

DEFERRED TAX

FRS 102 Factsheet

Practical help in a complex world

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Deferred Tax

This factsheet provides an overview of the accounting and disclosure requirements for deferred tax in accordance with FRS 102 in response to some frequently asked questions about this challenging topic.

Key regulations for this factsheet

This factsheet includes links and references to key regulations. There's a summary of the links, and guidance on how to use them, on page 2.

Section 1

Introduction

FRS 102 requires an entity to recognise the current and future tax consequences of transactions and other events that have been recognised in the accounts. Accounting for current tax is not considered further in this factsheet.

Deferred tax is the amount of tax payable or recoverable in future reporting periods as a result of transactions or events recognised in current or previous periods' accounts. Generally, FRS 102 adopts a 'timing difference' approach ie, deferred tax is recognised when items of income and expenditure are recognised in total comprehensive income in a reporting period different to when those transactions are included in tax assessments. However, there are exceptions to this general rule, as is the case for business combinations.

Deferred tax accounting involves the application of tax as well as of accounting knowledge. Its requirements can therefore be challenging, and the more complex areas require careful analysis. We consider some of the more common challenges in this factsheet. It is not intended to be a comprehensive guide.

Focus on financial reporting

The use of tax rates in this factsheet is for illustrative purposes only. The purpose of the examples is to demonstrate the financial reporting implications of transactions recognised in the accounts that may give rise to taxable profits or losses in a future reporting period. The examples are not intended to illustrate tax regulations (which are subject to change).

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Links to regulations

Using the links and margin notes in this document

The margin notes in this factsheet identify relevant sections of standards and other regulations – these sections cannot be considered in isolation when applying them in practice.

You might find it useful to download, or print out, relevant section(s) of the standard(s) so that you can refer to them when using this document.

Make sure that you use the right version of the regulations or standards

Standards and regulations are often updated and amended, and may have transitional provisions. It is important to use the right version, and to make sure that it applies to the relevant time period. The standards below are linked to the faculty's standards tracker which shows when standards were amended, and when amendments come into effect. Links are then provided to the version of the standard relevant to specific time periods.

Standards

Key regulations for this factsheet

[FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*](#)

Other relevant guidance and proposals

[FRS 102 – Editorial amendments and clarification statements](#)

Section 3

The basics

Overview

Deferred tax represents the future tax consequences of transactions and events recognised in the accounts of the current and previous periods. Items that are treated differently for tax and accounting purposes fall into two categories, timing differences and permanent differences, both of which are discussed further below.

Generally, deferred tax is provided only on timing differences. However, FRS 102 also requires deferred tax to be accounted for in respect of assets (other than goodwill) and liabilities recognised as a result of a business combination.

When recognised, the tax effect will usually be measured using the tax rates and laws:

- that have been enacted or substantively enacted by the reporting date; and
- that are expected to apply to the reversal of the timing difference.

Amendments to FRS 102 arising from the Triennial review 2017

In December 2017 the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Triennial review 2017 – Incremental improvements and clarifications* (the 'Triennial review 2017 amendments'), effective for accounting periods beginning on or after 1 January 2019. Early application is permitted provided that all of the amendments (with some limited exceptions) are applied at the same time. This factsheet reflects the revised requirements of FRS 102 but clearly identifies when this is a change from the requirements of the previous version of the standard.

Timing differences

Definition

FRS 102 defines timing differences as differences between:

- taxable profits; and
- total comprehensive income as stated in the accounts

arising from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in the accounts.

'Total comprehensive income' comprises gains and losses recognised in profit or loss and those recognised in other comprehensive income (OCI) for the period. This factsheet refers to one or the other as relevant.

Deferred tax must be recognised on all timing differences, with certain exceptions (when modified requirements apply). The main exceptions are:

- unrelieved tax losses and other deferred tax assets (see below); and
- income or expenses from a subsidiary, associate, branch, or interest in joint venture (see section 9).

Practical tip: understanding the tax rules

To understand whether or not a timing difference exists, you need to understand the tax rules applicable to the entity. Without this knowledge, it is not possible to determine whether or not deferred tax is required. Consultation with tax specialists may be needed.

Tax allowances versus depreciation

Deferred tax must be recognised when the tax allowance for the cost of an item of property, plant and equipment (PPE) is received either before or after the depreciation of the fixed asset is recognised in profit or loss.

If and when all conditions for retaining the tax allowances have been met, the deferred tax must be reversed. This requirement reflects the fact that it is usually only on the sale or full consumption of an asset that the associated tax allowances are finally determined. At that point, any outstanding deferred tax balance on the asset should be derecognised (ie, any remaining originating difference not yet reversed should now be reversed completely).

FRS 102.29.2, 6, 10, 12,
Appendix I

FRS 102 Appendix I,
FRS 102.29.6

FRS 102.29.6

FRS 102.29.8

Practical tip: pooling of assets

In the UK, this principle applies in theory when the final balancing allowance or balancing charge is calculated on an asset. However, in practice, most assets on which tax allowances are received are 'pooled' for the purpose of both the tax computation and the calculation of timing differences. Therefore, balancing allowances or charges are not normally calculated on individual assets.

Illustrative example: tax allowances – part 1

Entity A has a 31 December year end. On 1 January 20X7 Entity A acquires an item of property, plant and equipment (PPE) for £80,000 which is eligible for 100% capital allowances in the year of purchase. It is estimated that the item has a useful economic life of four years with nil residual value. Therefore, depreciation will be charged at £20,000 per annum in the accounts.

