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Accounting Considerations for the UK “Super-Deduction”

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United Kingdom (UK) tax proposals include temporary first-year capital allowances for qualifying investments in new plant or machinery made between April 1, 2021, and March 31, 2023. This article discusses accounting for income taxes considerations and how to determine the initial financial statement carrying amount under U.S. generally accepted accounting principles (“US GAAP”) for assets subject to this UK super-deduction.

Background

The UK’s Chancellor of the Exchequer presented Budget 2021 to Parliament on March 3, 2021. The UK 2021 Finance Bill (the “Bill”) contains tax proposals for new capital allowances reliefs, including a temporary 130 percent deduction for expenditures on new plant or machinery designed to promote productivity-enhancing capital investments.

Expenditures incurred for qualifying new plant or machinery between April 1, 2021, and March 31, 2023, will benefit from a tax super-deduction. Those expenditures will result in a 130 percent first-year allowance; in other words, an immediate deduction for 130 percent of the expenditure incurred. This relief is available only for taxpayers subject to corporation tax and applies only to expenditures incurred under contracts entered into from March 3, 2021, onwards. If a qualifying asset is sold in a period that

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begins prior to April 1, 2023, the sales proceeds would be deemed to be up to 130 percent of the actual proceeds.

The Bill also includes provisions that would increase the main rate of corporation tax from its current rate of 19 percent to 25 percent, effective April 1, 2023.

The Bill received its third reading in the House of Commons on May 24, 2021, and is expected to receive royal assent during the summer of 2021.¹ For US GAAP purposes, the date of enactment is considered to be when the Bill receives royal assent.²

Accounting for Income Taxes Considerations and Determination of the Financial Statement Carrying Amount of Acquired Assets

As the super-deduction regime results in a tax basis in an acquired asset that differs from the amount paid, we believe the asset should be accounted for following the simultaneous equation method.³ The simultaneous equation method is generally used to record the assigned value of an asset when an asset is purchased in a transaction that is not a business combination and the amount paid differs from the tax basis of the asset. This method considers that the calculation of deferred taxes becomes circular as the financial statement carrying amount of an asset is adjusted due to the recognition of deferred taxes and provides a solution to eliminate the circularity.

Example: Accounting for the Purchase of an Asset Subject to the Super-Deduction

Company A, a calendar year entity, purchases qualifying equipment on January 1, 2022 (after enactment of the Bill) for \$1,000 that has a useful life of five years and expects to hold the asset throughout its useful life. The super-deduction regime results in tax basis and an immediate deduction of \$1,300. Company A does not need a valuation allowance for any of its deferred tax assets. The amounts assigned to the equipment and the related deferred tax asset are determined using the simultaneous equation as follows:

Determine the amount assigned to the deferred tax asset:

$$\text{Preliminary temporary difference} \times (\text{tax rate} / (1 - \text{tax rate})) = (\$1,300 - 1,000) \times (0.19 / (1 - 0.19)) = \mathbf{\$70}$$

Determine the financial statement carrying amount assigned to the equipment:

$$\text{Preliminary book basis} - \text{deferred tax asset} = \$1,000 - 70 = \mathbf{\$930}$$

¹ Available at <https://bills.parliament.uk/bills/2835>.

² See paragraph 7.071 of KPMG Handbook, *Accounting for Income Taxes*.

³ See ASC 740-10-25-51 and 55-171.

The journal entry to record the asset purchase is as follows:

Account	Debit (credit)	Notes
Equipment	930	
Deferred tax asset	70	$(\$1,300 - 930) \times 19\%$
Cash	(1,000)	Cash paid for equipment

Accordingly, Company A would record the equipment with an initial financial statement carrying amount of \$930.

Future originating temporary difference

Upon purchase of a qualifying asset, an entity recognizes a deferred tax asset for the excess of the amount that will be allowed as a first-year allowance over the financial statement carrying amount of the asset. Immediately after purchase, the entity receives a tax deduction for the entire amount of the tax basis, which brings the tax basis of the asset to zero. As a result, the related deferred tax asset reverses and a taxable temporary difference originates for the excess of the financial statement carrying amount over the tax basis of zero.

As noted above, the Bill also proposes an increase in the UK tax rate to 25 percent, effective April 1, 2023. Accordingly, any temporary difference scheduled to reverse after the increase in the tax rate would be measured at the enacted tax rate for the year of reversal. In this situation, the deferred tax liability arising after purchase would be established at a tax rate that is greater than the rate for the year of the immediate tax deduction. We generally believe that the tax effect of this difference in tax rates should not be accounted for as part of determining the initial carrying amount of the acquired asset; instead, the tax effect of the difference in tax rates should be accounted for in earnings when the first-year allowance is permitted. If the asset is acquired during an interim period after enactment of the Bill, we would generally expect the tax effect of this originating temporary difference to be included as part of determining the estimated annual effective tax rate.

