Despite this, an entity must not **discount** any element of deferred tax to reflect the time effect on money.

These factors can make the deferred tax calculation very complicated. To address this, sometimes a different method of bookkeeping is used. Instead of adjusting balances each year, an entity may simply reverse whatever journal entry it made in the previous year for deferred tax, calculate the new figure from scratch and make that a journal entry for the current year. This may be done by comparing the net book value in the accounts with the written down value in the tax documents.

Making the calculation

Deferred tax is solely concerned with **timing differences**.

Some items in the accounts are disallowed for tax. These include personal expenditure, fines and entertaining customers. These do not affect deferred tax.

Capital expenditure for which no capital allowance may be claimed (such as land and most buildings) also do not affect deferred tax.

All the above are called **permanent differences** and are ignored for deferred tax.

Deferred tax is only concerned with items where:

- tax relief may be claimed
- the relief is given at a different rate from that used in the accounts, and
- the deferred tax will ultimately reverse.

By far, the commonest example is capital allowance for plant and machinery. Both depreciation in the accounts and capital allowances in the tax computations will eventually give the entity full relief for the capital expenditure, but the total cost is apportioned between the years differently. Usually capital allowances allow more relief at the beginning, which is why deferred tax is usually a credit balance on the balance sheet.

There are some other instances where deferred tax can arise. One is where an asset is revalued. Historically there have been other provisions, such as stock relief. There are a few tax provisions that allow a taxpayer to claim tax relief in an earlier period.

The UK standard on deferred taxation is FRS 102 section 29. This replaces FRS 19 for accounting periods that start from 1 January 2015.

More recent accounting standards make greater use of **fair value**. This can itself cause adjustments to deferred tax when assets are revalue, or are recognised for the first time. For example FRS 102 section 17 permits the use of the revaluation model for property, plant and equipment. This can require an adjustment for deferred tax whereas the previous standard FRS 19 did not.

Another significant change relates to **business combinations**. Under FRS 102 section 19, combinations are accounted for under the purchase method. Assets and liabilities are recognised at their fair value, which can differ from the tax-deductible amount.