As a result, taxable profits will be £60,000 lower than accounting profits in 20X7 but £20,000 higher in each of the subsequent three years. These are sometimes referred to as 'accelerated capital allowances'.

| Year | Depreciation £000 | Capital allowances £000 | Timing difference £000 | Cumulative timing difference £000 |
|------|----------------------|-------------------------------|------------------------------|---|
| 20X7 | 20 | 80 | (60) | (60) |
| 20X8 | 20 | 0 | 20 | (40) |
| 20X9 | 20 | 0 | 20 | (20) |
| 20Y0 | 20 | 0 | 20 | 0 |

The applicable tax rate (discussed further below) is then applied to the cumulative timing difference to calculate the deferred tax liability to be recognised in the accounts. In the example above, a deferred tax liability will be recognised in 20X7 to reflect the fact that taxable profits will be higher than accounting profits in the three subsequent years.

Assets carried at a revalued amount

Timing differences may also arise when assets are carried at a revalued amount. For example, PPE and intangible assets may be carried at a revalued amount rather than cost, and investment property is generally required to be carried at fair value. However, the revalued amount or fair value will usually be ignored in the tax computations until the asset is actually sold. Deferred tax on assets carried at a revalued amount is considered further in section 4.

Deferred tax assets

A deferred tax asset relating to timing differences arises when taxable profits will be lower than accounting profits in future periods (eg, there will be a future tax deduction). An example of such a situation is the existence of unrelieved tax losses that can be offset against taxable profits in future periods. Unrelieved tax losses and other deferred tax assets are recognised only to the extent that it is probable (defined in FRS 102 as more likely than not) that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits.

FRS 102.29.7

Illustrative example: unrelieved tax losses and deferred tax liabilities

As at 31 December 20X7 Entity A has unrelieved corporation tax losses of £50,000. As at 31 December 20X7 it has also claimed tax allowances in excess of depreciation of £60,000 arising on the acquisition of plant and equipment which will reverse over the next three years (see previous example). Under local tax legislation, the tax losses may be offset in future against the taxable profits generated by the reversal of the timing differences on the plant and equipment. Entity A therefore recognises a deferred tax asset in respect of the unrelieved tax losses, as it may be recovered against the reversal of the deferred tax liability recognised in respect of the tax allowances.

Note that this does not necessarily permit the offsetting of the deferred tax asset and liability in the 20X7 accounts. The circumstances in which offsetting is permitted are discussed below.

When there are no projected reversals of deferred tax liabilities, it will be necessary to exercise caution before recognising a deferred tax asset – remember, it has to be more likely than not that there will be sufficient taxable profits in future against which to claim the deduction. In the case of unrelieved tax losses, FRS 102 notes that their very existence is 'strong evidence that there may not be other future taxable profits against which the losses will be relieved'.

Illustrative example: unrelieved tax losses and future taxable profits

Entity L is a long-established business with a strong record of profitability and positive cash flows. Last year, it invested heavily in a new product and the one-off costs incurred gave rise to unrelieved corporation tax losses of £50,000. Under local tax legislation, the tax losses may be offset in future against any taxable profits generated by the same business. At the end of last year, Entity L considered whether it should recognise a deferred tax asset in respect of the unrelieved losses, but concluded that it was not able to forecast its future taxable profits with sufficient certainty.

In the current year, the new product has had a successful launch and Entity L is profitable once more. Taxable profits (before taking account of unrelieved losses brought forward) are £20,000 for the current year and are forecast to be £80,000 next year and continuing to rise thereafter. Based on this evidence, it may be considered appropriate to recognise a deferred tax asset in respect of the unrelieved losses of £30,000 (£50,000-£20,000) at the end of the current year.

Permanent differences

FRS 102 defines permanent differences as differences between an entity's taxable profits and its total comprehensive income as stated in the accounts, other than timing differences. They arise because certain types of income and expenses are non-taxable or disallowable (expenses for client entertaining are a common example of this), or because certain tax charges or allowances are greater or smaller than the corresponding income or expense in the accounts.

FRS 102 Appendix, FRS 102.29.10

Permanent differences will not reverse over time, and therefore deferred tax is not recognised on them except in the circumstances noted below on a business combination.

FRS 102.29.10

Business combinations

No timing difference arises on the recognition of assets and liabilities in a business combination. However, when an asset (other than goodwill) or liability is recognised as a result of a business combination and its carrying value is different from the amount that will be allowed or assessed for tax purposes, FRS 102 requires deferred tax to be recognised on that difference.

FRS 102.29.11

Business combinations are considered in greater detail in section 8 of this factsheet.

Measurement

Tax rates

Deferred tax must be measured 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. This requirement is modified for revalued non-depreciable assets and investment properties, when tax rates used will usually be those applying to the sale of the asset, as discussed in section 4 below.

FRS 102.29.12-13

Tax rates are regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so. In the UK, when a tax rate has been included in a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent, it is regarded as substantively enacted.

Practical tip: substantively enacted

More information on the UK parliamentary process can be found at parliament.uk. Details of the progress of individual bills through Parliament can be found in the section [Bills before Parliament](#). The government has also issued a [Guide to making legislation](#) which sets out what bill teams need to do at each stage of preparing primary legislation and taking it through Parliament, from bidding for a slot in the legislative programme to gaining Royal Assent.

