THE UK'S ACCOUNTING AND TAX TREATMENT OF DEPOSITS AND PREPAYMENTS

Julien Darras[1]

Introduction

Since 2001, the two major accounting standards setters on the world stage, namely the International Accounting Standards Board ('IASB') and the Financial Accounting Standards Board, have been working on a joint project on revenue recognition and measurement. The importance of this project rests on the significance of revenue in terms of its information value for investors. Thus, revenue, which pertains to the profit and loss accounts or the income statement, is considered to be one of the key inputs for the analysis of the performance of an entity. However, some finance experts emphasise the significance of the company's cash and explain that investors should firstly consider the analysis of the cash flow statement and then refer to the profit and loss account — not the other way around. By focusing their attention on the first sheets of the financial statements, people may underestimate the importance of cash as a measure of the profitability of a company.

These different approaches regarding the assessment of the success of a company's business, either in terms of revenue or cash, mark the essential distinction between accrual accounting and cash accounting. In the United Kingdom ('the UK'), most companies draw their accounts under the accruals accounting system, under which revenue is not recognised upon the receipt of cash but only at the date the contract matures into performance. Therefore, revenue and the cash are two different measures that do not recognise the company's accumulation of wealth at the same time.

In this context, the purpose of this study is to explore how the UK tax system approaches the question of timing recognition of income. In theory, corporation

1 Julien Darras LLM, Tax consultant. Email: julienpj.darras@gmail.com

tax is levied on the company's income that is computed on the basis of the accounting concept of revenue. Indeed, the company's cash movements are taken into account only under certain circumstances. Thus, the recognition of income in a specific year does not imply that the company has received the equivalent of this income in cash in the same year. On the other hand, not all amounts received by the company are regarded as income.

Nevertheless, the reliance of law on the concept of revenue rather than cash is questioned on its ability to tax all of the economic value created by the company. In fact, depending on the extent of the time lag between the date of income recognition and the date the income is received, there is a possibility that corporation tax is imposed only on the nominal value of income and not on the economic value of income.

Interestingly, it is underlined that the collection of income receipts ahead of the performance of the contract, either in the form of deposits or prepayments, does not trigger the charge of tax. Thus, the tax is in a way deferred until the income is recognised for tax purposes. The significance of this deferral is comparable to the effect of a tax exemption. Indeed, Andrews says that if tax exemption is not possible, the next best result is to defer paying taxes on the item of income. In fact, with a long-enough deferral period, the effective tax rate on an item of income may approach zero[2].

Consequently, this article will analyse the nature of these timing differences along with their significance on the value of corporation tax on trading income. This analysis is organised around three points: the origin of the timing differences arising upon the receipt of deposits and prepayments, their extent, and then their impacts on both the taxpayer and the tax authorities.

This article consists of four parts. In the first part, it will introduce the concept of the time value of money within the context of corporation tax charged on trading income. The following two parts study the accounting and tax treatment of deposits and prepayments with an emphasis on the timing of tax collection and the quantification of income. Finally, part IV analyses the impact on the value of corporation tax when the time value of money opportunities is materialised.

---

2 William Andrews, 'The Achilles' Heel of the Comprehensive Income Tax', in Charles Walker and Bloomfield Mark eds., *New Directions in Federal Tax Policy for the 1980s* (Ballinger Pub Co. 1983) 278.

Part I

The time value of money in the context of corporation tax on trading income

Trading companies carrying out a business deliver goods or perform services in exchange for consideration. This consideration is the price of the transaction that aims to pay the goods and services supplied. This ability to generate cash is inherent to the purpose of a company, which is defined as 'an association of persons formed for the purposes of an undertaking or business carried on in the name of the association'[3]. Business, in turn, is understood as including any trade which is characterised as 'business activity relating to the exchange of goods and services for money'[4].

In addition, this purpose is legally underpinned in company law through the directors' duty to promote the success of the entity. Under Section 172 of Companies Act 2006, a director of a company must manage the company for the benefit of its members. As taught by Griffin[5], this requirement of acting in the benefits of the shareholders is assumed to involve maximising profits in order to pay dividends.

Profits move into the company through the payment of its transactions following the issue of the invoice to the clients. Once this document is issued, the company may require the immediate payment of the transaction price or it may provide its clients with extended payment terms. Therefore, the entity's commercial policies, including the terms of payment, are set freely by the entity, or otherwise provided by law. In this aspect, Wild teaches the importance of cash management and sets out guiding principles to the attention of company managers under which the early collection of receivables is encouraged along with the delay of the payment of liabilities[6].

However, the mere collection of receivables by the company for the constitution of a reserve of cash is pointless because no value is created. Then, Wild recommends the collection of receivables and the investment of excess cash in a bank account or other short-term investments. In other words, it is understood that the economic value of money changes over time, either positively or negatively, depending on

---

3 Leslie Basil Curzon and Paul Richards, *The Longman Dictionary of Law* (8th edn., Pearson Education Limited 2011).

4 Ibid.

5 Stephen Griffin, *Company Law, Fundamental Principles* (4th edn., Pearson Education Limited 2006) 296.

6 John J Wild and Ken Shaw and Barbara Chiappetta, *Fundamental Accounting principles* (20th edn., McGraw-Hill 2011) 322.

the management of cash by the company (1). In addition, this also means that companies should monitor their cash outflows, including tax liabilities that could reduce the amount of income receipts (2). Taking into consideration the time value of money factor and the corporation tax factor, it appears that the collection and the subsequent investment of deposits and prepayments can provide the company with an economic advantage (3).

1. The value of money over time

The impact of time on the value of money is often summed up with the adage, 'a pound today is worth more than a pound in the future'. This is because the pound received today can earn interest up until the time the future pound is received. Thus, a pound invested for one year at 6 percent (%) interest will be worth £1.06 one year in the future. In finance terminology, £1.06 represents the future value of £1 invested for one year at 6% interest.

The time value of money is a fundamental concept in finance theory that Partnoy popularises to his readers in a simple but expressive situation of his own experience: On bonus morning I took my check to the Citibank branch (...). You might assume First Boston would have been sophisticated enough to pay its employees by instantaneous "direct deposit". However, (...) the firm's managers knew that if they paid us with physical checks, we'd have to deposit those checks in person. That might take a day or so. Meanwhile, the firm would earn the interest on our bonuses[7].

The author points out the power of the time value of money benefits existing on the basis of a sizeable sum of money during a one-day period. In addition, the longer the period of investment is, the large the return will be, due to the compounding effect. Compounding characterises the situation where earnings are made on the reinvestment of earnings previously generated by an asset.

In the context of a trading corporation, the time value of money encourages the billing of the price of sales and services at the earliest stage in the contractual relationship, which is the date of signature of the contract. Once the invoice is issued, the company should focus on the collection of its receivables. The earliest the collection of the receipts is, the longer the investment period and the larger the return will be.

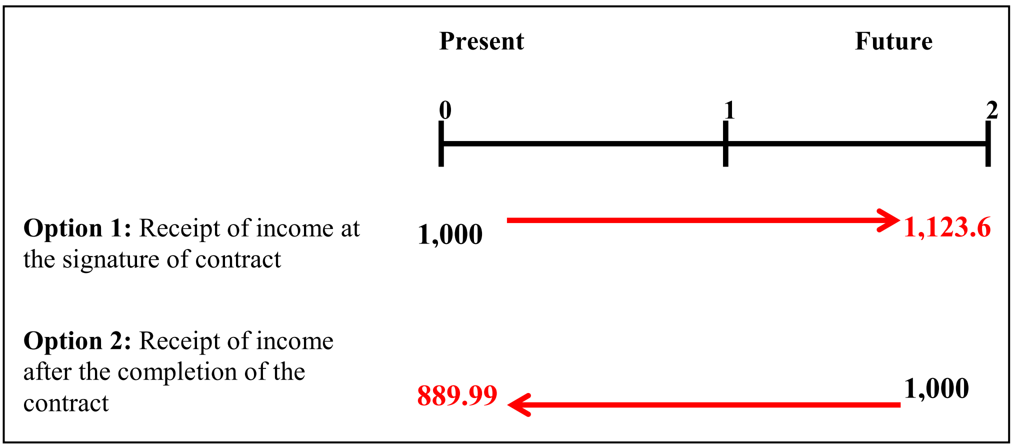
Therefore, the price of the transactions received at the date of the signature of the contract is worth more than the same price received in the future. Then, the timing differences in the payment of the price generate a difference between its nominal

---

7 Frank Partnoy, *FIASCO Blood in the Water on Wall Street* (Profile Books Ltd 1997) 41.

value, which is mentioned in the invoice, and its economic value. This assertion can be supported mathematically by comparing the value of the transaction price received at the beginning of the contractual relationship with the value of the same price received after the contract matures into performance.

In this respect, it will use the following example that distinguishes the value of the transaction price depending on the terms of payment. Option 1 features the receipt of the transaction price at the date of signature of the contract (i.e. year 0) for £1,000. Option 2 features the receipt of the transaction price after the completion of the contract (i.e. year 2) for £1,000. A 6% annual interest rate is used either to compound to its future value the price set in Option 1 or to discount to its present value the price set in Option 2, as illustrated below:



In accordance with this chart, a trading company would choose to receive £1,000 at the date of signature of the contract rather than £1,000 at the date of completion of the contractual obligations. This is because the transaction price in Option 1 has a future value of £1,123.6, which is £123.6 more than the amount receivable under Option 2.

Overall, it has been demonstrated that it is in the company's best interest to collect its trading income as soon as possible to be able to invest it and earn interest on that basis. The reference to the basis of the transaction price makes it necessary to study the impacts of cash outflows, specifically the corporation tax charged on the company's profits.

