Think Ahead ACCA

Technical factsheet

Deferred tax

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INTRODUCTION

FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with deferred tax in Section 29 *Income Tax.* For companies applying UK-endorsed IFRS Standards, IAS 12, *Income Taxes* will apply.

Micro-entities choosing to report under FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime* are prohibited from recognising deferred tax. This is on the grounds that it would not be possible to distinguish between current tax and deferred tax due to the lack of disclosure requirements; hence the Financial Reporting Council (FRC) scoped micro-entities that choose to report under FRS 105 out of the requirement for deferred tax.

1. SCOPE OF FRS 102, SECTION 29

The scope of FRS 102, Section 29 is outlined in para 29.2. The scope section confirms that Section 29 applies to the accounting for income tax, which is then split into component elements. FRS 102, para 29.2 states that Section 29 applies to:

*'(a) **income tax** comprising:*

*(i) **current tax**; and*

*(ii) **deferred tax** including deferred tax in respect of **assets** (other than **goodwill**) and **liabilities** recognised as a result of a **business combination**; and*

(b) value added tax (VAT) and other similar sales taxes, which are not income taxes.'[1]

The requirements in FRS 102, para 29.2(a)(ii) refer to assets (other than goodwill) and liabilities recognised as a result of a business combination. A 'business combination' for the purposes of FRS 102 arises when one entity obtains control over another entity; in other words, a parent company acquires a subsidiary, or an organisation acquires the trade of an unincorporated business. ACCA's *Technical factsheet: consolidated financial statements* provides more details about business combinations.

[1] FRS 102, para 29.2.

The recognition of deferred tax in respect of business combinations was included by the FRC so that FRS 102, Section 29 is aligned to the requirements of IAS 12 and hence the calculation of deferred tax under FRS 102 does not end up too dissimilar from the same calculation that would be arrived at under IFRS Standards.

2. DEFERRED TAX

FRS 102 requires deferred tax to be calculated using the 'timing difference plus' approach. As noted above, the calculating of deferred tax in the UK and Republic of Ireland is such that the end result would not be too different from the same calculation as that under IAS 12.

ACCA comment

Deferred tax in the UK and Republic of Ireland is calculated using a timing difference approach. Under this approach, deferred tax is recognised on timing differences between accounting profit and taxable profit, hence the focus of the timing difference approach is on the profit and loss account (income statement).

Under IAS 12, deferred tax is calculated on a temporary difference approach, which focuses on the book values of assets and liabilities and the tax written-down values (or 'tax bases') of those assets and liabilities, hence the focus of the temporary difference approach is on the balance sheet (statement of financial position).

Deferred tax is the application of the accruals concept. This requires the tax effects of a transaction to be reported in the same accounting period as the transaction itself. Hence, an adjustment to the tax charge in the financial statements may be needed. It is this concept that gives rise to deferred tax and the overall objective is to lessen volatility within the financial statements. This also helps to highlight future obligations to pay tax that are based on profits that have already been made, which may help the directors to manage their cash flow better and ensure they have enough cash to pay tax bills once the deferred tax 'turns into' current tax.

Example: basic principles of deferred tax

Sunnie Ltd prepares its financial statements to 31 March each year. During the year to 31 March 2020, the company purchased an item of machinery for £1m, which has an expected useful life of four years. Sunnie Ltd claims HMRC's *Annual Investment Allowance*, which allows 100% tax relief to be granted on this machine in the year of acquisition because it is a qualifying asset.

The draft financial statements for the year ended 31 March 2020 show a profit of £1.2m and forecasts suggest that this level of profit will continue for the foreseeable future as the company has a five-year contract in plac, meaning the income and profitability of the company is relatively static. The company pays tax at a rate of 19%[2].

What would be the pre- and post-tax profits for Sunnie Ltd for each of the four years ending 31 March 2020 to 31 March 2023, assuming:

a) deferred tax is **not** recognised
b) deferred tax is recognised?

[2] Note this example ignores the increase in corporation tax rate to 25% on 1 April 2023. The effect of this increase is discussed later in the factsheet.

