Mind the GAAP

Large Corporate | OMB | Tax voice



31 May 2016

Paul Martin looks at the path ahead

It has long been established that a business must pay tax on the profits of its trade and that the starting point for quantifying the taxable profits of that trade is the accounts. However, it is only as recently as 1998 (s42 Finance Act 1998) that this basic principle became enshrined in statute. To most of us, an approach of taxing the profit per the accounts would make sense; after all, these accounts generally have to show a 'true and fair' view of the business performance for the period.

Tax, however, is rarely that simple – how often have you been told that I wonder? Both companies (under s8 Corporation Tax Act 2009 (CTA 2009)) and unincorporated businesses (under s7 Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005)) are required to charge tax on the full amount of profits (including trading profits) arising in the relevant period.

"The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes."

The statement above has been lifted straight from s46 CTA 2009, and s25 ITTOIA 2005 (where the reference is to income tax rather than corporation tax). It means that the starting point for the quantification of taxable trading profits for a particular

period for both companies and unincorporated businesses, such as partnerships and sole traders, is the profit for that period calculated under generally accepted accounting practice (GAAP). However, one must also have regard to those rules in the relevant tax legislation and case law where departure from the accounts is required or permitted.

The publication of FRS 101 and 102 (new UK GAAP) and the mandatory adoption of this for accounting periods commencing on or after 1st January 2015 (1st January 2016 for companies using the FRSSE) has certainly focused many people's attention on the relationship between accounting treatment and tax treatment. A business needs to consider many things when evaluating the impact of the new accounting rules contained in new UK GAAP: the impact on balance sheet values (and any possible knock on effect for loan covenants), the impact on distributable profits and given what is said above, the possible impact on tax cash flows.

In light of the statutory starting point outlined above, when GAAP changes there may be a potential impact for tax purposes. To the extent that the change in GAAP is presentational or in disclosures required, there will be no impact on the calculation of taxable profit. However, if the recognition or measurement rules change for a particular item or transaction and that item is one where the tax treatment follows the accounting treatment (rather than replaces it with a separate treatment for tax purposes) the calculation of the tax effect of that item or transaction will also change. Possible relevant items include:

- financial instruments (loan relationships and derivative contracts);
- intangible fixed assets;
- lease incentives; and
- holiday pay accruals.

Any potential tax impact will be especially relevant in the first period for which the new accounting rules are adopted. This is because, not only will the taxable profits for that period need to be based on new UK GAAP, but the difference between the tax positions based on old and new UK GAAP for historic periods will also need to be reflected as a transitional adjustment. In most cases, such transitional adjustments will be taxable or relievable in full in the first period for which the new GAAP applies. In other cases, transitional adjustments can be spread over a longer period. There will only be spreading of these adjustments where the tax rules for a specific item specify that spreading is available. The main example of such specific legislation

(and possibly the most likely to be relevant) is to be found in the “The Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations 2004” SI 2004/3271 (COAP Regs) which mandatorily require a company to spread certain adjustments arising on the change to new GAAP on loan relationships or derivative contracts (both debits and credits) over 10 years. In some cases, debits and credits are specifically carved out from these spreading rules (such as debits or credits in relation to a loan relationship that falls to be fully discharged within the same accounting period as that in which the new accounting policy is to be first applied). In other cases, the adjustment may be exempt from tax altogether.

The increased focus on the relationship between accounting and tax resulting from the implementation of new UK GAAP is unlikely to dim in the future, particularly for ‘smaller companies’. In March 2016 the Office of Tax Simplification (OTS) published its review of small company taxation. The report contained 13 main recommendations, 6 of which the Government have indicated they will accept, 6 of which they have said they will consider further and only 1 of which they have rejected (the recommendation for a long-term study of a consolidated tax system). These include a recommendation to closer align taxable profits with accounting profits (focussing on exploring whether many of the sundry tax adjustments could be eliminated) and a recommendation to explore the possibility and practicality of a cash basis of accounting for the smallest companies.

Even after the issues arising on the transition to a new GAAP have been carefully navigated, and whatever the outcome of the OTS review, understanding the relationship between accounting profits and taxable profits will remain an important issue for all businesses in the foreseeable future. ‘Mind the GAAP’ remains the key message.