Example: Accounting for the Purchase of an Asset Subject to the Super-Deduction (Continued)

Continuing the example above of an asset purchased on January 1, 2022, Company A would record the following journal entries, resulting in \$43 of income tax expense, immediately after acquisition of the asset:

Account	Debit (credit)	Notes
Income taxes receivable	247	$\$1,300 \times 19\%$
Current tax benefit	(247)	
Deferred tax expense	290	
Deferred tax asset	(70)	To reverse the asset recorded at acquisition
Deferred tax liability	(220)	See below

The deferred tax liability is measured based on the scheduled reversal over five years of the \$930 taxable temporary difference (calculated as the difference between the \$930 financial statement carrying amount and zero tax basis) as follows:

Description	2022	2023	2024	2025	2026	Total
Scheduled reversal	186	186	186	186	186	930
Tax rate	19.0%	23.5% ⁴	25.0%	25.0%	25.0%	
Deferred tax liability	35	44	47	47	47	220

For the 2022 estimated annual effective tax rate, Company A includes the \$186 of depreciation expense within pretax ordinary income. Company A would include the \$247 current tax benefit and \$255 of deferred tax expense within the tax effect of ordinary income. The \$255 of deferred tax expense includes \$70 from the reversal of the deferred tax asset recognized when the asset was acquired and \$220 of deferred tax expense related to the establishment of the deferred tax liability, net of \$35 of deferred tax benefit on the 2022 tax effect of the change in the financial statement carrying amount of the asset. In summary, within the estimated annual effective tax rate (isolating solely the impact of the asset purchase), Company A would reflect \$186 of pretax ordinary loss and \$8 of income tax expense, consisting of \$35 income tax benefit of pretax ordinary loss and \$43 income tax expense related to the rate differential associated with the originating taxable temporary difference.

Retroactive changes in tax laws or rates

ASC 740 requires entities to reflect the impact of changes in tax laws or rates on deferred taxes in the annual or interim period that include the date of enactment. The adjustment should be included in income from continuing operations and treated as a discrete event in the interim period that includes the enactment date.⁵ In determining the discrete amount of deferred tax expense from a change in tax law, we believe it is acceptable to remeasure deferred taxes using either the enactment date temporary differences or beginning-of-year temporary differences.⁶

The retroactive tax effect of a change in tax laws or rates on current taxes for the current annual period is included in the estimated annual effective tax rate beginning in the interim period that includes the enactment date. The tax effect of a change in tax laws or rate on current taxes for a prior annual period is recognized as a discrete event in the interim period of enactment.⁷

For qualifying expenditures eligible for the super-deduction incurred before the date of enactment of the Bill, we would *not* expect the financial statement carrying amount of the asset to be adjusted as a result of enactment. However, we would expect entities to remeasure deferred taxes and adjust current taxes to reflect the 130 percent first-year allowance. This would have the effect of the tax benefit of the

⁴ 23.5 percent = (19 percent x (90 days / 365 days)) + (25 percent x (275 days / 365 days)).

⁵ ASC 740-270-25-5.

⁶ See paragraph 5.017a of KPMG Handbook, *Accounting for Income Taxes*.

⁷ ASC 740-270-25-5 and 25-6.

30 percent extra first-year allowance being recognized in earnings for those qualifying expenditures incurred before enactment.

For example, assuming enactment during 2021, calendar year taxpayers using the beginning-of-year approach would not have any temporary differences as of the beginning of year that are affected by the change in tax law. Thus, the discrete remeasurement of deferred taxes is zero, and the new tax law is applied to the ending temporary differences included in calculating the estimated annual effective tax rate beginning in the interim period that includes enactment. In this instance, both the current and deferred tax effects of enactment would be included in the estimated annual effective tax rate.

Conversely, calendar year taxpayers using the enactment date approach would generally have a discrete remeasurement resulting in deferred tax expense to reflect the adjustment of tax basis of qualifying assets to zero; however, the current tax benefit of the first-year allowance would still be included in the estimated annual effective tax rate.

Conclusion

In preparation for the enactment of the Bill, entities should carefully consider the accounting for income taxes consequences of qualifying expenditures and the impact of the change in tax laws or rates. Tax departments may need to coordinate with others in the organization as the super-deduction may result in an initial US GAAP carrying amount of assets acquired that is different from the amount paid for the asset.



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