Deferred tax is not recognised

	2020	2021	2022	2023	Total
	£'000	£'000	£'000	£'000	£'000
Accounting profit	1,200	1,200	1,200	1,200	4,800
Addback depreciation	250	250	250	250	1,000
Capital allowances	(1,000)	-	-	-	(1,000)
Taxable profit	450	1,450	1,450	1,450	4,800
Tax at 19%	86	276	276	276	914

Extracts from Sunnie's profit and loss accounts for the four years are as follows:

	2020	2021	2022	2023	Total
	£'000	£'000	£'000	£'000	£'000
Profit before tax	1,200	1,200	1,200	1,200	4,800
Current tax	(86)	(276)	(276)	(276)	(914)
Profit after tax	1,114	924	924	924	3,886

If deferred tax is ignored, the profit and loss accounts suggest a declining performance between 2020 and 2023. This is caused by the timing of the current tax charge on the company's profits. Due to the purchase of the machine in 2020 and the 100% tax relief available on it, some of the accounting profit is not charged to tax in 2020. This is only a postponement of tax (essentially a cash flow saving in the year of acquisition) until 2021, 2022 and 2023, when the taxable profit becomes more than accounting profit.

Deferred tax is recognised

Sunnie calculates deferred tax at a rate of 19% because this is the tax rate that will apply when the timing differences reverse. The deferred tax computation is as follows:

	Year ended 31 March			
	2020	2021	2022	2023
	£'000	£'000	£'000	£'000
New machine carrying amount	750	500	250	-
Tax written down value	-	-	-	-
Timing difference	750	500	250	-
Closing deferred tax at 19%	142.5	95.0	47.5	-
Opening deferred tax	-	142.5	95.0	47.5
Charge (credit) to P&L	142.5	(47.5)	(47.5)	(47.5)

Extracts from Sunnie's profit and loss account when deferred tax is recognised are shown below:

	Year ended 31 March				
	2020	2021	2022	2023	Total
	£'000	£'000	£'000	£'000	£'000
Profit before tax	1,200	1,200	1,200	1,200	4,800
Current tax	(86)	(276)	(276)	(276)	(914)
Deferred tax	(142.5)	47.5	47.5	47.5	-
Profit after tax	971.5	971.5	971.5	971.5	3,886

As you can see from the above, accounting for deferred tax provides a more meaningful performance profile of Sunnie Ltd, and smooths out profit and loss volatility due to timing differences.

2.1 Timing differences

The term ‘timing differences’ is defined as:

*‘Differences between **taxable profits** and **total comprehensive income** as stated in the **financial statements** that arise from the inclusion of **income** and **expenses** in tax assessments in periods different from those in which they are recognised in the financial statements.’*

Effectively, a timing difference arises in one period and is capable of reversal in another period.

Example: pension contributions

Harper Ltd operates a defined contribution pension scheme for its employees. The financial statements for the year ended 31 December 2021 recognise a pension accrual for three months’ pension contributions that had not been paid into the scheme by the balance sheet date.

In the UK, tax legislation grants tax relief on employer contributions when they are paid and not when they arise. Hence, the accrual will not be granted tax relief in the corporation tax computation for the year ended 31 December 2021. (It will be ‘added back’ to profit when calculating profit chargeable to corporation tax.)

Assume that the three months’ pension contributions are paid in March 2022. A deferred tax asset can be recognised in the financial statements for the year ended 31 December 2021 because a timing difference has arisen. The three months’ pension contributions have been recognised in the financial statements for the year ended 31 December 2021 but have been granted tax relief in the tax computation for the year ending 31 December 2022.

FRS 102, Section 29 therefore requires deferred tax to be calculated on all timing differences that have originated, but not reversed, by the balance sheet date.

Deferred tax is never provided on permanent differences. The term ‘permanent differences’ is defined as:

‘Differences between an entity’s taxable profits and its total comprehensive income as stated in the financial statements, other than timing differences.’

