

Tax reconciliations (Lecture B1313 – 22.49 minutes)

FRS 102 and IFRS requires a reconciliation between:

1. The applicable rate of tax multiplied by accounting profit before tax; and
2. Total tax expense.

For a UK company, the applicable rate would normally be the current rate of corporation tax for the accounting period. But if the company derives substantial profits from other countries, it is permitted (but not required) to use a weighted average rate instead.

The reconciliation can be in currency terms (e.g. £s) and/or in percentage terms.

A reconciliation is not required if a company is using the small company provisions in Section 1A of FRS 102. However, it is worth considering producing a reconciliation in any case as a control to ensure the tax expense in the P&L is correct.

Normally deferred tax would not feature in the reconciliation as it seeks to equalise the tax expense in P&L, but changes where different tax rates are used for deferred tax (see the article on this in a previous session), the differential from the corporation tax rate of the current period will be a reconciling item.

Permanent differences

Deferred tax is not booked on permanent differences. They are items that only affect accounting profits or only affect taxable profits and will always feature in the tax reconciliation.

Examples include:

- Non-staff entertaining;
- Abortive asset acquisition costs;
- Fines and penalties;
- The 130% SME R&D enhancement;
- 30% of the 130% super-deduction (if the assets will not be disposed of before 1 April 2023);
- Gains eligible for substantial shareholding exemption;
- Dividends received.

Example

In its year ended 31 December 2021 a company makes a profit before tax of £150,000. This includes customer entertainment expenses of £22,000 and accrued pension costs of £10,000 which were paid in January 2022.

Show the total tax expense under FRS 102 and the tax reconciliation.

Analysis

Current tax

- Adjusted profit (150,000 + 22,000 + 10,000) = £182,000
- Current tax @ 19% = £34,580

Deferred tax

- Timing difference on pension costs accrued
 - Deferred tax asset/tax credit (P&L)
 - 19%* x £10,000 = (£1,900)
- *reverses in y/e 31.12.22

Total tax expense £32,680

Effective rate (32,680 ÷ 150,000) = 21.79%

Profit before tax multiplied by applicable rate (150,000 x 19%)	28,500	19.00%
Disallowed expense (22,000 x 19%)	<u>4,180</u>	<u>2.79%</u>
Total tax expense	<u>32,680</u>	<u>21.79%</u>

Deferred tax does not feature in the tax reconciliation unless there are using a different tax rate to calculate it.

Example – change in rate of tax

A company with a December year-end accrued a December 2021 deferred bonus of £70,000 (leaving it with an accounting profit of £300,000). This will be paid in mid-January 2023 when it will become tax-deductible.

Calculate the total tax expense in the P&L and produce a tax reconciliation.

Analysis

Profit before tax	300,000
Current tax expense (19% on £370,000)	70,300
Deferred tax (timing difference £70,000 @ *23.5%)	(16,450)
Total tax expense	53,850
Profit after tax	246,150
Effective tax rate on PBT	17.95%

* Expected tax rate for y/e 31 December 2023 ($19\% \times 3/12 + 25\% \times 9/12$)

<i>Tax reconciliation</i>	£	%
Profit before tax multiplied by 19%	57,000	19.00%
Deferred tax calculated at future rates (70,000 x [23.5% - 19%])	<u>(3,150)</u>	<u>(1.05%)*</u>
Total tax expense	<u>53,850</u>	<u>17.95%</u>

*3,150 ÷ 300,000

Common items in a tax reconciliation

- Permanent differences;
- Deferred tax assets not recognised (losses and tax credits carried forward);
- Foreign income taxed at higher rates than the UK CT rate;
- Foreign income taxed at lower rates than the UK CT rate if exempt from UK tax;
 - E.g. foreign branch profits where branch exemption claimed, profits of foreign subsidiaries in group accounts, foreign income exempt under the terms of a double tax agreement;
- Using future tax rates in calculating deferred tax;
- Adjustments made this year to prior year CT liabilities:
 - But does this indicate lack of controls over accurate calculation of CT?
 - Or material judgements when calculating CT?

- Other taxes on profits chargeable, e.g.
 - Diverted profits tax
 - Residential property development tax
 - Petroleum revenue tax and/or supplementary charge

Comprehensive example

Your client, XYZ Limited has prepared its draft financial statements in accordance with FRS 102 for the year ended 31 December 2021. It is not a member of a group.

This shows a profit before tax of £845,000.

The draft CT600 shows the following adjustments to this profit:

Profit before tax	£845,000
a) Entertaining expenses	£25,400
b) Legal and professional fees relating to an abortive asset purchase	£18,200
c) Depreciation – buildings (acquired 10 years ago)	£6,240
d) Depreciation – plant and machinery	£12,470
e) Capital allowances – 130% super-deduction	(£31,850)
f) Capital allowances – 18% WDA	(£4,124)
g) R&D enhancement – 130%	(£18,100)
h) Deferred bonuses – 50% payable in January 2023, 50% in January 2024	<u>£60,000*</u>
	<u>£913,236</u>
Corporation tax provision in the accounts (19%)	<u>£173,515</u>

*includes the associated NIC and social care levy costs.

