

Deferred tax – dealing with tax rate changes (Lecture B1303 – 17.13 minutes)

FRS 102 and IFRS (IAS 12) state that we must use the rates of tax enacted or substantively enacted by the balance sheet date which are expected to apply when timing differences reverse in calculating deferred tax assets and liabilities.

‘Substantially enacted’ in the UK is usually taken to be after the third reading of the Finance Bill in the House of Commons.

However, occasionally a tax rate change is presented as part of the Budget Resolution after the post-Budget debate as it was when the Chancellor cancelled the legislated reduction in corporation tax rate from 19% to 17% in 2020.

The increase in the corporation tax rate from 19% to 25% from 1 April 2023 for companies with augmented profits above the upper profit limit of £250,000 was substantively enacted on 24 May 2021, so must be used for accounting periods ending on or after that date.

It is important to establish in which chargeable accounting periods the timing differences are expected to reverse then apply the appropriate rate of tax for those periods.

Some tax software will automatically calculate deferred tax at 25% at the moment unless the reversals are specifically scheduled and calculated for each future period.

Example – deferred bonus

A company with a December year-end accrued a December 2021 deferred bonus of £70,000 (leaving it with a profit of £300,000).

This will be paid in mid-January 2024 when it will become tax-deductible.

Assuming a tax rate of 19% throughout, prepare a summary P&L:

1. Using FRS 105 (where no deferred tax can be recognised), and
2. Using FRS 102 (where deferred tax must be booked)

Analysis

	FRS 105	FRS 102
Profit before tax	300,000	300,000
Current tax expense (19% on £370,000)	70,300	70,300
Deferred tax (timing difference £70,000 @ 19%)	N/A	(13,300)
Total tax expense	70,300	57,000
Profit after tax	229,700	243,000
Effective tax rate	23.4%	19%

Analysis using enacted tax rates:

	FRS 105	FRS 102
Profit before tax	300,000	300,000
Current tax expense (19% on £370,000)	70,300	70,300
Deferred tax (timing difference £70,000 @ 25%)	N/A	(17,500)
Total tax expense	70,300	52,800
Profit after tax	229,700	247,200
Effective tax rate	23.4%	17.6%

Mini tax reconciliation:

Profit before tax multiplied by statutory rate for year (300,000 x 19%)	57,000
Effect of change in tax rate on DT asset 70,000 x (19% - 25%)	<u>(4,200)</u>
Total tax expense	<u>£52,800</u>

Deferred tax and capital allowances

The timing difference is the difference between:

1. Net book value ("NBV") of qualifying assets, and
2. Tax written down value ("TWDV")

This will gradually reversal over a long period of time when the future depreciation will exceed the future capital allowances.

When tax rates change, we need to estimate reversals year by year and tax rates that will therefore apply to them.

Estimate future depreciation and capital allowances for the qualifying assets up to the periods affected by rate changes, then the balance will reverse at 25%.

Example – single asset

A company acquired a fixed asset on 1 January 2021 at a cost of £80,000. The company's depreciation policy is to depreciate on a straight-line basis over 5 years to a zero residual value.

The company will make accounting profits after depreciation of £100,000 in each of the next 5 years.

Assume that the expenditure qualifies for 100% AIA.

Prepare the P&L summary for each accounting period from 2021 to 2025.

Current tax

	2021	2022	2023	2024	2025
Profit before tax	100,000	100,000	100,000	100,000	100,000
+ Depreciation	16,000	16,000	16,000	16,000	16,000
- AIA	(80,000)	nil	nil	nil	nil
Taxable profit	<u>36,000</u>	<u>116,000</u>	<u>116,000</u>	<u>116,000</u>	<u>116,000</u>
Tax: 19%	6,840	22,040			
23.5%			27,260		
25%				29,000	29,000
Profit after tax	91,160	77,960	72,740	72,740	72,740
Effective tax rate	6.84%	22.04%	27.26%	29%	29%

Deferred tax

	2021	2022	2023	2024	2025
Book value	64,000	48,000	32,000	16,000	Nil
Tax WDV	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Timing difference	<u>64,000</u>	<u>48,000</u>	<u>32,000</u>	<u>16,000</u>	<u>Nil</u>

Reversal of TD:	2021	2022	2023	2024	2025
2022: 16,000 @ 19%	3,040*				
2023: 16,000 @ 23.5%	3,760*	3,760			
2024: 16,000 @ 25%	4,000*	4,000	4,000		
2025: 16,000 @ 25%	<u>4,000*</u>	<u>4,000</u>	<u>4,000</u>	<u>4,000</u>	
DT liability 31 Dec	<u>14,800</u>	<u>11,760</u>	<u>8,000</u>	<u>4,000</u>	<u>Nil</u>

Total

	2021	2022	2023	2024	2025
Profit before tax	100,000	100,000	100,000	100,000	100,000
Current tax	6,840	22,040	27,260	29,000	29,000
Deferred tax	14,800	(3,040)	(3,760)	(4,000)	(4,000)
Tax expense	21,640	19,000	23,500	25,000	25,000
Profit after tax	78,360	81,000	76,500	75,000	75,000
Effective tax rate	21.64%	19%	23.5%	25%	25%

Mini tax reconciliation:

Profit before tax multiplied by statutory rate (100,000 x 19%) 19,000

Effect of future tax rates on DT

2022	16,000 x (19% – 19%)	-
2023	16,000 x (19% - 23.5%)	720
2024	16,000 x (19% - 25%)	960
2025	16,000 x (19% - 25%)	<u>960</u>

2,640

Total tax expense

21,640

Contributed by Malcolm Greenbaum