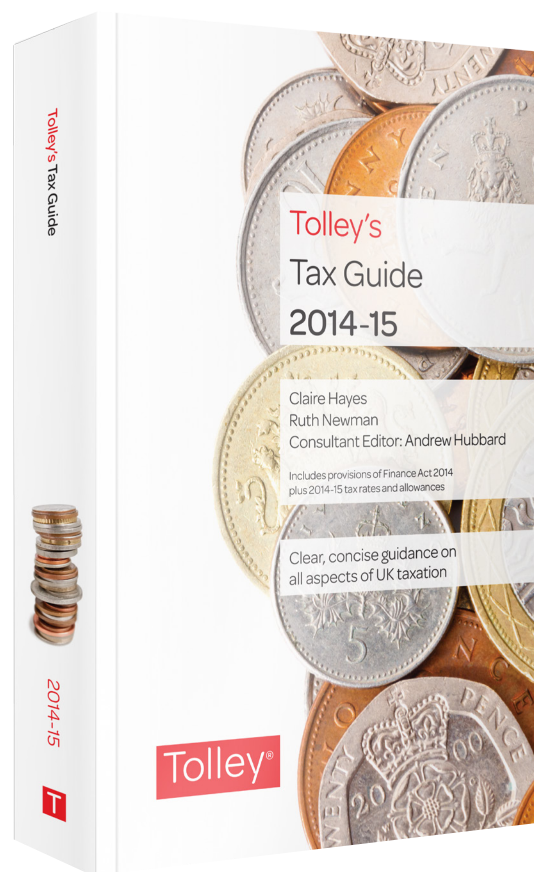
TOLLEY'S TAX GUIDE 2014-15

Excerpt from Chapter 20: Change in basis of computing profits



To order your copy of
Tolley's Tax Guide 2014-15
visit **www.lexisnexis.co.uk**
or call **0845 370 1234**.

Tolley® **Tax intelligence from LexisNexis®**

Change in basis of computing profits (FA 2002, ss 65–66; ITTOIA 2005, ss 25–27, 226–240; FA 2006, s 102 and Sch 15; CTA 2009, s 46, Pt 3 Ch 14)

[20.23]

Where a valid basis of accounting is changed, including a change to or from the cash basis (see **20.4**), such that income is not included or expenditure is included more than once, then in calculating taxable profits the excluded income is brought in as a one-off tax charge and the double-counted expenditure is reckoned only once. Such changes might occur because of the adoption of generally accepted accounting practice or court decisions.

Where completed, unbilled work is brought into accounts for the first time, such as occurred in 2005 when UITF 40 'Revenue recognition and service contracts' was applied to professional work in progress, its value at the beginning as well as at the end of that accounting period is brought in, so that the profits of the year are stated on a consistent basis. The inclusion of the value at the start of the accounting period without a corresponding amount being included in the accounts at the immediately preceding year-end would mean that the 'uplift' would not be charged to tax but for the one-off tax charge.

The one-off charge is reckoned for income tax purposes on the *last* day of the period of account in which the change occurs, and for corporation tax purposes on the *first* day of the accounting period in which the change occurs. The effect of reckoning an uplift within profits is spread forward in certain circumstances. Where the charge arises as a result of leaving the cash basis the adjustment may be spread over six years, with the flexibility of increasing the amount of the charge in any of the earlier tax years, an appropriate reduction then being made in later years.

The legislation does not cover a change from an invalid basis to a valid basis of accounting, for example where by reference to accepted methods of valuation, work in progress has been inadequately valued. In such cases, the tax consequences of having adopted an invalid basis have to be corrected, often with interest and penalties being incurred.

[20.23A]

The Financial Reporting Council has significantly changed what constitutes UK generally accepted accounting practice (GAAP). It introduced four new accounting standards between 2012 and 2014 (FRS 100, 101, 102 and 103). Accounting standards issued prior to FRS 100 will be withdrawn for accounting periods commencing on or after 1 January 2015 when the new accounting standards must be used, although entities can choose to adopt the new standards for periods ending on or after 31 December 2012. The tax legislation has been revised to ensure that it applies to the accounting transition adjustments arising from the changes and the comments outlined in **20.23** regarding a possible one-off tax charge may be relevant.

The changes in accounting practice in FRS 102 will have some implications in preparing tax computations. For example, the revaluation of investment properties under current UK GAAP is within the statement of total recognised gains and losses in the accounts but under FRS 102 such gains will be recognised in the income statement (known under current GAAP as the profit and loss account). This change will affect the tax computation as the revaluation gains will need to be deducted as they are not taxable until such time as the property is sold.

FRS 102 provides for a maximum five-year default life for the write-off of goodwill and intangibles (see **20.32**) where the entity is unable to make a reliable estimate of useful economic life. This will often result in goodwill being written off earlier than under current UK GAAP where 20 years is often used.

There is no default life within UK GAAP, but there is a prohibition on a life of more than 20 years in a small entity, and justification is required for a longer life in other entities. Many companies may therefore choose to adopt FRS 102 early in order to benefit from this goodwill write-off over the shorter period as it may reduce taxable trading profits sooner. However, where companies have elected to claim allowances at a fixed rate of 4% (see **20.34**) a change in the rate of write-off in the accounts does not change the tax treatment. An entity will be able to choose to retain the goodwill treatment calculated before the date of transition to FRS 102, rather than restate it under the new standard but this may not be the most beneficial option. Note that the earlier write-off will not benefit unincorporated businesses for tax purposes as the goodwill is treated as capital and not allowed as an income tax deduction. It is also treated as a capital asset for some companies (see **20.36**).

Another change relates to the treatment of lease incentives in the accounts of the lessee. Currently such incentives are recognised over the shorter of the life of the lease and the date of the next rent review. Under FRS 102 the incentive is recognised over the life of the lease.

Example 4

On 1 January 2012 A Ltd entered into a lease for £100,000 for 16 years which had a rent review after 5 years. The first 2 years are rent-free and thus the first rent payment is not actually made until the year ended 31 December 2014. A comparison of the relief under current UK GAAP (UITF 28) and FRS 102 is as follows:

Year to 31 December	Current UK GAAP	FRS 102
2012	£60,000	£87,500
2013	£60,000	£87,500
2014	£60,000	£87,500
2015	£60,000	£87,500
2016	£60,000	£87,500
2017 – 2027	£100,000 per year	£87,500 per year
Totals	£1,400,000	£1,400,000

It can be seen that if A Ltd adopted FRS 102 early it would receive relief for its rent payments earlier in its accounts and consequently in its tax computations. There is a transitional exemption when FRS 102 is first applied which permits entities to retain the UITF 28 treatment on leases entered into before the date of transition. As there is likely to be a tax advantage of not using the exemption, most entities are likely to restate figures as if FRS 102 had always been applied.

See **20.20** regarding a change in leasing accounting standard occurring on or after 1 January 2011.

The Front Line is where you stand face to face with HMRC and agree tax. It's not a place to be alone. Not a place to go to unprepared.

As the UK's only provider of critical tax information, in-depth reference, ground-breaking training and learning resources and unique market insight, Tolley is there by your side with four product families designed for tax professionals working on The Front Line.

Tolley® Insight | **Tolley® Guidance** | **Tolley® Library** | **Tolley® Learning**

Tolley, Lexis House, 30 Farringdon Street, London, EC4A 4HH

Tolley®

Tax intelligence from LexisNexis®