



December 2005

Income and profit recognition

Professional practices sector

Pre-Budget Report – UITF 40 and service contracts – tax spreading announced

The government has announced that it will introduce legislation in Finance Bill 2006 to spread the impact of UITF 40 over three years with spreading up to six years where the impact is greatest. The spreading relief will be available to all businesses.

UITF 40 introduces new requirements for income and profit recognition for professional service firms and affects accounting periods ending on or after 22 June 2005. Many businesses are likely to face an acceleration of income and profit on implementing the new rules. Partnerships would normally have had to pay the extra tax at the end of January 2007, or January 2008 depending on their accounting year end. Companies pay their tax nine months after their year end.

After considerable lobbying by professional bodies, the government has accepted the argument that many businesses will be adversely affected by the introduction of UITF 40 and it is appropriate to mitigate the impact.

The accountancy institutes presented a memorandum to HMRC and HM Treasury in October 2005 which indicated that a quarter of businesses faced an increase in their tax bill of more than 50 per cent and 17 per cent faced a tax bill that would more than double. In the latter case this means that the profit uplift would be at least 100 per cent of the normal taxable profit.

The detailed proposal

The final details will not be available until the Finance Bill is published next year but HMRC has written to the Presidents of the accountancy institutes and the Law Society and the current proposal is as follows.

Businesses need to calculate the profit adjustment and one third will be taxed in the first year ie in relation to the first accounting period ending after 22 June 2005 and one third in each of the next two years, but subject to a further test that may extend the spreading period for up to six years.

On each occasion, the one third of the profit adjustment must be compared with one sixth of the normal taxable income (ie excluding the uplift) for the particular year, and the extra taxable income is restricted to the lesser amount, but there will be a sweep up of any amount not yet charged at the end of the six year period.

So in practice the profit adjustment will be taxed over a minimum of three years but this could extend to six years if the taxable profits are low relative to the adjustment, as set out in the following example.

Example

Take a business which is severely affected by UITF 40 and whose profit adjustment is more than 100 per cent of the normal taxable profit. Assume the normal taxable profit is 90 and the profit adjustment is 120.

One third of the profit adjustment is 40 but the additional taxable income each year is restricted to one sixth of the taxable profit of 90 being 15.

If the taxable income remains unchanged over the next five years, the addition to the taxable profits will be capped at $16\frac{2}{3}$ per cent each year. In the sixth year that amount and the balance of the untaxed profit adjustment, in this case 30, will also be taxed, giving a total addition to the normal taxable income in that final year of 45. Five years of 15 plus a sixth and final year charge of 45 making a total of 120.

Early adopters or those who changed their accounting before UITF 40

Some businesses will have changed their accounting practice following the publication of Application Note G (ANG). ANG applied to accounting periods ending on or after 23 December 2003. The majority of those businesses will face the additional tax charge in January 2006. At the moment the government has not proposed any relief for such businesses. The issue was raised in the representations to HMRC and HMT but we suspect that the government may not be prepared to go further than its current proposals.

For more information on any of the above issues, go on-line to www.pkf.co.uk or contact

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