2. The levy of corporation tax on trading income

The sale of goods and the supply of services require human, material and financial resources in which costs reduce the trading income accordingly. However, a company must limit the transfer of its economic benefits in order to maximise the investment opportunities on the basis of the business proceeds. Aside from operating and financial expenses, corporation tax is also an item monitored by company managers.

Under Corporation Tax Act 2009 ('CTA 2009'), s 35, corporation tax is levied on the trading income of companies. Whereas it is provided that corporation tax is charged annually on the companies' trading income[8], there is no definition of income for tax purposes.

However, the Yates v Yates case gives a definition of income, which means in the context of a commercial business 'the profits made on that business (...) the balance of gains over loss. It seems (...) to be altogether straining the ordinary significance of the term "income" to say that it means the volume of business. That is the "turnover", not the "income"'[9]. In addition, it is settled case law that the income for tax purposes must be measured in accordance with the 'ordinary principles of commercial accounting'[10] for the determination of the 'true profit'[11]. Later, this reference to accounting standards was enshrined in tax law, which currently states under CTA 2009 Section 46 that the profits of a trade must be assessed in accordance with generally accepted accounting practice ('GAAP'). GAAP refers to the guidelines established by two standard-setting bodies, namely the Accounting Standards Board ('ASB') and the IASB, to assist companies in drawing accounts in a true and fair view. In this respect, the financial reporting standards ('FRS') set by the ASB are applicable to all UK companies except those such as listed companies that draw their accounts in accordance with the IASB's international financial reporting standards ('IFRS' or 'IAS'). The convergence programme of financial reporting standards issued by the ASB towards the standards set by the IASB ensures that all UK entities are subject to guidelines with similar content, particularly with regard to the definition of income.

Income is defined as 'increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants'[12]. The IAS conceptual framework specifies that the notion of income encompasses both revenue and gains. Revenue is distinct from gains as it arises in the course of the ordinary activities of an entity in the form of sales, fees, interest, dividends, royalties, and rent. In this respect, the ASB provides a similar meaning of revenue to IAS.

8 CTA 2009, s 8(3).

9 [1913] 33 NZLR 281.

10 *Odeon Associated Theatres Ltd v Jones* [1971] 1 WLR 442; 48 TC 257.

11 Ibid.

12 IAS The Conceptual Framework for Financial Reporting §4.25.

Therefore, the payments received by a trading company from its clients in exchange for the sales or the services supplied are income and a fortiori revenue from an accounting standpoint. Afterwards, corporation tax is levied on this income that arises during a given accounting period. Then, it appears that the levy of corporation tax is marked by a sequence of events in which the starting point is revenue. Indeed, it is the recognition of revenue that prompts the recognition of expenses pursuant to the matching principle[13] in which respective amounts allow the computation of the income for tax purposes. In this accounting and tax context, it is submitted that the taxation of the trading income is contingent upon the recognition of revenue and the accounts. Such recognition does not fall necessarily at the date the taxpayer receives the transaction price, although revenue is measured on that basis.

In this respect, GAAP revolves around the accrual accounting system under which revenue is recognised when it is earned and not when the cash has been received. In this matter, the ASB issued a specific note under which it states that the revenue from the supply of goods or services by a trader to its clients should be recognised when the former obtains the right to consideration in exchange for his or her performance[14]. This is the performance of the company's contractual obligations in terms of the delivery of goods or supply of services, which exclusively generates the right to consideration. In this respect, the ASB issued a statement in which the timing of payment is expressly disregarded in the recognition of revenue. The board asserts that the right to consideration does not represent a contractual right to demand stage payments from the customer. Rather a seller obtains the right to consideration in exchange for the performance of its obligations under a contractual arrangement with a customer. This approach avoids the recognition of revenue being distorted by the timing of payment; to do so would move towards cash accounting. This would lead to a lack of comparability and allow wide discretion in reporting revenue[15]. It goes on to say that 'the Application Note uses the term "the right to consideration" in place of "the right to be paid" to emphasise that this right does not necessarily correspond to stage payments'. In different but more accurate terms, IASB holds the same principle in its standard IAS 18 on Revenue.

Therefore, the accounting and corporation tax regime in force does not lay down that the receipt of income is a requisite for income recognition. Thus, the income can be received before the performance of the contract without any impact on the

---

13 IAS The Conceptual Framework for Financial Reporting §4.50.

14 Amendment to FRS 5 'Reporting the Substance of Transactions': Revenue Recognition November 2003.

15 Ibid §14.

recognition of income. Essentially, this means that the collection of income receipts before the recognition of income does not trigger the charge of corporation tax, which accordingly limits the cash outflows.

3. The existence of an economic advantage through the investment of deposits and prepayments

It is submitted that the current accounting and tax regime favours the investment opportunities in the situation where income receipts are collected ahead of the performance of the contract. Indeed, the absence of the charge of corporation tax allows the company to hold these receipts on a gross amount basis. Then, the investment of these monies for a gross amount increases the time value of money benefit, as illustrated in the following example:

Situation A: Gross amount		**Situation B: Net amount**	
Collection of income receipts ahead of the performance of the contract	£1,000	Collection of income receipts after the performance of the contract	£1,000
Investment of the receipts	£1,000	Taxation of the trading income (23%)	£230
Interest earned in a one-year period (6%)	£60	Investment of the receipts	£770
Taxation of the interest income (23%)	£13.8	Interest earned in a one-year period (6%)	£46.2
Taxation of the trading income (23%)	£230	Taxation of the interest income (23%)	£10.626
Total net cash flow	£816.2		£805.574

This table shows that the investment of the receipts for a gross amount is more profitable than investing an after-tax amount because it generates a higher amount of interest (i.e. a net interest of £10.626 in the example). This difference rests on the absence of taxation of the future value of the income receipts following the assessment of the income for tax purposes. On the contrary, corporation tax in Situation A is levied on the present value of these receipts existing at the date of their collection. Indeed, the example above reports a corporation tax charge for the same value (i.e. £230) both in Situation A and in Situation B, although A was subject to tax a year after B. Pursuant to the theory of the time value of money, A had not been charged on the real value of corporation tax, which is higher than its nominal value. At the end, both A and B took advantage of the time value of money by the investment of their trading income but the former increased its return over the second due to the regime of corporation tax.

Formally, the benefit of this cash advantage implies firstly the collection of payments at the date of signature of the contract, either in the form of deposits or prepayments.

Although these two means of payments are similar from a cash perspective, their legal regime is distinct.

Lord Macnaghten's ruling in Soper v Arnold is commonly quoted for the definition of deposit according to which it '(...) serves two purposes – if the purchase is carried out it goes against the purchase-money – but its primary purpose is this, it is a guarantee that the purchaser means business'[16]. In the context of trading income, deposit is understood as the sum of money received by the seller or supplier in relation to and before the performance of the contract, which aims to guarantee that clients intend to buy the goods or services. This deposit is different from the money collected by an agent on behalf of a third party (i.e. the principal) and kept as a deposit until its transfer to the principal. In this aspect, GAAP and particularly IAS 18 Revenue §8 confirm that the cash collected on behalf of the principal is not the agent's revenue. Indeed, the agent's revenue includes the commissions paid by the principal.

After the completion of the contractual obligation, the deposit, if not returned, can be used by clients for the payment of the transaction price due to the trading company. In this regard, the deposit is offset against the transaction price, as does an advance payment.

Black's Law Dictionary defines advance payments ('prepayments') as payments made in anticipation of a contingent or fixed future liability or obligation. From the recipient's perspective, the prepayment is the receipt of its consideration before the due date or before a service is rendered. Precisely, this investigation is focused on the regime of the payments received ahead of any sales or provision of services. This situation is different from the payments received before the total completion of the contract but in connection with the progression of the performance of the delivery of goods or the supply of services. In this case, the monies collected are not prepayments but rather the payment of the sales and services.

Although the receipt of deposits and prepayments generates additional rights and obligations respectively for the clients and the trading company, economically they are both funds that are potentially a source of future earnings. These earnings consist of the time value of money benefit, which result from the combination of the collection of income receipts before the recognition of income for tax purposes and the investment of these monies until the income is finally recognised. It has

16 *Soper v Arnold* [1889] 14 App. Cas. 429, 436.

been proven that the parallel execution of these two operations generates a supplement of cash in comparison with the situation where the collection and the investment of the income receipts are carried out after the income is recognised for tax purposes. In line with the earning principle, the deposits and prepayments have to be reported in the accounts under a specific accounting treatment to avoid the recognition of income.

Part II

The accounting treatment of deposits and prepayments

In compliance with accrual accounting, the timing of the collection of income receipts is disregarded for revenue recognition. As expected, the changes of the value of money between the date of receipt and the date of the recognition of revenue are neutralised through the accounting treatment of deposits and prepayments. This neutralisation entails that no gain is recognised on the increase of the cash asset by the reporting of a liability for an identical amount (1). In addition, the time value of money benefit on these receipts is not recognised under the computation rules of revenue, which is based on the basis of the historical value of the deposits and prepayments (2).

1. The balance of the receipt of deposits and prepayments by a liability entry

The report of a liability in the accounts to balance the cash asset representing the receipt of deposits and prepayments implies the identification of its nature (1.1) before considering its quantification (1.2).

1.1. The nature of the liability reported in the accounts

Pursuant to the accrual accounting, the revenue is recognised at the date the right to consideration arises following the performance of the contract. The collection of deposits and prepayments does not represent income on the date of receipt if it is balanced with a liability. In this respect, it makes reference to the notion of income understood in its accounting sense, which includes both revenue and gains[17]. Indeed, these receipts may not trigger the recognition of revenue because the performance is still expected, but they may generate an income in terms of gains.