Illustrative example: tax allowances – part 2

Continuing with the example for 'accelerated capital allowances' in the individual accounts of Entity A, the 20X7 timing difference of £60,000 is expected to reverse and give rise to taxable profits of £20,000 in each of the subsequent three years. As at 31 December 20X7, the substantively enacted tax rates are 20% for 20X8, 18% for 20X9 and 15% for 20Y0. Therefore, a deferred tax liability will be recognised in the 20X7 accounts as follows:

| Year | Timing difference £000 | Tax rate % | Deferred tax £000 |
|-------|---------------------------|---------------|----------------------|
| 20X8 | 20 | 20 | 4.0 |
| 20X9 | 20 | 18 | 3.6 |
| 20Y0 | <u>20</u> | 15 | <u>3.0</u> |
| Total | <u>60</u> | | <u>9.6</u> |

Impact of distributing retained earnings by way of dividend

In some jurisdictions more (or less) tax may be payable when some or all of an entity's profit or retained earnings are paid out in the future by way of dividend. In this situation, the entity should recognise deferred tax to reflect the future tax consequence of the profits it has currently earned, using the tax rates applicable to undistributed profits (until such time as the entity recognises a liability to pay the dividend).

FRS 102.29.14

Practical tip: additional tax payable/tax refundable on distribution

Whether or not additional tax is payable or refundable on distribution will depend on the tax rules applicable to the entity making the distribution. In the UK, it is unlikely that such additional tax will arise.

Practical tip: withholding taxes

FRS 102.29.18-19

An entity may have to pay a withholding tax when it pays a dividend, ie, the shareholder is taxed on the dividend, but the entity pays this to the tax authorities on the shareholder's behalf. This is outside the scope of this factsheet as it is not a tax matter for the entity.

Discounting

Although deferred tax assets and liabilities may be long term, discounting of such assets and liabilities is nevertheless not permitted.

FRS 102.29.17

Presentation

Allocation in comprehensive income and equity

A change in a deferred tax liability or asset must be presented as a tax expense (income) unless it relates to the initial recognition of a business combination, in which case it will be taken into account in the calculation of goodwill (see section 8).

FRS 102.29.21

Except for the tax effect of distributions to owners, the tax effect of a transaction or event must be presented in the same component of total comprehensive income or equity as the transaction or other event that gave rise to the deferred tax expense (income).¹

FRS 102.29.22

This will be relevant, eg, to deferred tax arising on certain revaluations (see section 4) and defined benefit pension schemes (see section 7).

The tax effect of distributions to owners must be presented in profit or loss.¹

FRS 102.29.22A

Presentation in the balance sheet

Section 29 requires deferred tax liabilities to be presented within provisions and deferred tax assets within debtors. When material, it may be appropriate to disclose deferred tax assets as an amount due after more than one year, either by way of note or on the face of the balance sheet.

FRS 102.29.23, FRS 102.4.2A
FRS 102.4.4A

However, when the entity has chosen to adapt the balance sheet format as permitted by FRS 102 Section 4 *Statement of Financial Position*, deferred tax assets and liabilities must be presented as separate line items, classified as non-current.

Further faculty factsheets
More information on adapting the balance sheet is available in the faculty's factsheet *An introduction to FRS 102*.

Offsetting

Deferred tax assets and deferred tax liabilities are offset if, and only if:

FRS 102.29.24A

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and liabilities relate to taxes levied by the same taxation authority on either the same taxable entity or different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

If both of these conditions apply, the net deferred tax asset or liability is presented in the relevant section of the balance sheet.

¹ Prior to the Triennial review 2017 amendments, FRS 102 required the tax expense or income to be presented in the same component of total comprehensive income or equity as the transaction or event that gave rise to the tax expense (income), including distributions to owners. For accounting periods beginning before 1 January 2019 adoption of this amendment would also require early adoption of the amendments in respect of gift aid (paragraph 29.14A), when relevant.

Section 4

PPE and investment properties

Deferral or rollover of chargeable gains

The general principle set out in section 3 above is that deferred tax must be recognised on all timing differences. This principle applies even if the taxable gain on disposal of an asset can be deferred or 'rolled over' into a replacement asset (eg, if holdover relief or rollover relief are available under UK tax law).

In such cases, the taxable gain is not eliminated, it is simply deferred (either for a known period of time or until such time as a replacement asset does not qualify for 'rolling over' of the gain). Therefore, a deferred tax liability must be recognised.

Revaluations of PPE

As noted in section 3 above, revaluations of PPE often give rise to deferred tax. The revaluation gain passes through other comprehensive income, and the increased carrying amount is subsequently depreciated through profit or loss over the useful economic life of the asset. However, the revalued amount or fair value will usually be ignored in the tax computations until the asset is actually sold. In addition, there may be differences between the depreciation expensed and the tax allowances received. Both of these factors are timing differences that will give rise to deferred tax.

As also noted in section 3, the deferred tax liability must be recognised in the same component of total comprehensive income as the transaction that resulted in the deferred tax.

FRS 102.29.22

Illustrative example: allocation of deferred tax expense

At the beginning of the year, Entity D remeasures a machine giving rise to a revaluation surplus of £100,000. This is recognised in a revaluation reserve via other comprehensive income. The deferred tax on the revaluation is measured at £20,000. The machine is being depreciated over its useful economic life, which at the beginning of the year is estimated to be 40 years.

The deferred tax attributable to the revaluation surplus will be recognised as a deferred tax expense within other comprehensive income.

The change in the deferred tax liability attributable to the reversal of the timing difference over the useful life of the asset will be recognised within profit or loss ie, £500 deferred tax income per annum.

Investment property

FRS 102 generally requires investment property to be measured at fair value, with changes in fair value recognised in profit or loss. However, the current tax consequences of changes in the property's value are likely to arise only on the sale of the property. This is a timing difference and will therefore give rise to deferred tax.

FRS 102.16.7

Which tax rates to use

As noted in section 3 above, FRS 102 generally requires deferred tax assets and liabilities to be calculated using tax rates that are expected to apply to the reversal of the timing difference.