A permanent difference arises because certain types of income and expense are non-taxable or disallowable. For example, customer entertaining is a disallowable expense for tax purposes and hence a permanent difference. However, an exception to this rule relates to business combinations as FRS 102, para 29.11 requires deferred tax to be provided on amounts that would not ordinarily meet the definition of a timing difference and hence would otherwise be permanent differences.

2.2 Deferred tax assets

‘Deferred tax assets’ are defined as:

*‘**Income tax** recoverable in future **reporting periods** in respect of:*

*(a) future tax consequences of transactions and events recognised in **financial statements** of the current and previous periods;*

(b) the carry forward of unused tax losses; and

(c) the carry forward of unused tax credits.’

FRS 102, para 29.7 is strict in its approach where deferred tax assets are concerned. Unrelieved tax losses (which could be offset against future taxable profits) and other deferred tax assets are only recognised to the extent that it is probable (ie more likely than not) that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits. The objective of this restriction is to prohibit entities from disproportionately inflating assets in the balance sheet which will never be recovered.

FRS 102, para 29.7 emphasises the point that the very existence of unrelieved tax losses is to be taken as strong evidence that there may not be other future taxable profits against which the losses will be relieved. Therefore, before recognising a deferred tax asset in the balance sheet, the entity must be satisfied that there is evidence that it is capable of recovery – for example, because some change in circumstance, such as a new order or product, has occurred that makes the turnaround to profit probable.

ACCA comment

FRS 102 does not prescribe any particular presentation requirements for deferred tax assets. In practice, deferred tax assets should be presented within current assets – either as a separate heading or as a sub-heading of debtors. In the majority of cases, deferred tax assets are presented as current; however, in the situation that recovery of a deferred tax asset is likely to take place over more than one year, the current and non-current potion should be presented to comply with *The Large and Medium-sized (Companies and Groups) Accounts and Reports Regulations 2008* (SI 2008/410, Sch 1, note 5 in respect of balance sheet formats). The same applies to small entities per *The Small Companies and Groups (Accounts and Directors’ Report) Regulations 2008* (SI 2008/409).

For entities preparing financial statements under UK-adopted IFRS Standards, IAS 12 requires a deferred tax asset to be presented in the balance sheet as a single non-current item.

The need to consider whether the entity will generate ‘future taxable profits’ is critical where deferred tax assets are concerned. If the entity does not have the ability to generate such future taxable profits, a deferred tax asset will not be recognised. Indicators that an entity may or may not generate future taxable profits to utilise a deferred tax asset are shown in the table below:

Indicators the entity WILL generate future taxable profits	Indicators the entity will NOT generate future taxable profits
The awarding of a contract to the entity in the next financial year that is likely to be lucrative.	Financial and taxable losses are being incurred from one period to the next with no sign of improvement.
Evidence that the taxable loss incurred in the year is an isolated incident, eg because of a large bad debt or restructuring, and the company's budgets and forecasts indicate that the company will return to profit in the next financial year.	The entity has entered into a financial reorganisation (eg a Company Voluntary Arrangement)
The entity is a member of a group and group relief is available whereby a loss in one group member can be offset against another group member's profit.	

3. DEFERRED TAX AND THE INCREASE IN CORPORATION TAX RATE FROM 1 APRIL 2023

FRS 102, para 29.12 requires an entity to measure deferred tax using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date and which are expected to apply to the reversal of the timing difference(s).

The term 'substantively enacted' is defined as follows:

'Tax rates shall be regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so.

A UK tax rate shall be 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).

A Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dail.'

There is an added complexity due to the increase in corporation tax rates in the UK from 19% to 25% from 1 April 2023.

Finance Act 2021 makes provision for the rate of corporation tax in the UK to increase from 1 April 2023 from 19% to 25% where a company has taxable profits exceeding £250,000. In addition, there is also a small profits rate of tax of 19% where taxable profits are £50,000 or less. Marginal relief is brought back to provide a gradual increase in the tax rate of companies where taxable profit lies between £50,001 and £250,000. These limits are effectively pro-rated where a company is associated with other companies. Hence, for example, if a company had two associated companies, the upper limit would be £83,333 (£250,000 / 3 – [number of associated companies +1]).