Therefore, it is necessary to identify the circumstances under which the receipt of deposits and prepayments generates an obligation for the trading company, which

---

17 IAS The Conceptual Framework for Financial Reporting §4.29.

will be reported in the accounts as a liability. Such an investigation implies the analysis of the stipulation of the contracts entered into with the clients. This reference to the substance of the contract is upheld by the ASB according to which entities should report turnover in accordance with the substance of their contractual arrangements with customers[18].

Under contract law, Fafinski reminds the character essential of the performance of the contractual obligations, as it is the standard way to discharge a contract[19]. Therefore, Sale of Goods Act 1979, s 27, states that the seller and buyer's duties consist respectively of the delivery of the goods on the one hand and the acceptation along with the payment on the other hand, in accordance with the terms of the contract of sale. In the same vein, Supply of Goods and Services Act 1982, ss 12 and 15, regulate the contract for the supply of a service as encompassing the obligation to carry out a service by the supplier in exchange for the payment of a consideration by the other party.

It is specified that contract law puts an emphasis on the completion of the seller or supplier's obligations, which are considered to be essential to the contract. On the contrary, the law expressly states that 'stipulations as to time of payment are not of the essence of a contract of sale'[20].

In this context, the obligation to perform the contractual obligations appears through the liability that is reported upon the receipt of deposits and prepayments. A liability is defined as an obligation to transfer economic benefits as a result of past transactions[21]. In addition, the liability that is reported in the accounts is more than an obligation to return the money received because the recipient is committed to delivering goods or services. In this aspect, the situation of a trading company that receives deposits while acting on its behalf is different with the situation of deposits kept by an agent on behalf of the principal. The latter has only a liability to return the money to the principal.

Moreover, it must be noted that the funds are received on different legal grounds depending on whether a deposit or a prepayment has been asked from the clients. Indeed, the prepayments are directly related to the payment of the transaction price, whereas the deposit is indirectly related to this payment insofar as it is offset against the price. At first, the deposit of money aims to provide the recipient with

---

18 The development of the Application Note, Amendment to FRS 5 'Reporting the Substance of Transactions': Revenue Recognition November 2003 §10.

19 Stefan Fafinski and Emily Finch, *Contract Law* (Pearson Education 2009) 168.

20 Sale of Goods Act 1979, s 10(1).

21 IAS The Conceptual Framework for Financial Reporting §4.46.

a guarantee for the execution of the contractual obligations. In theory, then, the deposit is returnable, whereas the prepayment is non-returnable.

All of these characteristics are considered in the reporting in the accounts of the deposits and prepayments. In this respect, Shekel explains that both types of receipts generate the credit of an asset account such as cash that is balanced by the report of a liability, which differs depending on the nature of the receipt[22]. Specifically, the receipt of prepayments implies the report of a liability to provide goods or services[23] to the clients. However, such a liability is divided into two different liabilities upon the receipt of deposits. In this case, a liability to provide goods or services is reported along with a liability to return part or the whole amount of the deposit. The fact that deposits are refundable by the recipient to the payer justifies the reporting of this second liability. According to Mirza, deposits from customers are generally classified as financial liability because they contain a contractual obligation to deliver cash to another entity[24]. Thus, IAS 32 and IAS 39, which were transposed respectively in FRS 25 and FRS 26, require the disclosure of this financial liability in the balance sheet when the entity becomes a party to this instrument.

Therefore, it appears that the receipt of deposits and prepayments leads to the movement of accounts that pertain only to the balance sheet, excluding the profit and loss or income statement account because no revenue is recognised yet. In addition, the measurement of the liability needs to correspond to the nominal value of the deposits and prepayments; otherwise a gain might result upon the receipt of cash.

1.2. The report of the liability in the accounts for the nominal value of the deposits and prepayments

The prepayment and the deposit, under certain conditions, constitute or will constitute part of the price of the transactions that will be recognised as revenue at a future date. However, the absence of revenue recognised does not exclude the possibility for the recipient to make a gain on these receipts. Such a gain should be avoided if the trading company expects to maximise its return by the investment of the deposits and prepayments. Indeed, CTA 2009, s 2, includes gains in the scope of corporation tax. The amount of corporation tax charged on the gain constituted

22 Moshe Shekel M, *The Timing of Income Recognition in Tax Law and the Time Value of Money* (Routledge Cavendish 2009) 11.

23 Amendment to FRS 5 ‘Reporting the Substance of Transactions’: Revenue Recognition November 2003 §G5 and IAS 18 Revenue §19.

24 Mirza A and Orrell M and Holt G, *IRFS Practical Implementation Guide and Workbook* (2nd edn., John Wiley & Sons 2008) 241.

by the difference between the recipient's assets and liabilities would accordingly reduce the amount of the receipts to be invested.

Then, a perfect balance between the debit of liability and the credit of asset (i.e. cash) is necessary to prevent the recipient's increase of wealth. The issue regarding the quantification of the liability has been already considered by the ASB, which promotes such a balance; otherwise the reduction of '(...) the liability would also give rise to a reported gain, which might suggest that the success of the business in a particular period depended on obtaining orders rather than satisfying customers'[25].

In this respect, the accounting standards deal with this issue by providing for a reporting of the liability for the nominal value of prepayments and deposits.

FRS 5 on Revenue Recognition is particularly clear about the measurement of the liability upon the receipt of prepayments. In this respect, it is set that 'liabilities relating to payments received in advance are reported at the amount the seller has received, for taking them on, which is their entry value'[26]. This entry value corresponds to the nominal value of the prepayments. The ASB justifies the reporting of the liability for its entry value with the recipient's obligation to provide goods or services in compensation for the receipt of the prepayments. Indeed, according to the ASB, 'on making a payment in advance, the customer will have a claim on the entity to receive value for the amount paid. If the liability were reported at the cost of performance, the financial statements would not faithfully report the entity's obligation to its customer'[27]. Therefore, it can be considered that the liability is deferred revenue or deferred income because the advance payment strictly matches the whole or part of the value of goods or services that the clients are entitled to. Reciprocally, this is also the value of the financial consideration that the trading company will be deemed to have earned upon the recognition of revenue.

On the other hand, the valuation of the liability upon the receipt of deposits is slightly different from the prepayments, as it requires the report of an additional liability entry in which the nature is financial. IAS 39 and FRS 26 provide for the rules regarding the valuation of this liability. The approach set by the standards is to isolate the pure financial instrument from the remainder of the deposits. Accordingly, at the date of receipt, in addition to the 'deferred revenue' displayed as a liability, a financial liability is recognised. This liability is classified in the

---

25 Development of the Application Note, Amendment to FRS 5 'Reporting the Substance of Transactions': Revenue Recognition November 2003 §23.

26 Ibid §21.

27 Ibid §23.

category of financial liabilities measured at amortised cost. In this respect, the liability is measured on recognition at its fair value using the discounted cash flow technique. Basically, the recipient has to estimate the amount of the deposits to be returned to the clients. Once estimated, this amount is discounted to its present value using the applicable discount rate [28]. Then, the difference between the amounts received as deposits and the fair value of the financial liability represents the amount to be reported as deferred revenue. The addition of the financial liability and the deferred revenue liability results in the report of the deposits for a nominal value.

The deposits and prepayments accounting entries allow the recipient to enjoy the possession of a cash asset without having to report a gain at the collection date. This advantage in terms of cash is retained at the date the revenue is finally recognised.

2. The recognition of revenue for the nominal value of the deposits and prepayments

The preservation of the time value of money benefit upon the receipt of deposits and prepayments is ensured by the computation of the revenue recognised on the basis of the historical value of the liability initially reported (1). In addition, the absence of adjustment of the value of these income receipts supports this result (2).

2.1. The recognition of revenue on the basis of the historical value of the liability

Once the fulfilment of the performance of the contract has been further recognised, the revenue is measured at its fair value, which is normally the price specified in the contractual arrangements[29]. In this regard, accounting standards, particularly FRS 5, state that the right to consideration entitles the seller to report the corresponding revenue either by an increase in assets, which corresponds to the receipt of cash or the report of a receivable, and/or by a decrease in liabilities, which were initially reported further to the receipt of prepayments. The reduction of these liabilities results in the increase of the recipient's wealth because of the revenue recognition.

It is underlined that the reporting of revenue is made wholly or partly on the basis of the historical value of these liabilities. Thus, there is no revaluation of the amounts previously reported as liabilities. This is in line with the guidelines published by the UK tax administration Her Majesty's Revenue and Customs

28 Please note that the determination of the discount rates is out of the scope of this paper.

29 FRS 5 Reporting the Substance of Transactions §G5 and IAS 18 Revenue §10 and 11.

('HMRC') on this subject, according to which 'at present, the great majority of UK companies use the historic cost model. Their financial instruments (e.g. deposits, debtors, creditors, loans, debentures and shares) are therefore recorded at historic cost (...)'[30].

Considering that these liabilities were initially reported to balance the receipt of deposits and prepayments, it results that their historical value corresponds to the nominal value of these income receipts. Therefore, it appears that deposits and prepayments are included in the revenue on the basis of their nominal value without any revaluation.

2.2. The absence of revaluation of deposits and prepayments

The absence of adjustment of the value of the deposits and prepayments demonstrates that financial accounting does not take into account the economic advantage constituted by holding these monies for a certain period of time before the recognition of revenue.

On the contrary, it is noticed that negative impacts of time on the value of money are reflected on the measurement of revenue in the case of flexible payment terms which are granted by the trading company to its clients. This deferral of the collection of the transaction price constitutes a renunciation to the time value of money benefit associated with the holding of the money. In this specific case, accounting standards provide for the measurement of the fair value of the revenue by discounting to their present value the expected cash inflows. However, the ASB poses as a prerequisite the materiality of the impact of the time value of money on the reported revenue. This materiality supposes that the fair value of the consideration, which is discounted to its present value, is lower than the nominal value of the price to be received in the future[31].

