

Deferred tax – Changes in tax rates

(Lecture B1153 - 16.23 minutes)

Deferred tax is not permitted to be booked when using FRS 105 but must be booked when using FRS 102 or IFRS (IAS 12).

One of the aims of deferred tax is to assist in aligning the tax expense more closely with the accounting profit, even where tax law would charge or relieve certain items in different periods to when they appear in the profit and loss account.

In other words, deferred tax assists in trying to make the effective rate of tax in the profit and loss account closer to (if not fully aligned with) the statutory rate applying for that period.

Example – accelerated capital allowances

	DT Provided £	DT not provided £
Profit before tax	1,100	1,100
Capital allowances minus depreciation	<u>(100)</u>	<u>(100)</u>
PCTCT	<u>1,000</u>	<u>1,000</u>
Current tax at 19%	190	190
Deferred tax at 19%	<u>19</u>	<u>N/A</u>
Total tax expense	209	190
Effective tax rate on PBT	19%	17.3%

Deferred tax in this case aligns the effective rate of tax with the statutory rate.

Examples of timing differences

Pension cost expense: Only deductible for tax purposes when paid by the company, but recognised on accruals basis in the financial statements.

Capital allowances: 100% AIA may be available on purchase of certain fixed assets, if not then 18% pa or 8% pa reducing balance. The depreciation policy decided by directors – to expense the cost over the asset's useful life. This will not be same as the capital allowance rate.

Example – pension costs

A company with a March year-end accrues its March 2020 defined contribution pension cost of £10,000 (leaving it with a profit of £200,000). This will be paid in mid-April 2020 when it will become tax-deductible

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

- Using FRS 105
- Using FRS 102

	FRS 105	FRS 102
Profit before tax	200,000	200,000
Current tax expense (19% on £210,000)	39,900	39,900
Deferred tax (£10,000 @ 19%)	N/A	(1,900)
Total tax expense	39,900	38,000
Profit after tax	160,100	162,000
Effective tax rate	19.95%	19%

Dealing with a rate change

For FRS 102 and IFRS we must use the rate applicable when timing difference reverses, based on enacted or substantively enacted tax rates at year-end. The corporation tax rate has been enacted to change:

- Since 1 April 2017: 19% (enacted 2015);
- From 1 April 2020: 17% (enacted September 2016).

Deferred tax needs to take these rates into account. This makes the tax reconciliation more complicated (covered in a separate session) and the effective tax rate in the first year won't appear to make much sense.

Solution to previous example using live tax rates

	FRS 105	FRS 102
Profit before tax	200,000	200,000
Current tax expense (19% on £210,000)	39,900	39,900
Deferred tax (timing difference £10,000 @ 17%)	N/A	(1,700)
Total tax expense	39,900	38,200
Profit after tax	160,100	161,800
Effective tax rate	19.95%	19.1%

Capital allowances and deferred tax

The timing difference is the difference between the net book value ("NBV"), and the tax written down value ("TWDV") as is widely known. This difference gradually reverses over a long period of time.

When tax rates change, strictly, we need to estimate reversals year by year and tax rates that will therefore apply to them. Judgement will be needed in practice and materiality needs to be considered.

If different tax rates will not have material effect on the DT amount, it may not be worth over-complicating the process. Remember that something is not material if a primary user reading the accounts wouldn't have made any different economic decisions if the strictly correct figures had been used.

For OMBs where the owners rely on dividends for their income, they can be very sensitive to the profit after tax figure, so materiality of the tax figure may be quite small.

Example – single asset

A company acquired a fixed asset on 1 January 2016 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 a tax rate of 20% throughout and that the expenditure qualifies for 100% AIA.

Show how the P&L would look if:

- No deferred tax was booked (FRS 105)
- Deferred tax is booked in accordance with FRS 102

Solution – FRS 105

	2016	2017	2018	2019	2020
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>
Current Tax: 20%	7,200	23,200	23,200	23,200	23,200
Profit after tax	92,800	76,800	76,800	76,800	76,800
Effective tax rate	7.2%	23.2%	23.2%	23.2%	23.2%

Solution – FRS 102

	2016	2017	2018	2019	2020
Net 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>
DT liability 20%	12,800	9,600	6,400	3,200	Nil
DT P&L expense / (income)*	12,800	(3,200)	(3,200)	(3,200)	(3,200)

	2016	2017	2018	2019	2020
Profit before tax	100,000	100,000	100,000	100,000	100,000
Current tax*	7,200	23,200	23,200	23,200	23,200
Deferred tax	12,800	(3,200)	(3,200)	(3,200)	(3,200)
Tax expense	20,000	20,000	20,000	20,000	20,000
Profit after tax	80,000	80,000	80,000	80,000	80,000
Effective tax rate	20%	20%	20%	20%	20%

Example - Same details as before but using live tax rates.

Solution – FRS 105

	2016	2017	2018	2019	2020
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	<u>(80,000)</u>	<u>nil</u>	<u>nil</u>	<u>nil</u>	<u>nil</u>
Taxable profit	<u>36,000</u>	<u>116,000</u>	<u>116,000</u>	<u>116,000</u>	<u>116,000</u>
Tax: 20%	7,200				
19.25%		22,330			
19%			22,040	22,040	
17.5%					20,300
Profit after tax	92,800	83,830	84,040	84,040	85,300
Effective tax rate	7.2%	22.33%	22.04%	22.04%	20.3%

Solution – FRS 102

	2016	2017	2018	2019	2020
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:	2016	2017	2018	2019	2020
2017: 16,000 @ 19.25%	3,080*				
2018: 16,000 @ 19.00%	3,040*	3,040			
2019: 16,000 @ 19.00%	3,040*	3,040	3,040		
2020: 16,000 @ 17.50%	<u>2,800*</u>	<u>2,800</u>	<u>2,800</u>	<u>2,800</u>	
DT liability 31 Dec	<u>11,960</u>	<u>8,880</u>	<u>5,840</u>	<u>2,800</u>	<u>Nil</u>

* These individual amounts represent the DT P&L movement each year

	2016	2017	2018	2019	2020
Profit before tax	100,000	100,000	100,000	100,000	100,000
Current tax	7,200	22,330	22,040	22,040	20,300
Deferred tax	11,960	(3,080)	(3,040)	(3,040)	(2,800)
Tax expense	19,160	19,250	19,000	19,000	17,500
Profit after tax	80,840	80,750	81,000	81,000	82,500
Effective tax rate	19.16%	19.25%*	19%*	19%*	17.5%*

* Same as the statutory rate for these periods

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