

Societies and Inflation

With Particular Relation to Taxation

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The effects of inflation on business taxation are very much in the news. In his latest Finance Bill the Chancellor of the Exchequer, Mr. Denis Healey, introduced a revolutionary tax relief for the inflation element in the value of stock in trade at the end of an accounting period. This proposal has been well received in business circles as a first step to easing company cash flow problems. How does inflation affect corporation tax?

Commonly the tax computation is based on the profit (with certain statutory adjustments) shown in accounts prepared on an actual cost basis. This taxable profit figure, therefore, is higher than if inflation accounting adjustment were made to the accounts.

Tax depreciation (capital allowances) on fixed assets like industrial buildings and plant/machinery is also calculated on the original historic actual cost. Arguably the tax system should recognise the different values in the cash of 1975 and that of three or five years ago. Where a machine cost £150 five years ago, its replacement now costs £450: and the business has no greater real value than before. Can the £300 be said to be taxable profit?

The result in both cases is taxing not real profits but paper profits, not trading surplus but the inflation element. Inflation itself causes liquidity problems but payment of tax on a profit that does not accrue in cash or receivables makes it more acute.

It is to improving company liquidity that the Chancellor's proposal about stock in trade is directed. Before he goes any further Mr. Healey awaits the report of the Sandilands Committee on Accounting for Inflation (expected in March 1975).

Awaiting Further Proposals

The extent of any proposed inflation adjustments is important for tax purposes. It is necessary to assume that any comparisons of the present historic cost system and any one of a number of reformed inflation accounting methods will rest on equal tax yields. Otherwise there will be dispute concerning the incidence of taxation between companies and, say, individual wage earners. Equity may have a place in economics: it has none in taxation.

It is likely that tax/accounting adjustments will be needed in other areas than profit-fixed assets, monetary transactions, stock in trade, losses, payment of taxes, capital gains.

At present accounting depreciation is disregarded for tax purposes and a set scale of capital allowances substituted. Inflation accounting would alter this. One method is to continue the present accelerated depreciation (first year allowances). Companies would be taxed on inflation adjusted profits and inflation adjusted depreciation would be disallowed: capital allowances (tax depreciation) would then be allowed, based on accelerated depreciation, inflation adjusted as necessary. Where depreciable assets (like plant and machinery) were allowed at 100% First Year Allowance, inflation adjustment would be unnecessary for tax purposes in this respect.

Alternatively tax might be charged on the inflation adjusted profit, thus allowing the inflation adjusted commercial charge for depreciation as a deduction. Rates of depreciation for specific types of plant would require to be laid down by the Revenue for accounting purposes. But this is no different in essence from the pre October 26th, 1970 system for capital allowances.

In both cases proceeds of sales and tax written down values would require inflation adjustment in any computation of balancing charges/allowances on disposal.

Profit and loss account items - sales, other income, expenses - have to be adjusted to balance date pounds. Conveniently an even flow of transactions may be assumed though this may prove unfair to the Revenue on the one hand and the seasonal business on the other. Some refinement may well be required.

Non-allowable expenses, e.g., entertaining, may be added back for tax purposes in the inflation adjusted amounts. Bad debts would be adjusted over their period outstanding.

Non-taxable income, especially franked investment income (dividends paid by one UK company to another) would be extracted in the inflation adjusted amount from the inflation adjusted profit.

Fluctuations in monetary items (e.g., debentures, bank deposit accounts) will give rise to gains and losses on adjustment. These may be fairly frequent and accordingly should be brought in as taxable and deductible items respectively.

Stock in trade is traditionally valued at the lower of historic cost or net realisable value. Inflation adjustment is needed for the period between acquisition and the year end accounting date. It may be difficult administratively to isolate each item and adjust it with complete accuracy. To begin with, it will be necessary to establish working rules which can be refined over the years for seasonal and other peculiarities.

Inflation adjustment for stock in trade is important to meet the taxation imbalance between companies with considerable stock holdings, like food and drink companies which are presently taxed on the inflationary uplift in those stocks and those companies with heavy investment in fixed assets, like heavy engineering, which benefit from accelerated depreciation.

In this area the proposed relief for increase in stock values in the financial year 1973 is a total change of attitude by the Revenue. By it companies holding stocks of £25,000 or more will be able to reduce the closing valuation of stocks by the amount by which the increase in book value exceeds 10% of the trading profit before capital allowances.

Essentially this is only a tax deferment because an undervaluation of closing stock is brought forward in the next year as opening stock. Further relief will depend first on the Sandilands Report.

Until the burst of inflation of the 1970s the main grievance about taxing paper gains was in capital gains tax. Because for businesses it was possible to defer payment of tax by replacing the asset, the inflation effect became even more pronounced. Therefore, to compute the real gain adjusted historical cost or adjusted 6th April, 1965 value will be deducted from sale proceeds.

The logic of inflation accounting projects that tax losses should be inflation adjusted. Assuming a continuing inflation, losses would be expanded where relief was given by carry forward and contracted as a carry back.

Inflation Accounting and Payment of Tax

Inflation based accounting may affect payment of tax. First, advanced corporation tax is deducted from dividends paid by a company and is remitted to the tax authorities. When mainstream corporation tax is computed at the end of the accounting year, the ACT is deducted to arrive at the further amount payable. Mainstream CT will be inflation expressed in year end pounds in the balance sheet. Advance CT which may have been due nine months before would be converted also to pounds at the balance sheet date when computing the MCT.

It is also arguable that to preserve real value to the Revenue final payments of corporation tax, which can be due as long as twenty months after the balance sheet date, should also be inflation adjusted. This is probably unlikely - although the Government also needs to make up its loss in revenue because the tax profits of an accounting period form only a measure of tax due. But certainly the trend is there for earlier payments to account and heavier interest charges for late payment.

Similarly tax deposit accounts for use in settlement of future corporation tax could also be kept in real terms so that deposits rose in value with inflation.

The final form of any change from present methods of computing taxable income on an historic cost basis will depend, firstly and fundamentally, on the Government's views of the Sandilands Report. The inflation accounting method adopted - whether CPP or Replacement Cost or one of the many variations thereof affects the tax system mightily.

Nor can political interpretations be left out. Some would oppose a tax system on an inflation adjusted accounting base, believing that grants, incentives and controls can be more equitable.

For sure, the future tax system will be no less complex.