In this context, a question arises about the reason that causes the time value of money impacts to be considered only in the situation where the collection of the transaction price is delayed. Indeed, the concern of materiality expressed by the ASB equally applies to the situation where the time value of money impacts upon the value of deposits and prepayments. Technically, while it is provided the possibility of discounting to their present value the expected cash inflows, it could have also been provided compounding to their future value the cash inflows received prior to the recognition of revenue.

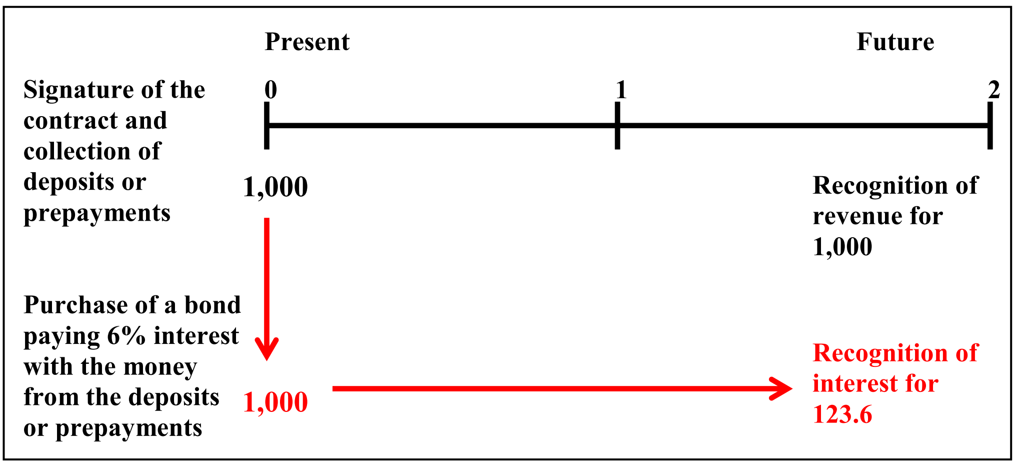
---

30 HMRC Corporate Finance Manual 12055.

31 Amendment to FRS 5 'Reporting the Substance of Transactions': Revenue Recognition November 2003 §G8.

A justification may be found in the accounting principle of prudence. According to the concept of prudence, in cases of doubt in measuring income and expenses items, or assets and obligations items, a cautious approach is required, such that assets or income are not overstated and liabilities or expenses are not understated. This view is confirmed by the ASB regarding deferred payments for which it evoked the risk that revenue would be overstated if no adjustment was made to the price specified in the contractual arrangement in the case where interest-free credit was granted to the client over a number of years[32].

This being said, it could be argued that the principle of prudence justifies the increases of the value of deposits and prepayments over time to be disregarded in the measurement of revenue. Indeed, the existence of benefits pursuant to the time value of money concept depends on the conclusion of contractual arrangements specifically designed for the investment of income receipts. Without such an investment these benefits are not materialised and the recipient earns no advantage. The following graph illustrates the materialisation of these ‘time value of money’ benefits, taking the purchase of a bond as an example:



Therefore, it could be considered that including in its basis the future value of the deposits and prepayment (i.e. 1,123.6 instead of 1,000) as a rule may overstate revenue of companies which did not invest the income receipts (e.g. investment through the purchase of a bond).

To conclude, the economic advantage resulting from the combination studied in Chapter I rests on its principal component, which is the collection of income receipts before the recognition of the revenue for accounting purposes. This implies that the recognition as revenue of these monies is deferred until the

32 Ibid §18.

contract matures into performance. In this respect, the accounting treatment of deposits and prepayments ensures such deferral by the reporting of a liability equal to the nominal value of the cash asset. Therefore, this balance between the asset and liability entries neutralises the recognition of a gain that could have triggered a tax liability.

Afterwards, these accounting entries are not reassessed until the recognition of revenue, which is measured on the basis of the historical value of the 'deferred revenue' liability. Therefore, the value of the deposits and the prepayments is the same in the trading company's accounts from the date of receipt until the date they are finally recognised as revenue and then income. In other words, the value of these receipts at the date of collection equals their future value at the date the revenue is recognised in the accounts. Considering that trading income for tax purposes is determined on the basis of revenue, this accounting regime has an impact on the tax treatment of deposits and prepayments.

Part III

The tax treatment of deposits and prepayments

The accounting treatment of deposits and prepayments does not create by itself advantages for taxpayers. However, the application of tax law relies on this financial information for the recognition and the assessment of income. The resulting tax liability is economically a cash outflow in which deferral generates an economic advantage. In this respect, corporation tax is consistent with GAAP in the recognition as income of the deposits and prepayments (1). This regime allows taxpayers to enjoy these monies on a gross amount basis until corporation tax is effectively recovered by HMRC (2).

1. The reference to financial accounting for the determination of the trading income

The mantra that 'tax follows the accounts' bears no exception regarding the taxation of deposits and prepayments as trading income. Therefore, these income receipts are not subject to corporation tax at the date of collection (1.1). This regime allows the holding of deposits and prepayments for a gross amount basis and this economic advantage is not compromised by the measurement of the trading income (1.2).

1.1. The absence of taxation of deposits and prepayments at the date of collection

The corporation tax regime refers broadly to financial accounting for the determination of the taxable income[33], which relies on the recognition of revenue. In addition, CTA 2009, s 48, uses the accounting entries "debit" and "credit" to designate respectively the expenses and receipts for the calculation of the profits of the trade. Paragraph 2 of the same section emphasises the incorporation of the accrual accounting system into corporation tax law by stating that for tax purposes the references to 'receipts or expenses do not imply that an amount has actually been received or paid'.

However, CTA 2009, s 46, tempers the principle that tax follows the accounts by authorising exceptions. Indeed, the reference to GAAP for the computation of the taxable income is 'subject to any adjustment required or authorised by law'. The departure from financial accounting for the estimation of the taxable trading income is made by statutory override. Interestingly, some provisions of tax law disregard the accounting accruals to consider the cash movements in the company. In this respect, CTA 2009, s 373, lays down that debits relating to the interest due to another entity are to be brought into account for tax purposes on the assumption that the interest does not accrue until it is paid if certain conditions are met.

In the specific case of deposits and prepayments, there is no tax provision that brings forward the charge of corporation tax before the date of income recognition. In this respect, it could have set a statutory override with a similar regime to the value added tax rules ('VAT') applicable to deposits and prepayments. Whereas VAT and corporation tax are two distinct taxes, they share some features, particularly regarding the recognition of the taxable income. Indeed, VAT Act 1994, s 6, explains that VAT is chargeable when the goods are removed or made available and the services are performed, which is similar to corporation tax pursuant to GAAP. However, VAT Act 1994, s 6(4), brings forward the charge of VAT on the receipt of advance payments. In addition, the Court of Justice of the European Union ruled that this regime also applies to deposits in the case where they are applied to the price of the transaction[34].

Regarding corporation tax, UK courts ruled that the receipt of money ahead of the date the contract matures into performance could trigger the charge of corporation tax at the date of receipt. However, these rulings were given on the basis of specific circumstances. Elson v Prices Tailors Ltd is a landmark case in which the

---

33 CTA 2009, s 46.

34 Case C-277/05 *Société thermale d'Eugénie-les-Bains v Ministère de l'Economie, des Finances et de l'Industrie* [2007] OJ C211/05.

court dealt with the tax treatment of deposits that were demanded from the customers of a bespoke tailor when ordering a garment[35]. In this case, the deposit was either treated as part payment of the transaction price if the client accepted the good or it was held by the taxpayer and reimbursable to the client on demand if the latter rejected the good or never collected it. Often, however, the customer never reclaimed the deposit.

Firstly, the analysis of the obligations arising from the contract led the court to confirm that the monies received by the taxpayer were deposits, not prepayments. Judge Ungoed Thomas highlighted that these receipts were deposits in the sense of 'a security for completion of the purchase' because there was no evidence that clients knew the seller's commercial policy of returning deposits even if they defaulted in collecting their orders[36].

Secondly, the court's decision to include the deposits among the taxpayer's trading income required the identification of the time when they were chargeable to tax. It appears that the issue revolved around the fact that the deposits became the taxpayer's property because the contractual stipulations did not provide the possibility to make a refund to the clients.

In this context, it is important to note that the court ruled that the deposits were income receipts in the year during which they were received by the taxpayer. Nevertheless, this decision has to be considered in accordance with the nature of the contractual arrangements between the taxpayer and its clients. Indeed, all deposits are not liable to corporation tax in the hands of the recipient and if they become liable to tax, it is not necessarily in the accounting period in which they were collected. As put by HMRC, 'The decision in Elson v Prices Tailors (1963), 40TC671, was not simply that all deposits and part payments should be recognised in full when they are received. The judgement contained a qualification about the obligations arising'[37].

The court itself recognised in its decision that receipts in the form of deposits are not liable to corporation tax when the terms of the contracts provide that the clients retain ownership of the money deposited. Judge Ungoed Thomas expressly distinguished the situation of the tailor company with the situation of an agent in the Morley v. Tattersall case. According to him, in the latter case, '(...) the balances in the traders' hands were not theirs but were held for others, and this fact is fundamental to the decision[s]. The traders had no beneficial interest in them at the relevant time, and, although it was because they were traders that they

---

35 [1963] 1 All ER 231; 40 TC 671.

36 *Elson v Prices Tailors Ltd* [1963] 1 WLR 292.

37 HMRC Business Income Manual 31110.

received them, they were not receipts to their trade at all'[38]. By contrast, the taxpayer in Elson v Prices Tailors was considered as having obtained ownership of the deposits due to the lack of any obligation of repayment. Therefore, it had, according to the court, a beneficial interest in receiving the receipts.