The draft notes to the balance sheet shows the following carrying values:

	Land & buildings	Plant & machinery
<u>Cost:</u>		
At 1 January 2021	£542,000	£122,520
Additions	<u>-</u>	<u>£24,500</u>
At 31 December 2021	<u>£542,000</u>	<u>£147,020</u>

Accumulated depreciation

At 1 January 2021	£56,160	£34,790
Depreciation	<u>£6,240</u>	<u>£12,470</u>
At 31 December 2021	<u>£62,400</u>	<u>£47,260</u>
Carrying value at 31 December 2021	<u>£479,600</u>	<u>£99,760</u>
Carrying value at 31 December 2020	<u>£485,840</u>	<u>£87,730</u>

Assume that future depreciation will be charged on a straight line basis to depreciate the carrying value of plant and machinery to nil over the next 5 years.

The capital allowances computation has been prepared by a colleague of yours:

	Super-deduction	General pool	Total
At 1 January 2021		£22,911	
Additions	<u>£24,500 x 130%</u>		<u>£31,850</u>
WDA (18%)		<u>(£4,124)</u>	<u>£4,124</u>
Tax written down carried forward		<u>£18,787</u>	<u>£35,974</u>

The audited financial statements for the year ended 31 December 2020 showed a deferred tax liability of £12,316. The notes to those financial statements disclose only one source of timing difference – accelerated capital allowances.

The audit file shows the calculation of this deferred tax liability as:

Carrying value of plant and machinery	£87,730
Tax written down value	<u>£22,911</u>
Timing difference	<u>£64,819</u>
Deferred tax at 19%	<u>£12,316</u>

Requirements:

1. Calculate the deferred tax assets and liabilities in respect of the timing differences at 31 December 2021 and explain the extent to which they will be netted against each other in the financial statements.
2. Calculate the deferred tax expense (credit) for the year ended 31 December 2021, the total tax expense and the effective tax rate.
3. Prepare a tax reconciliation for the year ended 31 December 2021.

Analysis

1 Calculation of deferred tax assets and liabilities

Accelerated capital allowances:

At 31 December 2021:

Book value of plant and machinery	99,760
Tax written down value	18,787
	<u>80,973</u>

Future depreciation is expected to be :

Year ended 31 December 2022	(99,760 ÷ 5 years)	19,952
Year ended 31 December 2023		19,952
Later accounting periods		59,856 *
		<u>99,760</u>

* balance to reduce carrying amount of 99760 to zero

Future WDAs are expected to be:

Balance 31 December 2021		18,787
Year ended 31 December 2022	18%	3,382
		15,405
Year ended 31 December 2023	18%	2,773
Later accounting periods		<u>12,632</u>

Timing difference are therefore expected to reverse as follows:

	Year ended 31 December				
	2022	2023	2024 onwards		
Depreciation	19,952	19,952	59,856		
WDAs	3,382	2,773	12,632		
	<u>16,570</u>	<u>17,179</u>	<u>47,224</u>	Total	80,973
Tax rate	19%	23.50%	25%		
Deferred tax liability	<u>3,148</u>	<u>4,037</u>	<u>11,806</u>	Total	<u>£18,991</u>

Deferred bonuses

These will be tax deductible when paid as they are not payable within 9 months of the end of the accounting period

Deferred tax asset arises, calculated as:

			DT asset
Bonuses payable in year ended 31 December 2023	30,000	23.5%	7,050
Bonuses payable in year ended 31 December 2024	30,000	25%	7,500
	<u>60,000</u>		<u>£14,550</u>

The DT asset must be netted against the DT liability as they relate to tax payable and recoverable in the same jurisdiction.

The net deferred tax liability at 31 December 2021 should be **£4,441**

2 Deferred tax (credit) in the income statement will be the change in the deferred tax liability:

At 1 January 2021	£12,316
At 31 December 2021	<u>£4,441</u>
DT credit in P&L	<u>(7,875)</u>

Total tax expense:

Current tax expense	£173,515
Deferred tax credit	<u>(7,875)</u>
Total tax expense:	<u>£165,640</u>

Effective tax rate **19.60%**

(tax expense ÷ profit before tax)

Profit before tax	845,000
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3 Tax reconciliation

	£	%
Profit before tax multiplied by applicable tax rate (19%)	160,550	19.00%
Expenses disallowed for corporation tax purposes (25,400+18,200+6,240)	9,470	1.12%
Capital allowances super-deduction (30% x 24,500 x 19%)	(1,397)	(0.17%)
R&D enhancement relief (18,100 x 19%)	(3,439)	(0.41%)
Effect of change in tax rates on deferred tax*	456	0.05%
Total tax expense in income statement	<u>165,641</u>	<u>19.60%</u>

*Capital allowance timing difference reversals

2023	17,179	(23.5% - 19%)	773
2024+	47,224	(25% - 19%)	2,833

Deferred bonus timing differences

2023	30,000	(23.5% - 19%)	(1,350)
2024	30,000	(25% - 19%)	<u>(1,800)</u>
			<u>456</u>

Contributed by Malcolm Greenbaum