FRS 102.29.15-16

An entity should consider how it intends to recover the value of the asset in question (through sale or through use), and therefore whether rates of tax applying to asset sales or trading tax rates should be used in calculating deferred tax, and whether any allowances available on the sale of the asset should be taken into account.

There is additional guidance in FRS 102 regarding the rates to be used for certain types of asset.

Specifically, deferred tax relating to:

FRS 102.29.15-16

- a non-depreciable asset that is measured at a revalued amount, or
- most investment properties measured at fair value (see below)

is measured using the tax rates and allowances that apply to the sale of the asset.

This is an important principle in tax jurisdictions in which:

- different rates of tax apply to asset sales by an entity and the trading profits it generates; or
- certain allowances may be available specifically on such sales (eg, indexation allowances in the UK).

Revalued non-depreciable assets

FRS 102 requires deferred tax on revalued non-depreciable assets (eg, freehold land) to be measured using tax rates that will apply to the sale of the asset, irrespective of whether or not the entity actually intends to sell the asset (and always with the proviso that those rates must be enacted or substantively enacted at the reporting date).

FRS 102.29.15

The principle behind this is that depreciation is a measure of the 'consumption' of an asset's value through use. Therefore, if an asset is not depreciated, none of its value is expected to be consumed through use, and therefore it would not be appropriate to calculate deferred tax on this basis. Tax rates and allowances applying to the sale of the asset must be used instead.

Investment property measured at fair value

Similarly, FRS 102 generally requires deferred tax on investment property measured at fair value to be measured using tax rates and allowances that will apply to the sale of the property, irrespective of whether or not the entity actually intends to sell it (and always with the proviso that those rates must be enacted or substantively enacted at the reporting date).

FRS 102.29.16

The only exception is an investment property that has a limited useful life and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time. In such a case, the rules for depreciable assets (below) are followed.

Indexation allowances

In some tax jurisdictions, such as the UK, indexation allowances are available, which will reduce the amount of tax payable when certain assets are eventually sold.

The principle in FRS 102 is that deferred tax must be measured using tax rates and laws that are expected to apply to the reversal of the timing difference. At the point the timing difference reverses (ie, when the asset is sold), indexation will apply and it would therefore be appropriate to account for indexation which has already been 'earned' (ie, to reduce the deferred tax by indexation allowances available up to the reporting date).

FRS 102.29.12

Depreciable assets

Whereas FRS 102 requires deferred tax on revalued non-depreciable assets and investment property carried at fair value to be measured using tax rates that will apply to the sale of the asset, it does not explicitly set out the reverse principle. In other words it does not explicitly require deferred tax on depreciable assets to be measured using tax rates that will apply to the entity's trading activities.

FRS 102.29.15

However, the standard is clear that the measurement treatment for revalued non-depreciable assets and investment property carried at fair value is an exception to the general principle that deferred tax must be measured using tax rates that are expected to apply to the reversal of the timing difference.

FRS 102.29.12

When an asset is depreciated to nil net book value over its useful economic life, this indicates that its value is expected to be consumed (and that the timing difference is expected to reverse) through use rather than through sale. Therefore, deferred tax (whether arising on accelerated capital allowances or on a revaluation) should be calculated based on tax rates applying to the entity's trading activities (as the entity is using the asset to generate trading profits), rather than to the sale of the asset.

FRS 102.29.12

Practical tip: assets depreciated to a residual value

When an asset is depreciated to a residual value, this indicates that its value is expected to be consumed through a mixture of use and sale. FRS 102 is silent on whether the asset's carrying value should be split, with deferred tax on the residual value calculated on a sale basis, and deferred tax on the remainder calculated on a use basis. The general principle set out above suggests that such a split could be appropriate, but there is no explicit guidance in this area.

Mixed use properties

FRS 102 requires 'mixed use property' (eg, a building with several floors let to a third party at commercial rates and the remainder being used as the entity's own offices) to be separated between investment property and PPE.

FRS 102.16.4

Practical tip: split between investment property and PPE element

Again, FRS 102 is silent on whether it is necessary to apply different rates of deferred tax to the separate elements (ie, a sale basis for the investment property part and a use basis for the PPE part). The general principle set out above suggests that such a split would be appropriate, but there is no explicit guidance in this area.

Section 5

Financial instruments

A number of deferred tax issues can arise in connection with financial instruments. Some of the more common issues are set out below.

Practical tip: don't underestimate the potential complexity of the tax rules

The tax treatment of financial instruments, particularly derivatives, can be complex. For example, in the UK, the Disregard Regulations mean that in certain circumstances fair value gains and losses on derivatives are ignored when calculating current tax. In some cases, differences between taxable profits and total comprehensive income as stated in the accounts may be permanent rather than timing differences. For example, the adjustments made in the accounts for certain directors' loans granted at non-market rates will give rise to permanent differences.

Further faculty resources

More information on the accounting for directors' loans is available in the faculty's FRS 102 Updates

Accounting for Directors' Loans under FRS 102 and Loans from director-shareholders under the new UK GAAP.

Investments in equity instruments carried at fair value through profit or loss

The requirement to account for deferred tax needs to be considered when investments in equity instruments are held at fair value through profit or loss. Such investments may give rise to a timing difference, as the change in fair value is recognised in profit or loss every year but may not be relevant for tax purposes until the investment is actually sold. Once again it is necessary to understand the tax treatment of the investment in order to determine whether or not there is a timing difference.