In this aspect, the court referred to the Morley v. Tattersall case that illustrates the tax situation of a firm of auctioneers in which business was the sale of horses on behalf of their owners[39]. The sales proceeds received by this agent were not included in its trading receipts because legally the money was owed to the owners of the horses. In addition, the process of the transfer of the sales price from the agent to its clients required a written authorisation from the latter. Meanwhile the unclaimed money was kept in a deposit account in the hands of the firm. Later on, it had been decided to transfer the deposits to the capital accounts of the partners who were committed to paying the money to the clients on demand and in proportion of the deposits received. In such a context, the court held that the unclaimed balances thus received did not become trading receipts liable to tax because there was no transfer of ownership of these sums from the clients to the partnership.

Therefore, the terms of the contractual arrangements are fundamental to the determination of the tax regime applicable to the deposits. Thus, the chargeability of corporation tax on deposits is contingent either to the date on which the revenue from the sales or the services is recognised in accounting or to the date on which the taxpayer is 'reasonably certain that no goods or services will ever be provided and the deposit will be forfeited'[40].

Interestingly, in a recent case[41], Lord Phillips and Lord Mance commented on the Elson v Prices Tailors Ltd decision to say that the income tax position of the money received as "deposits" would have been different had it been given merely as part payment for suits not yet completed or delivered. In this situation, the receipts would have been liable to corporation tax only if and when the revenue had been recognised, which corresponds to the date the suits were finished and accepted by the customer.

This opinion corresponds to the corporation tax treatment of prepayments commonly accepted in case law. Besides, this treatment merely draws the consequences of the accruals concept in accounting. It should be noted, in this

38 *Elson v Prices Tailors Ltd* [1963] 1 WLR 293.

39 [1938] 22 TC 51.

40 HMRC Business Income Manual 31110.

41 *Total Mauritius Limited v Mauritius Revenue Authority* [2011] UKPC 39.

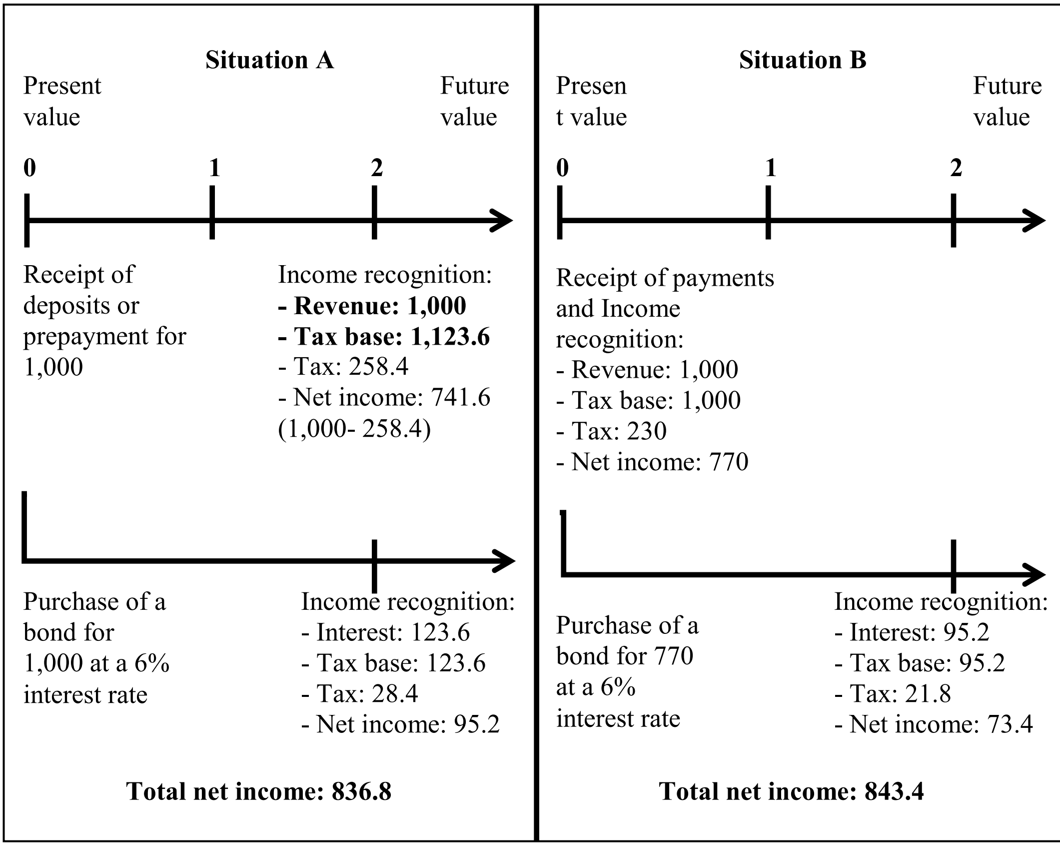
aspect, that the courts have confirmed the necessary reference to the accounting standards for the assessment of the income tax for a long time [42].

1.2. The quantification of trading income on the basis of the nominal value of deposits and prepayments

Upon the recognition of trading income at the date the contracts mature into performance, the income receipts become chargeable to corporation tax. In this aspect, tax follows the accounts, specifically for the measurement of the income. Therefore, the deposits and prepayments should be chargeable as income on a nominal value basis, which excludes any adjustment for changes of value over time.

In addition, there is no statutory override dealing with the measurement of deposits and prepayments that would depart from financial accounting in order to levy tax on the increases in value of these receipts over time. On the basis of the chart of Chapter II paragraph 2.2, the following chart illustrates that the implementation of such a provision would entitle HMRC to tax these increases of the value of money (i.e. Situation A). At the end, such taxation would ensure approximately an equal treatment between the taxpayer who obtained this economic advantage and a taxpayer who did not (i.e. Situation B):

42 *Odeon Associated Theatres Ltd v Jones* [1971] 1 WLR 442; 48 TC 257; *Gallagher v Jones; Threlfall v Jones* [1993] STC 537; (1993) 66 TC 77; *Johnston v Britannia Airways Ltd* [1994] 67 TC 99.



It appears from the chart that the absence of taxation by HMRC of the deposits and prepayments at the date of receipt could be balanced by the taxation of these income receipts on the basis of their future value (i.e. 1,123.6) and not on the basis of the accounting entry (i.e. 1,000) at the date the income is recognised. In addition, such taxation could ensure that the collection (or not) of deposits and prepayments by taxpayers is almost neutral from the perspective of corporation tax.

However, the case law already set that income is measured on the basis of the nominal value of deposits and prepayments as reported in the accounts. For instance, the Tapemaze Ltd v Melluish case illustrates a situation in which the court investigated the taxpayer's accounting treatment of prepayments for the determination of the corporation tax regime[43]. The facts of the case involved a company that carried on a business of car rentals in respect of which it required from the customers advance payments. Theses prepayments were reported on the

43 [2000] STC 189; (2000) 56 TC 630.

balance sheet as deferred income in the form of assets balanced by liabilities to perform the hire contracts. They were released to the profit and loss account as turnover in the following period during which the services were supplied. Eventually, the court did not have to decide on the value of the prepayments on which corporation tax should be levied because the tax issue was different. However, the court implicitly upheld that the prepayments should be considered for their nominal value in the computation of the taxpayer's trading income. Precisely, the court confirmed that the recognition of the profits for tax purposes was made on the basis of the write-back of the liabilities for their historical value.

Overall, the regime of corporation tax does not provide for the taxation of receipts of deposits and prepayments until the income is recognised. This taxation results in taking a slice out of these funds for the payment of corporation tax. The remaining part corresponds to the taxpayer's net income. Nevertheless, the effective payment of corporation tax takes place after the recognition of income for tax purposes. This situation entitles the taxpayer to continue to hold these income receipts on a gross basis for a certain period of time.

2. The charge and the collection of corporation tax

The recognition as trading income of the deposits and prepayments, which were previously collected, does not mean that corporation tax becomes payable immediately by taxpayers to HMRC. On the contrary, the levy of corporation tax is divided into stages of different times, including the charge of corporation tax following the income recognition (2.1) and the collection of the tax (2.2).

2.1. The charge of corporation tax on an annual basis

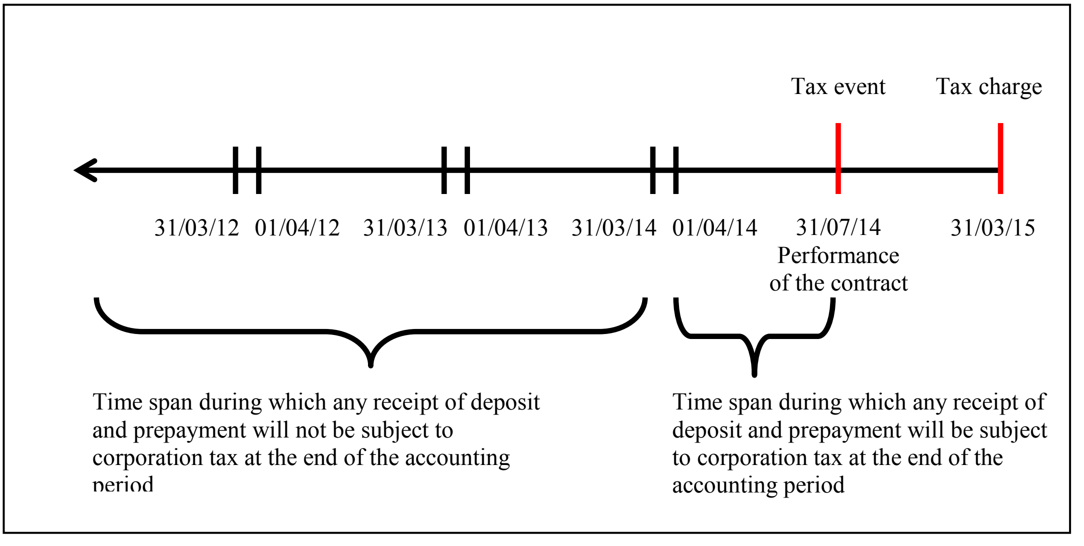
As provided by CTA 2009, ss 2 and 8, corporation tax is charged annually on companies' profits arising during the given year. In addition, the computation of this tax is made by reference to accounting periods. In this aspect, there could be a mismatch regarding the start date and the end date of the financial year of corporation tax and a company's accounting period. Although the financial year is a twelve-month period, it does not coincide with the calendar year because it extends from 1st April to 31st March of the following year.

