Statement of Financial Accounting Standards No. 31

Note: This Statement has been completely superseded

FAS31 Status Page
FAS31 Summary

Accounting for Tax Benefits Related to U.K. Tax Legislation Concerning Stock Relief

September 1979

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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FAS 31: Accounting for Tax Benefits Related to U.K. Tax Legislation concerning Stock Relief

FAS 31 Summary

This Statement specifies how an enterprise subject to United States generally accepted accounting principles should account for income taxes relating to recent changes in the United Kingdom tax law concerning "stock relief," which permits an income tax deduction for increases in inventory. The changes have modified the provisions for recapture of the tax benefit of that deduction. The Statement requires that certain previously deferred tax benefits related to "stock relief" be recognized as of July 26, 1979 when the legislation was enacted. Other tax benefits related to "stock relief" should be deferred unless it is probable that those tax benefits will not be recaptured.

INTRODUCTION AND BACKGROUND INFORMATION

1. The FASB has been asked to clarify the accounting for income taxes relating to recent changes in the United Kingdom tax law with respect to "stock [1]relief" for enterprises reporting in conformity with United States generally accepted accounting principles. The U.K. "stock relief" legislation permits enterprises to deduct, for the purpose of determining taxable income, increases in the carrying amount of inventories. The FASB has been informed that tax benefits from "stock relief" have been deferred as if this deduction were a timing difference,[2] which reverses if inventories decrease in future years. The reversal increases taxable income, thereby resulting in the recapture of previously granted tax benefits. This recapture is known in the United Kingdom as the "clawback provision." In July 1979, the United Kingdom adopted legislation to limit the timing and the amount of tax that could be recaptured. Under the new legislation, the potential for recapture of tax benefits in 1973-1974 and 1974-1975 fiscal [3] years has been eliminated, effective from the beginning of an enterprise's 1979-1980 fiscal year. The legislation also provides that the potential for recapture of the "stock relief" tax benefit received in a year will terminate if it has not been recaptured during a six-year period.[4] Thus, for an enterprise with a December year-end, any "stock relief" for the year ended December 31, 1975

(1975-1976) not recaptured by December 31, 1981 (1981-1982) will not be subject to recapture after January 1, 1982.

2. The Board believes that the change in the U.K. tax law changes the character of the "stock relief" deduction for purposes of accounting for income taxes as of the date the legislation was enacted. Because the potential for recapture exists for six years, the Board concluded that the tax benefit resulting from "stock relief" should be deferred unless it is probable that the benefit will not be recaptured. The Board also concluded that the deferred benefit should be adjusted if circumstances change, indicating that the probability of recapture has changed; any accrual or reversal should be included in the determination of income tax expense of the period in which circumstances change. The Board believes that the change in the U.K. tax law with regard to "stock relief" creates a unique situation in accounting for income taxes and that the accounting specified by the Statement should not extend to other situations.

3. An Exposure Draft of a proposed Statement on "Accounting for Income Taxes Related to U.K. Tax Legislation Concerning Stock Relief" was issued for public comment on July 30, 1979. The Board received 49 letters of comment in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in Appendix A, "Summary of Consideration of Comments on Exposure Draft."

4. The Board has concluded that it can reach an informed decision on the basis of existing data without a public hearing and that the effective date and transition specified in paragraphs 8 and 9 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

5. Because of the potential recapture of "stock relief," the tax benefit related thereto shall be deferred unless it is probable that the tax benefit will not be recaptured prior to the end of the relevant six-year recapture period. If the tax benefit related to "stock relief" has been deferred and circumstances subsequently change indicating that it is probable that the tax benefit will not be recaptured prior to the end of the relevant six-year recapture period, the tax benefit previously deferred shall be recognized by a reduction of income tax expense in the period in which circumstances change.[5] If the tax benefit related to "stock relief" has not been deferred and circumstances subsequently change, the tax benefit attributable to that "stock relief" shall be deferred to the extent appropriate by a charge to income tax expense of the period in which circumstances change.

6. For interim reporting purposes, except as provided in paragraph 9, any change in circumstances requiring an adjustment of the tax benefit related to "stock relief" shall be included as an adjustment of the estimated annual effective tax rate in the interim reporting period in which circumstances change.