Finance (No. 2) Bill became substantively enacted on 24 May 2021. Consequently, there are impacts on deferred tax accounting depending on whether the accounting period ends before or after 24 May 2021.

Accounting period ends pre-24 May 2021

For accounting periods that end prior to 24 May 2021 (ie 30 April 2021 year ends and prior), but where the financial statements are approved post-3 March 2021 (the date of the spring Budget), deferred tax continues to be calculated at a rate of 19% because this was the rate that was enacted or substantively enacted by the reporting date.

The entity may need to make additional disclosures as to the effect of the increased tax rate on current and deferred taxes, particularly where the effect of the change in tax rate is material.

Accounting period ends post-24 May 2021

For accounting periods ending on or after 24 May 2021, deferred taxes in respect of timing differences that are expected to reverse on or after 1 April 2023 will need to be remeasured at 25% where profits are expected to exceed £250,000; or at the marginal rate if profits are expected to fall between £50,001 and £250,000.

Example: deferred tax with marginal rate calculations

Zico Ltd acquires a machine on 1 April 2021 at a cost of £75,000. The company's depreciation policy for this machine is to depreciate it on a five-year straight-line basis. The directors anticipate a £nil residual value at the end of this five-year useful life. The company has taken advantage of HMRC's Annual Investment Allowance and has claimed 100% tax relief on the cost of the machine in the year of acquisition.

The company's taxable profit for the year ended 31 March 2022 is £50,000 and it has no associated companies.

	£
Corporation tax provision for the year	
£50,000 x 19%	9,500
Net book value of new machine	
Cost	75,000
Depreciation (£75k/5 years)	(15,000)
Net book value as at 31 March 2022	60,000
Deferred tax calculation	
Timing difference	60,000
Tax rate enacted at the year end	19%
Deferred tax liability	11,400

For the year ended 31 March 2023, taxable profit is £150,000 and forecasts indicate that this level of profit is expected to continue for the next five years. The calculations are now as follows:

	£
Corporation tax provision for the year	
£150,000 x 25%	37,500
Less marginal relief:	
3/200 x (£250k- £150k)	(1,500)
Tax provision	36,000
Effective tax rate (£36k/ £150k)	24%
Net book value of new machine	
Net book value b/f	60,000
Depreciation (£75k/5 years)	(15,000)
Net book value as at 31 March 2023	45,000
Deferred tax	
Timing difference	45,000
Tax rate (use the marginal rate as calculated above)	24%
Deferred tax liability as at 31 March 2023	10,800
Deferred tax liability b/f	11,400
Unwinding of timing difference	600
Dr Deferred tax provision (balance sheet)	600
Cr Deferred tax expense (profit and loss)	600

ACCA comment

It is important to keep in mind the requirement of FRS 102, which is to measure deferred tax using the tax rates and laws that have been enacted or substantively enacted by the reporting date *that are expected to apply to the reversal of the timing difference(s).* This requirement means that, in some cases, the rate of tax to be used in the year-end tax computation will be different from the rates used in the calculation of deferred tax because the entity must use the future rate for deferred tax purposes.

3.1 'Super deduction' and deferred tax

In the spring 2021 Budget, the chancellor announced a temporary 130% deduction for qualifying expenditure on new plant and machinery. This expenditure will result in a 130% first-year allowance. Where a qualifying asset is sold in a period that commences prior to 1 April 2023, the sales proceeds are deemed to be up to 130% of the actual proceeds.

For UK GAAP purposes, the super deduction will comprise a 100% allowance for the cost of the asset and an additional 30% that is considered an investment tax credit on the grounds that there are no additional related conditions that need to be fulfilled relating to this investment.

Hence, if the qualifying asset is sold prior to 1 April 2023, a balancing charge will be calculated equal to 1.3 times the sales proceeds.

For the purposes of FRS 102, the 100% allowance will be dealt with in the normal way (ie as a deferred tax liability). FRS 102 does not provide any guidance in respect of the super deduction. IAS 12 *Income Taxes*, para 51[3] states:

'The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.'