Shares classified as liabilities

FRS 102 requires entities to classify financial instruments they issue on initial recognition as either liabilities, equity or compound instruments. Certain types of share (eg, preference shares with mandatory dividends and that are mandatorily redeemable for a fixed amount on a fixed date) are classified as liabilities because of the contractual obligation to deliver cash and will be accounted for under Sections 11 or 12 of FRS 102. In such cases, the dividends will be accrued through profit or loss under the effective interest method, but this 'interest expense' may often be disallowable for tax purposes because the instrument is legally a share.

FRS 102.22.1

Illustrative example: shares classified as liabilities

On 1 January 20X7 Entity B issued 500,000 £1 5% preference shares, redeemable at nominal value on 31 December 20Y6. The dividend of 5% is paid at the end of each calendar year but is charged as an interest expense in profit or loss. Neither the interest charge to profit or loss nor the dividends paid are deductible for tax purposes. The £25,000 interest charged to profit or loss is therefore a permanent difference in each of the ten years of the preference shares' life, and deferred tax is not recognised.

Compound financial instruments

From the issuer's point of view, a compound financial instrument is one that has characteristics of both debt and equity, and is required by FRS 102 to be 'split' on initial recognition between a liability component and an equity component.

FRS 102.22.13

Such a split does not in itself create a timing difference (as it has no effect on either taxable profit or total comprehensive income) and therefore has no deferred tax consequence.

Subsequently, the interest payable on the instrument and the unwinding of the discount on the liability component will be charged as a finance cost in profit or loss. Whether or not this gives rise to a timing difference (and therefore deferred tax) depends on whether the interest cost is deductible for tax purposes in the relevant jurisdiction.

Section 6

Share-based payments

Cash-settled share-based payment

FRS 102 requires an entity to remeasure the fair value of the liability recognised in respect of a cash-settled share-based payment at each reporting date. Any change in the value of the liability is taken to profit or loss.

FRS 102.26.14

If a tax deduction is receivable when the cash is actually paid, this represents a timing difference on which a deferred tax asset is recognised (provided that the recognition criteria discussed in section 3 are met).

Equity-settled share-based payment

Share options

FRS 102 Section 26 generally requires an expense to be recognised in profit or loss in respect of share options granted. This expense is usually calculated at the grant date and spread over the vesting period. However, the amounts included in tax computations in respect of share options, and the timing of that inclusion, are often very different. In such circumstances, a timing difference will arise between the expense recognised in profit or loss each year and the amount recognised in the tax computation.

In some tax jurisdictions (such as the UK), companies may receive a corporation tax deduction in relation to employee share options. However, this deduction is not received until the options are actually exercised. (The deduction is usually the amount of taxable gain on exercise, being the intrinsic value of the options. This is calculated as the market value of the shares at the exercise date less any consideration paid by the employee.) This leads to the recognition of a deferred tax asset at the appropriate rate, subject to the usual rules for recognising deferred tax assets discussed in section 3 above.

Practical tip: share-based payment and deferred tax assets in the UK

As explained in section 3, a deferred tax asset is recognised only if it is probable that it will be recovered.

At each year end during the vesting period, it will be necessary to estimate the market value of the company's shares at the expected exercise date, and hence the expected intrinsic value of the options. In practice, the best estimate is likely to be the company's current share price.

The cumulative expense recognised in profit or loss should be compared with the expected intrinsic value of the options at the exercise date. FRS 102 has no specific guidance as to whether or not the intrinsic value should be the total expected value or a time-apportioned amount. The latter approach is used in the example below.

If the expected intrinsic value is higher than the cumulative expense recognised in profit or loss, the deferred tax asset will be calculated based on the cumulative expense. If it is lower, the deferred tax asset will be 'capped' by calculating it based on this lower amount. This is illustrated in the example below.

Illustrative example: share options – part 1

A company grants share options with a fair value of £400,000 at the start of year 1. There is a 4-year vesting period. The options are exercised at the end of year 5. The company expects to receive a tax deduction as described above.

The expected intrinsic value of the options at the exercise date is estimated as £420,000 at the end of year 1, £340,000 at the end of year 2, £290,000 at the end of year 3, and £320,000 at the end of year 4.

Assume a tax rate of 20%.

| Year | Cumulative P&L charge | Expected intrinsic value at exercise (time apportioned) | Cumulative deferred tax asset (movement during each period to P&L tax credit) |
|------|-----------------------|---|---|
| 1 | £100,000 | £105,000 | 20% x £100k = £20,000 |
| 2 | £200,000 | £170,000 | 20% x £170k = £34,000* |
| 3 | £300,000 | £217,500 | 20% x £217.5k = £43,500* |
| 4 | £400,000 | £320,000 | 20% x £320k = £64,000* |

*The deferred tax asset is capped at the expected intrinsic value at exercise (ie, the future tax deduction)

At each year end during the vesting period, the company will need to reassess the number of options expected to vest.

If the expense recognised in profit or loss changes (eg, because some employees forfeit their options), this will prospectively affect the deferred tax asset recognised.

If at any point the options are not expected to be exercised at all (eg, because they are out of the money), the deferred tax asset should be written off.

Illustrative example: share options – part 2

On exercise at the end of year 5, the actual intrinsic value of the options is £410,000. The company will receive a corporation tax deduction of this amount in its year 5 tax computation.

The company will therefore recognise a current tax asset of £82,000 (£410,000 x 20%) and reverse the deferred tax asset of £64,000. Both entries will be taken to the tax charge for the year in profit or loss.

Share options in groups

It is common for the parent company of a group to issue share options to the employees of its subsidiaries. In such cases, the subsidiaries will account for an expense in respect of the options granted, in accordance with FRS 102 Section 26.

If any related tax deduction is also received by the subsidiaries, there will be a timing difference to be accounted for in the subsidiaries' accounts as shown in the illustrative examples above.