7. If accounting for "stock relief" in accordance with this Statement creates a significant variation in the customary relationship between income tax expense and pretax accounting income, that fact shall be disclosed.

Effective Date and Transition

8. The provisions of this Statement shall be applied in the first annual or interim financial statements issued after September 30, 1979 for periods ending on or after July 26, 1979. Application in such statements issued by September 30, 1979 is encouraged but not required.

9. In the initial application of this Statement in an interim reporting period ending after July 26, 1979, any recognition of previously deferred tax benefits related to "stock relief" shall be reported as an item of income tax expense of that interim period only rather than as an adjustment of the estimated annual effective tax rate and shall not be reported as an extraordinary item.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

10. Some respondents indicated that they believed the "stock relief" deduction is a timing difference that will reverse on recapture or become a permanent difference when the potential for recapture is eliminated, i.e., after the six-year time period. They therefore recommended that tax benefits deferred from 1975-1976 to date should not be recognized until the relevant six-year period has passed, when in their view the timing difference would become a permanent difference. Further, some respondents commented on the wording used the Exposure Draft to describe the previous treatment of "stock relief": "the FASB has been informed that deferred

taxes have been provided *as if* this deduction were a timing difference." (Emphasis added.) The Board believes that "stock relief" does not have the characteristics of a timing difference for the following reasons. Inventory and merchandise purchases are accounted for the same way each year for both income tax and financial reporting; an additional deduction for any increase in inventory is allowed for income tax purposes in the year the increase occurs. Because any increase in inventory is accounted for the same way each year for both income tax and financial reporting, the increase does not have the characteristics of a timing difference.[6] Likewise, the additional deduction does not have the characteristics of a permanent difference because the tax benefit is subject to recapture during the six-year period.[7] In some respects, "stock relief" is like the investment tax credit in that a tax benefit is realized because of an increase in particular assets and is recaptured if those assets or their equivalent are not held for the required period. APB Opinion No. 11, *Accounting for Income Taxes,* defines differences as either timing differences or permanent differences and does not contemplate a timing difference that later changes into a permanent difference. The Board has therefore concluded that accounting for "stock relief" as a timing difference that becomes a permanent difference is inappropriate under the existing principles of income tax allocation.

11. Some respondents questioned the use of the probability approach and suggested that recapture was not simply probable or improbable. Other comments on this approach suggested that it was too subjective and would be difficult to implement in practice. The Board has modified the approach proposed in the Exposure Draft so that the tax benefit related to "stock relief" is deferred unless it is probable that the tax benefit will not be recaptured.

12. Some respondents recommended that for interim reporting purposes the reversal of previously deferred tax benefits should be treated as a discrete item and not as an adjustment of the estimated annual effective tax rate as proposed in the Exposure Draft because treatment as a discrete item would minimize any distortion of earnings and would not include a nonoperating item in the results of operations. The Board accepted this recommendation for initial application of this Statement because of the unusual nature of this unique situation. However, for ongoing accounting, paragraph 6 is consistent with FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods,* which requires the tax effect of changes in estimates to be reflected in the computation of the estimated annual effective tax rate. The Board does not believe this existing principle should be modified for such future changes.

Footnotes

FAS31, Footnote 1--In the United Kingdom, inventory is known as "stock."

FAS31, Footnote 2--Timing differences are defined in paragraph 13(e) of APB Opinion No. 11, *Accounting for Income Taxes.*

FAS31, Footnote 3--Fiscal is used in this Statement to indicate an enterprise's financial year ended after March 31 of one year and before April 1 of the following year, as that term is used in the United Kingdom.

FAS31, Footnote 4--The legislation stipulates that any recapture will be on a LIFO basis; for example, a decrease in inventory in 1978-1979 would first be offset against any "stock relief" claimed in 1977-1978.

FAS31, Footnote 5--An increase in net income of a U.K. subsidiary from recognition of the tax benefit related to "stock relief" may require income tax allocation under APB Opinion No. 23, *Accounting for Income Taxes--Special Areas,* when that increase is recognized by the U.S. parent company.

FAS31, Appendix A, Footnote 6--See par. 13(e) of Opinion 11.

FAS31, Appendix A, Footnote 7--See par. 13(f) of Opinion 11.