Moreover, the taxation of trading income of a given accounting period implies the recognition of this income during the same accounting period. In this respect, courts' decisions, which include those abovementioned, confirm that the timing on which the income will be deemed to have been earned does not necessarily fall in the year in which it was received, but according to accounting standards, it falls on the date on which the contractual obligations are performed.

In such a context, this means that the receipt of money ahead of the performance of the contract, either in the form of deposits or prepayments, but in the same accounting period of this performance will be included in the taxable income of that period.

However, the deposits and prepayments received in an accounting period in which no performance of the contractual obligations has been carried out will not be liable to corporation tax at the end of this accounting period. In this situation, these receipts will be included in the chargeable income of a subsequent accounting period in which the taxpayer will perform the contract.

The following timeline shows that the possibility of having the deposits and prepayments on a gross amount basis is limitless insofar as the contract does not mature into performance in the same accounting period[44]:



Therefore, the longer the time span is between the date of signature of the contract and the performance of the contractual obligations, the longer the time is during which the taxpayer enjoys the deposits and prepayments for their gross amount (i.e. supposing that these receipts were collected at the signature of the contract).

Another feature of corporation tax that can positively affect the taxpayer's tax position rests on the tax rate applicable to the deposits and prepayments at the date they are chargeable as income. If the latter receipts are collected during an accounting period in which no performance is carried out, then the taxpayer has an

44 The following timeline shows accounting periods that begin and end at the same dates as the financial years.

opportunity of being subject to tax on these receipts at a lower rate when the income will be recognised for tax purposes[45]. Indeed, under CTA 2010, s 4, corporation tax is calculated by applying the appropriate corporation tax rate to the company's total taxable profits of the accounting period. This tax rate is set by parliament for each financial year[46]. In this respect, the main corporation tax rate was set at 23%[47] in 2013 and it will fall to 21%[48] in 2014. Then, in the situation in which the deposits or prepayments are received during the 2013 accounting period (which extends from 1st April 2013 to 31st March 2014) in consideration of sales or services supplied during the 2014 accounting period (which extends from 1st April 2014 to 31st March 2015), these receipts will be subject to a 21% corporation tax rate — not 23%.

Such a decrease in the corporation tax rates accordingly reduces the money that the taxpayer will have to transfer to HMRC for the payment of the tax.

2.1. The collection of tax

The charge to corporation tax on the trading income at the end of a given accounting period does not make the tax payable immediately to HMRC[49]. Indeed, the taxpayer is given a certain period of time for the payment of the tax, which depends on the qualification of the taxpayer as a large, a medium or a small company.

Taxpayers who meet one of the thresholds regarding either the amount of tax liability or the amount of profits accumulated during a given accounting period qualify for the large-company status. Otherwise they are treated as small and medium-sized companies for the payment of corporation tax[50].

The qualification as a large company entails the payment of corporation tax by quarterly instalments, wherein the first begins six months and thirteen days after the start of the accounting period and the others are then payable every three months. However, the deadline for the payment of corporation tax by small and

45 Please note that the benefit of distinct corporation tax rates can also occur within the same accounting period insofar as it does not run from 1 April to 31 March and spans two financial years.

46 CTA 2010, s 3.

47 Finance Act 2012, s 6.

48 Finance Act 2013, s 4.

49 Please note that HMRC is the tax authority responsible for the collection of taxes.

50 The Corporation Tax (Instalment Payments) Regulations 1998, SI 1998/3175 reg 3.

medium-sized companies is nine months and one day after the end of the accounting period. Thus, in the position of a small or medium-sized company, the taxpayer has the deposits and prepayments on a gross amount basis for a longer time. For instance, the cash inflows received in the form of deposits or prepayments on December 2013 for sales or services to be performed on February 2014 will effectively bear the corporation tax on 1st December 2014.

To conclude, the corporation tax regime on deposits and prepayments merely incorporates the accrual accounting system. Therefore, deposits and prepayments are not subject to tax when the company receives them because the recognition of income is deferred until the performance of the contract. In addition, the specific features of corporation tax allow taxpayers to keep these income receipts on a gross amount basis for a period of time that goes beyond the date of the recognition of income for tax purposes. In this legal context, taxpayers can manage to defer the payment of corporation tax upon the receipt of deposits and prepayments for a period of time exceeding one year and potentially a couple of years. This regime replaced in the context of the time value of money has an impact upon the value of corporation tax levied on trading income.

Part IV

The impact of the time value of money on the value of corporation tax on trading income

The analysis of the accounting and tax treatment of deposits and prepayments demonstrated that these income receipts are received and kept for a gross amount basis until the expiry of the deadline for the payment of corporation tax. Until then, taxpayers are encouraged to invest these monies in order to increase the returns on the trading income. Ultimately, these earnings will impact upon the value of corporation tax on trading income and then affect both taxpayers and HMRC. These impacts are analysed under the theory of the partnership. Although this theory focuses on the impacts of tax deferrals (1), its application is also relevant for the study of the impacts of the deferral of the recognition of income (2).

1. Presentation of the Partnership Theory on tax deferrals

The ‘Partnership Theory’ developed by Brown and thoroughly commented upon by Hanna[51] contributes to the understanding of the relationship between tax deferrals and the time value of money.

---

51 Christopher H. Hanna, ‘Demystifying tax deferral’ (1999) 52 Smu Law Review 383.

The purpose of tax deferral measures is to defer the taxation of an income or to accelerate the deductions. These measures create differences between financial accounting and tax accounting and generate cash opportunities under the theory of the time value of money.

Therefore, when the government lays down a provision that delays the tax liability of a taxpayer, the latter disposes of a greater amount of cash to be invested. By doing so, it is said that the government is in essence contributing to this investment with the amount of tax saved by the taxpayer. That is why Brown and Hanna qualify this situation as a 'partnership' entered into by the government and the taxpayer, although no real contract of partnership is concluded.

The following table shows that under a 23% corporation tax rate, the tax deferral enjoyed by Taxpayer 1 on the trading income of 100,000 generates a 'partnership' in which shares are allocated between the taxpayer and the government as follows:

Partners	Contributions to the partnership (23%)
Taxpayer 1	77,000
Government	23,000
TOTAL	**100,000**

Under this partnership, the deferred taxation of 100,000 allows the taxpayer to invest 100,000 rather than 77,000 by, for instance, the purchase of a bond. Under a 10% annual interest rate, the capital invested by the partnership yields an interest income of 10,000, which is then subject to corporation tax as illustrated in the table below:

Amount invested	Income of the partnership (10%)	Taxation of the income (23%)	Net income
100,000	10,000	2,300	7,700

Although this income is formally subject to corporation tax for 2,300, the two authors abovementioned submit that this is not taxation in substance. Indeed, they explain that the taxation of the interest amounts only to the allocation of the share of the interest owed to the government in proportion to its right in the "partnership", as shown below:

Partners	Allocation of the income of the partnership (23%)
Taxpayer 1	7,700
Government	2,300
TOTAL	**10,000**

Hanna asserts that the government should levy corporation tax on Taxpayer 1's share of the interest income for 1,771 (i.e. $7{,}700 \times 0.23 = 1{,}771$); otherwise the income is in a way exempted from taxation. It seems that a juridical double taxation takes place but economically it does not. The following table shows the situation of Taxpayer 2 who invested at a 10% interest rate only on the basis of 77,000 because it did not benefit from a tax deferral on 100,000:

	Amount invested	**Income (10%)**	**Taxation of the income (23%)**	**Net income**
Taxpayer 2	77,000	7,700	1,771	5,929

The cells highlighted above show the cash differences generated by the tax deferral. In this respect, the same amount of 7,700 constitutes the after-tax amount of the interest earned by Taxpayer 1 on the first hand, and the gross amount of the interest earned by Taxpayer 2 on the other hand. This means that afterwards Taxpayer 2 will be subject to tax on its income and end up with an after-tax amount of 5,929.

The termination of the 'partnership' coincides with the expiration of the tax deferral measure and the taxation of the trading income for 23,000. This is, in essence, merely returning its initial contribution to the government originally invested in the partnership.

In this context, Taxpayer 1 benefited from a time span, for the payment of tax on its trading income, for a period long enough to make earnings that economically are not taxed by the government. Indeed, the latter government would have levied 1,771 if Taxpayer 1 had not been granted a tax deferral. In this case, Taxpayer 1's position would have been similar to Taxpayer 2's situation. Then, the absence of a tax levy on Taxpayer 1's interest income for 1,771 demonstrates the government's failure in taxing the time value of money benefit generated by the tax deferral.

From the perspective of the time value of money, the existence of similarities between tax deferrals and the income recognition rules applicable to deposits and prepayments makes relevant the analysis of these latter rules with the Partnership Theory.