If any related tax deduction is to be received instead by the company issuing the shares, ie, the parent, there will be a permanent difference between the accounting and taxable profits for the subsidiary, so no deferred tax will arise in the individual entity's accounts. However, from a group perspective, the same 'entity' is recognising the share-based payment expense and receiving the tax deduction. Therefore, in the group accounts, there will be a timing difference to be accounted for as shown in the illustrative examples above.

Section 7

Defined benefit pension schemes

Timing differences may arise on UK defined benefit pension schemes because any tax deductions received will be based on the actual contributions paid, which have no direct relationship with the amounts charged to total comprehensive income in the accounts (due, eg, to actuarial gains and losses). These timing differences will, as usual, require deferred tax to be calculated. (The deferred tax implications of overseas defined benefit pension schemes will depend on the tax legislation in the relevant jurisdiction.)

Calculating the deferred tax asset or liability

For schemes that are in deficit, actuarial losses will usually increase the defined benefit liability. This liability may be reduced in future years by increases in contributions (which often attract tax deductions) and/or greater investment returns (which usually do not).

Conversely, actuarial gains may result in decreased contributions in future years.

Given that producing a reasonable estimate of the various figures is highly unlikely to be practicable, the deferred tax asset is usually calculated simply by applying the relevant tax rate to the defined benefit liability, on the basis that this represents the maximum amount of tax that could theoretically be recovered in the future if the entire liability was funded through increased contributions.

Similar principles apply to schemes that are in surplus, ie, the deferred tax liability is usually calculated simply by applying the relevant tax rate to the defined benefit asset.

Allocation of the tax expense between profit or loss and other comprehensive income

As explained in section 3, FRS 102 requires the tax expense or income to be presented in the same component of total comprehensive income or equity as the transaction or other event that gave rise to the deferred tax expense or income.

FRS 102.29.22

When a tax deduction is received on a contribution to a defined benefit pension scheme, it may not be clear how much of that deduction relates to items recognised in profit or loss and how much relates to items recognised in other comprehensive income. In such cases, both the current and deferred tax expense will need to be allocated between these components of total comprehensive income on a reasonable basis.

Practical tip: what is a 'reasonable basis'?

FRS 102 does not specify what basis should be used. It is generally considered reasonable to allocate the amount of the tax deduction against items recognised in profit or loss first, with any remainder allocated to other comprehensive income.

The movement in the deferred tax asset or liability from the start to the end of the reporting period is generally allocated to other comprehensive income, as long as doing so does not result in the total (current plus deferred) tax allocated to OCI exceeding the actuarial gain or loss multiplied by the tax rate.

This is illustrated in the example below.

Illustrative example: allocation between profit or loss and OCI

| | Net defined benefit liability £000 | Current tax deduction @ 20% £000 | Deferred tax @ 20% £000 |
|--|---|---|------------------------------------|
| Brought forward | (310) | | 62 |
| Net pension cost in profit or loss | (60) | 12 | |
| Actuarial loss in OCI | (40) | 6 | 2 |
| Contribution paid (deduction received) | <u>90</u> | <u>18</u> | <u>—</u> |
| Carried forward | <u>(320)</u> | | <u>64</u> |

The current tax deduction received of 18 is split:

- first, it is allocated to profit or loss ($60 \times 20\% = 12$);
- the remainder ($18 - 12 = 6$) is allocated to OCI.

The movement in the deferred tax asset ($64 - 62 = 2$) can be allocated to OCI in this example, as the total tax allocated to OCI ($6 + 2 = 8$) doesn't exceed the actuarial loss multiplied by the tax rate ($40 \times 20\% = 8$).

Presentation

It should be noted that deferred tax in respect of a defined benefit liability or asset should be presented with other deferred tax assets or liabilities. It should not be netted off against the defined benefit liability or asset.

Practical tip: consistency in presentation

This is different from the approach taken in the previous version of UK GAAP (FRS 17), and aligns the presentation of deferred tax on defined benefit pension schemes with the presentation of other deferred tax assets and liabilities.

Section 8

Business combinations

Although no timing difference arises on the recognition of assets and liabilities in a business combination, FRS 102 requires deferred tax to be recognised when necessary. Specifically, for an asset (other than goodwill) that is recognised in a business combination, it is necessary to compare:

FRS 102.29.11

- the amount that can be deducted for current tax in respect of the asset; and
- the value at which it is recognised in the accounts.

A deferred tax liability or asset must be recognised for the additional tax that will be paid or avoided in respect of that difference.

In assessing the amount that can be deducted for tax, an entity must consider the manner in which it expects to recover the asset. The expectation is as at the end of the reporting period.

FRS 102.29.11A

Practical tip: FRS 102 clarification statement – amount that can be deducted for tax

Prior to the Triennial review 2017 amendments, 'the amount that can be deducted for tax' was not a defined term in FRS 102. The FRC issued a clarification statement in November 2013 to assist in the interpretation of this requirement. This clarification is now reflected in paragraph 29.11A (as noted above) which was added as part of the Triennial review 2017 amendments.

FRS 102 Editorial amendments and clarification statements

The wording in paragraph 29.11A is not identical to the original clarification statement but there is no substantive difference between the two.

Similarly for a liability that is recognised in a business combination, a deferred tax asset or liability must be recognised for the additional tax that will be avoided or paid because of the difference between the value at which the liability is recognised and the amount that will be assessed for tax.

In assessing the amount that can be deducted for tax, an entity must consider the manner in which it expects to settle the liability. The expectation is as at the end of the reporting period.

FRS 102.29.11A

The amount of deferred tax asset or liability recognised is adjusted against goodwill, rather than being shown as tax income or expense.