FRS 102 does not go into this level of detail in respect of the way in which the entity expects to recover the asset or settle the liability. However, a similar approach could be taken under UK GAAP, hence:

(a) If the entity does not expect to sell the plant and machinery subject to the super deduction prior to 1 April 2023, the additional 30% would be regarded as a permanent difference. Deferred tax is not recognised on permanent differences.

(b) If the company does expect to sell the plant and machinery subject to the super deduction prior to 1 April 2023, the super deduction is regarded as a timing difference as the tax benefit is expected to reverse in future tax periods, hence a deferred tax liability would need to be recognised in respect of this timing difference.

4. DISCLOSURE REQUIREMENTS

FRS 102, para 29.25 requires the entity to disclose information that enables users to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events.

Company law requires every profit and loss account to contain a line item 'Tax on profit or loss'.

4.1 Components of tax expense (income)

For amounts of current tax, FRS 102, para 29.26 requires the entity to separately disclose the major components of tax income or expense, which may include:

(a) current tax expense (income)

(b) any adjustments recognised in the period for current tax of prior periods

(c) the amount of deferred tax expense (income) relating to the origination and reversal of timing differences

(d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes

(e) adjustments to deferred tax expense (income) arising from a change in the tax status of the entity or its shareholders

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[3] Note, if FRS 102 does not deal with a transaction, management must develop an accounting policy that results in financial information that is relevant and reliable (FRS 102, para 10.4). While management does not have to refer to the provisions in the IFRS Standards in developing such a policy, it can be a useful starting point.

(f) the amount of tax expense (income) relating to changes in accounting policies and material errors.

Example: disclosure of reconciliation of tax expense

	31.12.22	31.12.21
	£	£
Corporation tax		
Corporation tax expense for the current year	23,600	22,420
Under provision for prior years	1,225	985
Total current tax	24,825	23,405
Deferred tax		
Origination and reversal of timing differences	6,410	2,219
Increase in tax rate	-	541
Total deferred tax	6,410	2,760
Tax on profit	**31,235**	**26,165**

4.2 Additional items

FRS 102, para 29.27 requires disclosure of:

(a) the aggregate current and deferred tax relating to items that are recognised as items of other comprehensive income or equity

(b) a reconciliation between

(i) the tax expense (income) included in profit or loss; and

(ii) the profit or loss on ordinary activities[4] before tax multiplied by the applicable tax rate

(c) the amount of the net reversal of deferred tax assets and deferred tax liabilities expected to occur during the year beginning after the reporting period together with a brief explanation for the expected reversal

(d) an explanation of changes in the applicable tax rate(s) compared with the previous reporting period

(e) the amount of deferred tax liabilities and deferred tax assets at the end of the reporting period for each type of timing difference and the amount of unused tax losses and tax credits

(f) the expiry date, if any, of timing differences, unused tax losses and unused tax credits

(g) in the circumstances described in paragraph 29.14 [of FRS 102], an explanation of the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders.

[4] Note, the statutory formats no longer use the term '…on ordinary activities' for profit/loss before tax or the tax expense (income). However, FRS 102, para 29.27(b)(ii) does still refer to this term.

Example: reconciliation of tax charge to tax charge per profit and loss account

The effective tax rate is higher than the UK average rate of tax for the year as explained below:	£	£
Profit for the year	552,632	
Multiplied by the applicable tax rate of 19%		105,000
Impact of non-deductible expenses		650
Foreign income taxed at a higher rate		2,200
Capital allowances in excess of depreciation		(200)
Impact of change in tax rate		(1,100)
Total tax charge for the year		106,550

Small entities applying FRS 102, Section 1A

For small entities applying the presentation and disclosure requirements of FRS 102, Section 1A, disclose the following:

(a) where fixed assets are measured at revalued amounts, provide an explanation of the tax treatment of movements in the revaluation reserve during the reporting period

(b) the treatment for tax purposes of amounts credited or debited to/from the revaluation reserve

(c) any other required disclosures in respect of taxation to enable a true and fair view.

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