2. Application of the Partnership Theory to the deferral of income recognition

The receipt of prepayments and deposits in connection with the taxpayer's business are subject to corporation tax only further to the date of the recognition of income. Until then, the income and, consequently, the levy corporation tax are deferred, which leaves the taxpayer free to invest the money received in advance for a gross amount.

Over time, this situation will impact upon both the taxpayer and HMRC's cash position. The illustration of this impact and its analysis are made throughout the example of a company taxpayer ('*Company A*') that receives prepayments in the course of its trade.

For the purpose of this example, Company A's situation is compared with a standard taxpayer ('*Company B*') who does not take advantage of the time value of money on the basis of the current features of corporation tax. The aim of this comparison is to emphasise the existence of the economic advantage enjoyed by Company A.

2.1. Data on the situation of Company A

2.1.1. Factual situation

Company A is a good manufacturer that sells its products every day of the year. At the end of each accounting period, this company accumulates revenue of approximately £132,000, which corresponds to an income of £42,000 after the deduction of the expenses for £90,000. The corporate accounting period begins on the 1st of April and ends on the 31st of March.

Under Company A's commercial policy, orders must be placed at least one year ahead of the expected date of delivery of the goods. In addition, the payment in advance of the full amount of the sale price is required from the clients at the date the orders are placed. Therefore, it received by 31st November 2012 the orders to manufacture goods with a delivery scheduled in January 2014[52] along with the prepayments of the merchandise for £11,000[53].

On 1st December 2012, Company A decided to invest the excess of the gross amount of the prepayments over the expenses (i.e. £3,500). This decision to invest the prepayments only for the difference between the revenue and the expenses is caused by Company A's anticipation of the costs that will be incurred for the production of the goods, before the end of the investment. In this respect, the remaining part of the prepayments was placed into an interest-bearing account at an investment bank ('*the Bank*')[54]. In return for the money lent by the company, the bank pays a fixed annual interest rate set at 10% in accordance with the credit rating of the investment[55].

---

52 This example has been designed from the perspective of the date 12th August 2013.

53 The amounts used for the purpose of the example are VAT excluded.

54 Please note that the example does not include the bank's fees on the investment made by Company A.

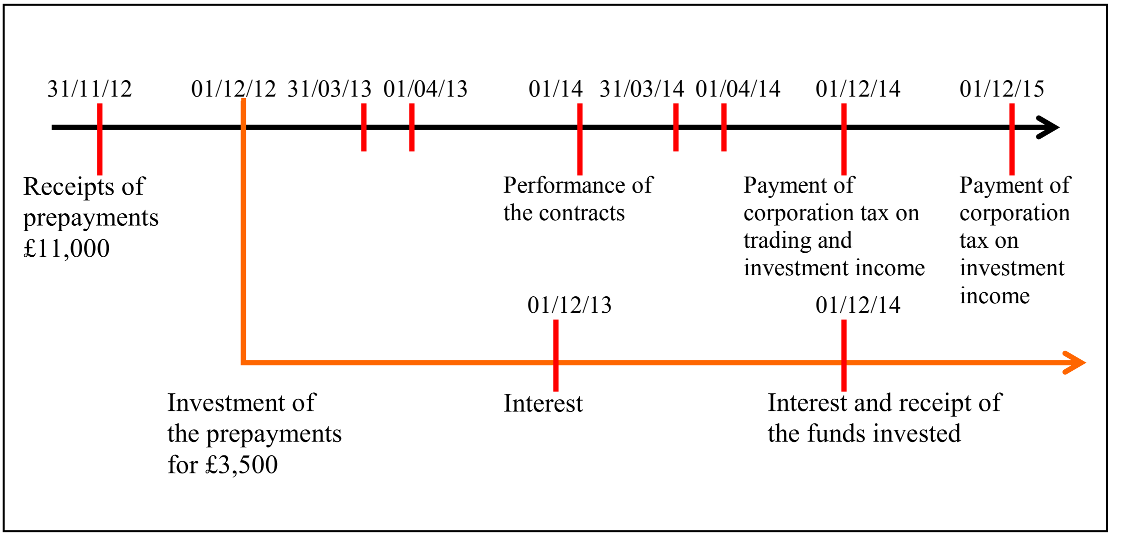
55 Please note that the 10% interest rate has been created for the purpose of this example.

2.1.2. **Legal situation**

The trading income will be subject to corporation tax at the rate applicable to the accounting period in which the income will be recognised. In this respect, the recognition of the trading income including the sales of January 2014 will arise during the financial year 2013. Therefore, the company taxpayer's income will be subject to a 23% corporation tax rate.

Furthermore, the payment of this tax will be due nine months and one day following the end of the accounting period, that is, on 1st December 2014. Indeed, Company A falls into the small and medium companies category under the Corporation Tax (Instalment Payments) Regulations 1998, SI 1998/3175.

This being said, the following timeline summarises Company A's cash position:



2.2. Company B

Company B carries on the same trade as Company A under the same prices and during the same accounting periods but its terms of payment are set differently. Indeed, Company B does not ask for the payment in advance of the price of the sales. On the contrary, its clients are granted flexible payment terms under which they can pay the sale price up to two months after the delivery of the goods. Thus, Company B will receive the full amount of the consideration regarding the January 2014 sales by 1st March 2014 at the latest. On the same date, it will decide to put the after-tax amount of the trading income[56] on a financial product similar to

56 Please note that this income already includes the deduction of the expenses.

Company A's. The decision to invest only the net income from the January 2014 sales is justified by the anticipation of the payment of corporation tax due on 1st December 2014, which is before the expiration of the investment with the bank, which is scheduled on 1st March 2015.

2.3. Analysis of the situation of Company A

The following table summarises Company A's cash movements in the context of the sales of January 2014:

Timeline		**Cash inflows**		**Cash outflows**	
2012	**31/11**	11,000	Receipt of the prepayments		
	01/12			(3,500)	Investment of the prepayments received
2013	**31/03**	No liability to corporation tax of the prepayments			
	01/12	350	Receipt of interest earned during the period 2012–2013	(350)	Investment of the interest received
2014	**01/01 – 31/01**	Delivery of the goods to the customers			
	31/03	Liability to corporation tax of the trading income and the income interest of 2013			
	01/12	3,850	Receipt of the capital invested (3,500+350)	(885.5)	Payment of corporation tax on the sales income [(11,000–7,500)*23%] and the interest income earned in 2013 (350*23%)
		385	Interest earned during the period 2013–2014		
2015	**31/03**	Liability to corporation tax of the income interest of 2014			
	01/12			(80.85)	Payment of corporation tax on the interest income earned in 2014 (385*21%)
Net cash flow		**3,268.65**			

As highlighted in the table, the investment of the prepayments will generate the earning of interest for £350 on 1st December 2013 and £385 on 1st December 2014. The quantified representation of the interest that Company B will earn through the investment of its income receipts and its comparison with Company A's earnings would have shown that the latter taxpayer will obtain an economic advantage over the former.

The identification of such an advantage is possible through the application of the Partnership Theory to the income recognition deferral enjoyed by Company A.

Therefore, the latter company's cash and tax position is analysed under the three stages of the 'partnership' from its inception to its end.

2.3.1. The formation of the partnership

A partnership is formed between Company A and HMRC due to the differed taxation of the prepayments as trading income until its recognition. Thus, Company A invested the excess of the gross amount of the prepayments over the expenses (i.e. £3,500) on 1st December 2012.

In this context, the proportion of Company A and HMRC's shares in the partnership corresponds to the corporation tax that will be levied at a 23% rate on the income from the sales of January 2014 once it will be recognised during the 2013 financial year:

2.3.2. The income of the partnership

Partners	Contributions to the partnership (23%)
Company A	2,695
HMRC	805
TOTAL	**3,500**

2.3.2.1. The 1st December 2012 – 1st December 2013 period

On 1st December 2013, a gross income of 350 will be earned by the partnership on the basis of the prepayments invested at a 10% yearly interest rate on 1st December 2012. Afterwards, this income will be subject to corporation tax on 31st March 2014, in which the amount will be payable by 1st December 2014 at the latest, as illustrated below:

Amount invested	Income of the partnership	Taxation of the income (23%)	Net income
3,500	350	80.5	269.5

Although the formal charge of £80.5 on the interest income looks like the corporation tax will be levied, in substance Company A will not bear tax on its income of £269.5. Indeed, the situation of Company A, which invested the gross amount of the prepayments compared with the situation of Company B, which could only invest the after-tax amount of the sales prices, reveals the existence of a tax discrepancy of £124.71, as illustrated below:

	Amount invested	Income earned	Taxation of the income (23%)	Net income
Company B	2,695	269.5	61.98	207.52

In other words, Company A will be in the same situation as a taxpayer who would be granted a tax exemption of the interest income of £269.5.

Moreover, a breakdown of the amount of the prepayments invested by Company A makes it possible to isolate the tax part that will be levied further to the income recognition (i.e. 'tax-deferred part' below) from the rest of the prepayments that will remain with the taxpayer (i.e. 'after-tax part' below). Then, it is possible to trace the earnings made on the 'tax-deferred part' of the prepayments as follows:

	Amount invested	Income earned	Taxation of the income (23%)	Net income
	3,500	350	80.5	269.5
After-tax part	2,695	269.5	61.98	207.52
Tax-deferred part	805	80.5	18.515	61.98

These two highlighted cells show that the net interest income earned on the 'tax-deferred part' of the prepayments is identical to the corporation tax charge on the interest income earned on the 'after-tax part' of the prepayments (i.e. £61.98). In other words, the levy of corporation tax on the interest related to the 'after-tax part' of the prepayments is neutralised by the net interest earned on the 'tax-deferred part' of the prepayments.