Illustrative example: differences arising on a business combination (1)

Entity C acquires Entity A on 1 January 2018. The fair value of an item of PPE on the date of acquisition is £70,000, compared to a book value of £60,000 in the accounts of Entity A. The tax value of the asset is £nil.

On acquisition, the difference in the consolidated accounts between the carrying value of the asset and its taxable value is £70,000. Deferred tax must be provided on this difference and included as an adjustment against goodwill.

In subsequent years, the deferred tax liability will reduce as the asset is depreciated (and the difference between its carrying value and its taxable value reduces).

Note that deferred tax is calculated on a group basis in the consolidated accounts, ie, the deferred tax provision referred to above would be instead of, not in addition to, any deferred tax provided in the individual accounts in respect of the asset (see section 9 of this factsheet).

Illustrative example: differences arising on a business combination (2)

In the acquisition described above, the consolidated accounts of Entity C also include an intangible asset of £40,000 in respect of a brand name belonging to Entity A (in accordance with FRS 102.18.8). This asset is not recognised in Entity A's own accounts. The tax value of the asset is £nil.

The difference in the consolidated accounts between the carrying value of the asset and its taxable value is £40,000. Deferred tax must be provided on this difference and included as an adjustment against goodwill.

In subsequent years, the deferred tax liability will reduce as the asset is amortised (and the difference between its carrying value and its tax value of nil reduces).

Practical tip: acquisition of trade and net assets

An entity may acquire a trade and net assets that constitute a business, rather than acquiring a separate entity. When the acquisition is from a non-group company, the assets and liabilities acquired will be measured at fair value in the individual accounts of the acquiring entity. (When the acquisition is from another group company, it may be possible to use merger accounting principles for the acquisition, such that the assets and liabilities are recorded at book value rather than fair value.)

Often the tax values of the assets and liabilities acquired will be equivalent to their fair values attributed at acquisition.

Therefore, although the principles for the recognition of deferred tax are the same as those set out in the examples above, a provision for deferred tax may not be necessary on acquisition to the extent that:

- fair values rather than book values are used to measure the assets and liabilities acquired;
and
 - those fair values are used as the tax values of the assets and liabilities acquired.
-

Section 9

Group aspects

Unrealised profits within a group

When entities within a group trade with each other and generate a profit, an individual entity is likely to be taxed on its intragroup profit, but in the consolidated accounts the profit will be eliminated as it is unrealised. This gives rise to a timing difference in the consolidated accounts, meaning that deferred tax may have to be recognised.

Illustrative example: unrealised profits within a group

Entity M manufactures widgets which it sells on to other entities within the group at a profit.

At the year end, Entity M has recognised profits of £300,000 in its individual accounts on which current tax will be payable. The widgets are still held in group stock at this date.

M's profits are entirely unrealised from a group perspective and have therefore been eliminated on consolidation.

When the widgets are sold outside the group in the future, part of the profit recognised in the group accounts will already have been subject to tax. A deferred tax asset may therefore need to be recognised in the group accounts (subject to the recognition criteria discussed in section 3). This asset will be calculated using the selling entity's rate of tax (ie, entity M).

Income or expenses from a subsidiary, associate, branch, or interest in joint venture

When an entity has recognised income (or expenses) from a subsidiary, associate, branch, or interest in joint venture that will be assessed (or allowed) for tax in a future period, deferred tax must be recognised unless:

- the reporting entity is able to control the reversal of the timing difference; and
- it is probable that the timing difference will not reverse in the foreseeable future.

Illustrative example: undistributed profits in a subsidiary company

Entity P has a wholly-owned subsidiary Entity Z. In its consolidated accounts Entity P has included Entity Z's post-acquisition retained earnings within consolidated reserves. Under the tax laws in its jurisdiction, Entity P will be subject to tax on these earnings when they are paid by Entity Z as a dividend. This creates a timing difference in the consolidated accounts.

Entity P generates sufficient cash to maintain and grow its business and pay dividends to its members, so is not reliant on Entity Z for this. Entity Z is growing rapidly and Entity P has documented its intention that all profits and cash flows generated by Entity Z are to be reinvested to ensure future growth and solvency of the business.

As Entity P controls the timing of Entity Z's dividend payments, it is able to control the reversal of the timing difference. There is no intention to distribute Entity Z's retained earnings for the foreseeable future, meaning it is probable that the timing difference will not reverse in that period. Therefore, no deferred tax will be recognised in the consolidated accounts in respect of Entity Z's undistributed profits.

Illustrative example: undistributed profits in an associate

Entity P has a 30% shareholding in Entity Y. In its consolidated accounts Entity P has included its share of Entity Y's post-acquisition retained earnings within its investment in associate. Under the tax laws in its jurisdiction, Entity P will be subject to tax on these earnings when they are paid by Entity Y as a dividend.

Again, this creates a timing difference in the consolidated accounts. However, because Entity P only has significant influence, it may not be able to prevent Entity Y from paying a dividend. It would therefore be unable to control the reversal of the timing difference, and deferred tax will need to be recognised in the consolidated accounts in respect of Entity Y's undistributed profits.

Practical tip: joint ventures

With a joint venture, whether or not deferred tax will need to be recognised will depend on the terms of the agreement in place between the venturers. For example, if a dividend cannot be declared without the agreement of all venturers, each venturer is able to prevent reversal of the timing difference; therefore, if it is also not probable that a dividend will be paid in the foreseeable future, no deferred tax will arise.

Section 10

Disclosures

Overarching requirement

FRS 102 requires an entity to disclose the information necessary for a user of the accounts to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events. The disclosures required in respect of deferred tax are set out below.

FRS 102.29.25

Major components of tax expense

The entity must disclose separately the major components of tax expense (income) which may include:

FRS 102.29.26

- the amount of deferred tax expense (income) relating to the origination and reversal of timing differences;
- the amount of deferred tax expense (income) relating to changes in the tax rate or imposition of new taxes;
- adjustments to deferred tax expense (income) arising from a change in the tax status of the entity or its shareholders; and
- the amount of tax expense (income) relating to changes in accounting policies and material errors.

Other separate disclosures

The following also need to be disclosed separately:

FRS 102.29.27

- the aggregate deferred tax relating to items that are recognised in other comprehensive income or equity;
- a reconciliation between:
 - the tax expense (income) included in profit or loss; and
 - the profit or loss on ordinary activities before tax multiplied by the applicable tax rate;
- 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;
- an explanation of changes in the applicable tax rate(s) compared with the previous reporting period;
- 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;
- the expiry date, if any, of timing differences, unused tax losses and unused tax credits; and
- an explanation of the nature of the potential tax consequences that would result from additional tax payable (refundable) from the payment of a dividend by the entity to its shareholders (see section 3 of this factsheet).

Practical tip: applicable tax rate

The term 'applicable tax rate' is not defined in FRS 102. Therefore judgement is required in establishing which rate will provide the most useful information to the user. For a UK entity, generally this will be the corporation tax rate for the reporting period. As noted above, any changes in the applicable tax rate(s) as compared with the previous period must be explained.

Practical tip: making the right disclosures

Disclosure plays an important role in the accounts and it has become evident that some of the disclosures required by FRS 102 are not fully understood. For example, the FRS 102 requirement for a reconciliation to the total tax expense (income) is sometimes misinterpreted as being a reconciliation to the current tax expense. The requirement to disclose the amount of reversals expected in the next year and the explanation of the potential tax consequences of a distribution may be overlooked. Care must be taken that the disclosures given are in accordance with the requirements of FRS 102.

Practical tip: key sources of estimation uncertainty

FRS 102.8.7 requires an entity to disclose information about key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year. By its very nature, the recognition and measurement of deferred tax requires assumptions to be made about the future. The detailed disclosures required by Section 29 will usually be sufficient for the needs of the users of the accounts. However, there may be instances, eg, when deferred tax assets have been recognised, when additional disclosures will be necessary to meet the requirements of paragraph 8.7.

Practical tip: tax payable (refundable) is not included in financial instruments analysis

For accounting periods beginning before 1 January 2019 when the Triennial review 2017 amendments are **not** being adopted early, FRS 102.11.41 requires disclosures of different categories of financial assets and financial liabilities. A financial asset or a financial liability arises from a contract with another entity whereas tax assets and tax liabilities arise from legislation ie, they are statutory, not contractual, assets and liabilities. Therefore, current and deferred tax assets and liabilities are not included in this note. For more information on financial instrument disclosure, read the faculty's FRS 102 Update [Disclosure of Categories of Financial Assets and Financial Liabilities](#).

For accounting periods beginning on or after 1 January 2019, or for those entities adopting the Triennial review 2017 amendments early, FRS 102.11.41 requires disclosure in respect of financial assets and financial liabilities measured at fair value through profit or loss only.

Practical tip: FRC guidance on improving disclosures

In October 2016 the FRC published the results of its [Corporate Reporting Thematic Review – Tax Disclosures](#) which gives examples of good practice and considers ways in which disclosures might be improved. Although the thematic reviews are conducted on IFRS accounts of listed companies and the disclosure requirements under IFRS are more detailed, FRS 102 has many similar requirements and the report may be a useful guide for those entities looking to improve the quality of disclosures in their accounts.

Small entities

Small entities applying Section 1A of FRS 102 are required to disclose movements in the revaluation reserve together with an explanation of the tax treatment of the items. There are no other specific disclosure requirements in respect of current or deferred tax. However, as the accounts of a small entity must still present a true and fair view, a small entity might consider providing some of the additional disclosures outlined above.

FRS 102.1AC.17, 29.27(a)

Practical tip: editorial amendment to FRS 102 – deferred tax and the fair value reserve

FRS 102 Section 1A as issued in September 2015 includes a disclosure requirement in respect of the treatment for taxation purposes of amounts credited or debited to the fair value reserve. However, this requirement does not exist in law and the FRC issued an [editorial amendment](#) in September 2015 noting that this requirement was included in error. The relevant paragraph (1AC.25) has been deleted as part of the Triennial review 2017 amendments and will be deleted in future editions of FRS 102.

Practical help in a complex world

Contacts and further help

Factsheets for faculty members

This factsheet is part of a series designed to provide practical help for Financial Reporting Faculty members in exercising their professional judgement.

The faculty cannot offer interpretations of standards or give views on the application of standards to particular companies or transactions.

The faculty's standards trackers

To check for current standards and recent amendments go to the faculty's standards trackers at: icaew.com/frfstandardstracker.

Factsheets

Topics covered by other factsheets include:

- An Introduction to FRS 102
- 2017 UK GAAP Accounts
- The UK Financial Reporting Framework

A complete list of factsheets can be found here:

icaew.com/frffactsheets

Factsheet comments and suggestions

To comment on factsheets, or to suggest topics that you'd like to see covered by factsheets, email us at frfac@icaew.com

Faculty resources icaew.com/frf

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The Financial Reporting Faculty

The faculty aims to help members keep up to date with the implications of new standards, regulations and practice in financial reporting.

Our international community of financial reporting professionals also contribute to the ICAEW's work in influencing the development of financial reporting concepts, standards and regulation.

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