Therefore, under the Partnership Theory, the levy of corporation tax for £80.5 on the interest earned by the partnership corresponds merely to the allocation of HMRC's share of the profits:

Partners	Allocation of the income of the partnership (23%)
Company A	269.5
HMRC	80.5
TOTAL	**350**

If we continue the analysis under the Partnership Theory, it is understood that HMRC should tax the share of interest income allocated to Company A (i.e. £269.5) in order to subject to corporation tax the time value of money benefit achieved under the deferred income. To this aim, Company A should be charged £142.48 (i.e. 80.5+61.98). However, tax law provisions do not specifically provide a measure that could override the accounting regime.

Then, the £61.98 earned by Company A is tax revenue that HMRC is deprived of the possibility to collect. Therefore, it is submitted that income deferral has the effect of reducing the value of corporation tax chargeable on the taxpayer's profits. If HMRC will collect only £80.5 from Company A, whereas it should collect £142.48 to tax the time value of money benefit, this means that the value of Company A's tax charge will fall by approximately 56.5%.

2.3.2.2. The 1st December 2013 – 1st December 2014 period

The delivery of the goods by Company A to its customers in January 2014 will trigger the recognition of the income from the sales for accounting and tax purposes. However, this paper previously explained that corporation tax is not charged immediately once the income is recognised. Indeed, the assessment of the tax due on the trading income will be made on 31st March 2014 and then the tax will be payable by 1st December 2014 at the latest. Thus, Company A will maintain its investment on the same gross basis for £3,500 on 1st December 2013. This basis, however, will be increased by the gross income interest earned on 1st December 2013 for £350. Indeed, corporation tax on the £350 interest will be payable only by 1st December 2014. Then, the interest previously earned will also generate interest. On 1st December 2014, Company A will earn an interest income of £385.

Although these interest earnings will be attributable to the tax collection rules, which allowed Company A to invest a gross trading income along with a gross interest income, it is interesting to note that the income recognition rules will still have an impact for £35 (i.e.385-350) even after the income recognition for tax purposes. This £35 interest will result from the compounding of the interest of £350 earned during the deferral of the recognition of income.

Furthermore, this interest of £385 will be liable to corporation tax at a 21% rate, which will be payable to HMRC by 1st December 2015 at the latest, as illustrated below:

Amount invested	Income of the partnership	Taxation of the income (21%)	Net income
3,850	385	80.85	304.15

The analysis of this second interest return calls for the same conclusions as for those made for the first return. Indeed, Company A will be in the same situation as a taxpayer that would be granted a tax exemption on £304.15 because economically the levy of corporation tax is merely the allocation of HMRC's share in the profits of the partnership.

In addition, it is underlined that the change of the corporation tax rate between the financial years 2013 and 2014 will alter the initial allocation set between the members of the partnership under which Company A was entitled to 77% of the profits and HMRC 23%. The new proportions of the allocation of the income favour Company A to the detriment of HMRC. Indeed, the interest income will be shared between Company A and HMRC respectively for 79% and 21%, as illustrated below:

Partners	Allocation of the income of the partnership (21%)
Company A	304.15
HMRC	80.85
TOTAL	**385**

Mathematically, the reduction of HMRC's share in the partnership for 2% equals the transfer of profits to Company A for £7.7.

As explained in paragraph 2.3.2.1, HMRC should increase the levy corporation tax on the £385 interest earned by Company A in order to tax the time value of money benefit. In this respect, HMRC would have to levy £144.65 (80.85+63.8). Without such a move, the value of the corporation tax to be collected on 1st December 2015 will fall by approximately 56%.

2.3.3. The end of the partnership

Two events will occur on 1st December 2014: on the one hand, Company A will receive back the amount invested with the bank (i.e. 3,850) along with the interest (i.e. 385), and, on the other hand, it will finally have to pay corporation tax (i.e. £805) on the income from the sales of January 2014. This payment of £805 to HMRC will put an end to the partnership because each partner will recover its initial contribution.

The Partnership Theory facilitates the understanding of the economic advantages that Company A will achieve upon the investment of the prepayments from the date of their receipt until the date the trading income will be recognised and the tax be paid to HMRC. Over a two-year period, such an investment will yield a supplement of £125.78 (61.98+63.8) interest in comparison with the situation of a taxpayer who would have invested only the after-tax amount of the prepayments. This cash benefit will increase the cash asset including the trading income, whereas the value of the tax liability corresponding to the charge of corporation on this income will stay the same. In other words, the value of Company A's corporation tax charge will decrease. Thus, it is suggested as a rule that the longer the payment of corporation tax is deferred in time, the larger the time value of money benefit is and the lower the economic value of the corporation tax will be.

The fact that a skilful management of a company's cash may lessen the value of corporation tax causes a serious impact on HMRC and the other taxpayers. The example of Company A concerns only one taxpayer out of millions that make up the UK, regarding the trading income of a one-month period only.

On the one hand, it is questionable whether this impact really causes losses in tax revenue for HMRC. Using the term of 'loss' to qualify this impact seems too risky. Indeed, this would mean that HMRC could tax the time value of money benefit arising on the receipt of deposits and prepayments. However, this article demonstrated that without a statutory override, HMRC must assess and tax the trading income in accordance with GAAP, which does not recognise changes in value of deposits and prepayments. The qualification of a loss of opportunity to tax would be, therefore, more appropriate in this context. However, such a loss of opportunity should be tempered by the cost of introducing a statutory override to entitle HMRC to act accordingly. This would create a new disparity between financial accounting and tax accounting and increase the administrative costs of both HMRC and the taxpayers to deal with the collection of the additional corporation tax.

On the other hand, the comparison of the situations of Company A and Company B in the example demonstrated that inequalities could arise between taxpayers depending on their contractual terms of payments. It is then debatable whether such an issue could jeopardise the neutrality of the tax system according to which Shekel holds that 'there should be no fiscal preference for a transaction being carried out one way as opposed to one that is carried out in another way'[57]. Even if this principle of neutrality might constitute a justification for a reform of the corporation tax regime, its balance against the efficiency principle, which provides for the reduction of the costs linked to tax collection, may hamper any change of law.

To conclude, it has been demonstrated that the taxpayer's trading income is subject to tax in accordance with ordinary law. In addition, the earning of interest through the investment of prepayments (or deposits) bears also the charge of corporation tax. However, Brown's Partnership Theory proved that this interest is economically received free of taxation. This kind of tax saving is reflected in a supplement of cash earned by the taxpayer to the detriment of HMRC. Accordingly, this economic advantage alleviates the taxpayer's corporation tax burden on its trading income. In this respect, it could be possible for the UK Parliament to implement a reform entitling HMRC to subject to tax the time value of money benefit on the receipt of deposits and prepayments. However, it would

57 Shekel M, *The Timing of Income Recognition in Tax Law and the Time Value of Money* (Routledge Cavendish 2009) 18.

require additional human and material resources that may threaten the viability of such a project.

Conclusion

This article has explored how the UK tax system approaches the question of timing recognition of income for corporation tax purposes. In this aspect, the close connection between financial accounting and tax law has proven to be central in the taxation of trading income. Thus, income is earned and becomes chargeable to corporation tax further to the date the contract matures into performance.

This situation necessarily creates timing differences between the date the tax liability arises and the date the income is actually received by taxpayers. In this respect, it has been demonstrated that taxpayers can exploit these timing differences for their own benefits by collecting deposits and prepayments from their clients. These monies received before the recognition of income can, then, be put into an investment, such as a loan. Under this cash management, taxpayers can achieve a greater return in comparison with the earnings that would be made on the income receipts collected and invested after the recognition of income.

The technical developments of Parts II and III described that the rules regarding both the collection procedure of tax and the quantification of income provide the necessary context for the achievement of this investment opportunity. On the one hand, the collection of income receipts does not trigger corporation tax on trading income because the increase of the cash asset is balanced by the report of liability corresponding to the nominal value of the deposits and prepayments. Then, the recognition of income and, a fortiori, the charge of corporation tax are deferred in time. In addition, this paper showed that this deferral extends until a date later than the date the contract matures into performance. Indeed, the timing related to the recovery of the tax provides taxpayers with an extension of the period during which they hold their receipts on the basis of a gross amount. The breakdown of this gross amount includes both the net income part and the tax-deferred part that will be allocated respectively to taxpayers and HMRC further to the recognition of income for tax purposes. In other words, the investment of deposits and prepayments allows taxpayers to generate more earnings through the investment of the tax-deferred part of these receipts.

On the other hand, the value of deposits and prepayments is not adjusted to their economic value further to the recognition and assessment of the chargeable income. Indeed, corporation tax is charged on the nominal value of these income receipts. Therefore, tax law does not take into account the time value of money benefit on the deposits and prepayments.

Furthermore, Part IV illustrated the impact of the investment of the deposits and prepayments on the taxpayers and HMRC's respective cash position, which are antagonistic. The supplement of the return made by taxpayers through the investment of these income receipts for a gross basis dwindles the value of corporation tax on trading income. Then, the value of the tax revenue collected by HMRC falls in proportion to taxpayers' return.

Although it has been explained that the shortfall for HMRC could be significant due to the number of UK taxpayers, a reform of the accounting standards or the corporation tax provisions is not expected in the foreseeable future. Indeed, the current debate on revenue recognition revolves mainly around issues on the characterisation of the performance of the contract. In addition, the possibility of the implementation of a statute providing HMRC with the necessary powers to tax the time value of money benefit is also uncertain. Such a reform should pass the viability test under which a tax is worth being collected only if the necessary resources attached to it are lower than the expected tax revenue.

Overall, tax optimisations that are capable of reducing taxpayers' tax bills are not limited to specific tax exemptions provided by tax law. In fact, taxpayers can manage their cash flow in a way that lessens the burden of corporation tax on their trading income and that is comparable to the effects of a tax exemption from an economic perspective.