

Deferred taxation arises when the book value of assets and liabilities is different from the taxation value and this is usually the case in the initial years of trading.

The depreciation of fixed assets over their useful productive lives has long been recognised by the accounting fraternity. Revenue authorities of most countries have recognised this principle and usually have fixed rates of depreciation for the various asset classes. The depreciation rates are usually referred as capital allowances or wear and tear allowances or some similar wording according to the terminology used in the tax law as enacted in the various countries. The revenue authorities usually specify a fixed rate based on the original cost of the specific asset class until the value has been reduced to say one dollar or pound or the specific currency in use in the country concerned. The revenue authorities usually make provision for an asset register to be maintained in order that the value of the asset is recouped on disposal of the asset. In addition to the normal capital and wear and tear rates of depreciation the revenue authorities may also grant higher rates in certain areas of the country where they wish to encourage the development of industry and commercial activity for the purpose of job creation and reducing overcrowding in other areas of the country.

The rates of capital allowances and wear and tear allowances prescribed by the revenue authorities do not usually provide for some residual valuation and the accounting fraternity have recognised that the disparity in the rates adopted by the various companies in their financial records and the rates claimed for taxation purposes result in the profits being a lot higher in the initial years than the years after the tax benefits have been exhausted. To prevent the profits being distributed more generously to shareholders in the early years and then being withheld in the later years due to an increase in the taxation charge due to the lower capital allowances and wear and tear allowances, the principle of raising a tax charge on the disparity in the allowances is generally adopted. This charge is known as deferred taxation since it is providing for the amount of taxation that would have been paid but for the allowances, and then deferring it to a future date.

The method used in calculating the deferred tax amount to be raised is to list the tax value of the assets and liabilities where the allowances differ from the book value and apply the tax rate to the difference and deduct this amount from the profits for the year and credit this amount to a deferred tax account. Where the tax is higher due to income being taxed in advance as is the case sometimes with advance deposits then the tax paid in advance is deducted from the current tax charge and carried forward to the next year as taxation paid in advance.

Example no 1

The book value of fixed assets at the end of the first year of trading is as below: -

These are the amounts as they would appear in the financial statements and these values would have been extracted from the fixed asset register

	Depreciation rate on cost	Cost \$	Accum Deprec \$	Book Value \$	
Plant and equipment	15%	300000	45000	255000	
Motor vehicles	20%	400000	80000	320000	
Computer equipment	33.33%	100000	33333	66667	
Computer software	33.33%	100000	33333	66667	
Furniture and fittings	15%	160000	24000	136000	
		<u>1060000</u>	<u>215666</u>	<u>844334</u>	844334

The tax value of the fixed assets at the end of the first year of trading is as below: -

A separate asset register would be kept showing the tax value of the assets

	Annual tax Allowance	Cost \$	Tax Allow Claimed \$	Tax Value \$
Plant and	25 % p a	300000	75000	225000

equipment				
Motor vehicles	25 % p a	400000	100000	300000
Computer equipment	33 1/3 % p a	100000	33333	66667
Computer software	50 % p a	100000	50000	50000
Furniture and fittings	25 % p a	160000	40000	120000

	<u>1060000</u>	<u>298333</u>	<u>761667</u>	<u>-761667</u>
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The financial statement value of the fixed assets exceeds the tax value by	<u>82667</u>
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Deferred tax calculation

Using the tax rate of 25 % and rounding up to nearest full digit - deferred tax	<u>20667</u>
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Calculation being 25 % of \$ 82667 rounded up to nearest dollar

Income tax calculation

Supposing the income as per the financial statements is	400000
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The taxable income is reduced by the additional tax allowances	<u>-82667</u>
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Amount subject to tax	<u>317333</u>
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Actual tax on taxable income using 25 % and rounding down to nearest full digit-	<u>79333</u>
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The note to be included in the financial statements on the tax charge for the year would be

\$

Taxation charge for year at 25 %	79333
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Deferred taxation on timing differences - 25 %	20667
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<u>100000</u>

The tax deduction as reflected in the income statement

The full \$ 100 000 would be deducted from the income before taxation in the financial statements

\$

Net income before taxation	400000
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Deduct taxation	<u>100000</u>
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Net income after taxation	<u>300000</u>
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In the balance sheet you would show the following under current liabilities

Current liabilities

Accounts payable	xxxx
Taxation	79333
Deferred taxation	<u>20667</u>

Important to note

The tax that is shown in the Income Statement is the exact percentage of the profit according to the official tax rate. This is the tax as calculated plus the deferred tax. The only time this varies is when there are fines or other non-allowable expense items included in the Income Statement. Once the capital allowances or wear and tear allowances have been exhausted then the tax payable will be more than the amount calculated directly from the income statement, but the difference will be debited to the deferred taxation account thereby reducing this account.

Example no 2

This is a summary of the first five years of the depreciation claimed in the financial statements and the allowances claimed for taxation purpose and the change from the tax benefit to the tax liability will be obvious in respect of the accelerated tax claims.

The accounting value of the fixed assets for the first five years of trading are as below: -

Financial statements	Depreciation rate on cost	Cost \$	1st Year	1st Year	2nd Year	2nd Year	3rd Year	3rd Year	4th Year	4th Year	5th Year	5th Year
			Deprec Claimed \$	Book Value \$	Deprec Claimed \$	Book Value \$	Deprec Claimed \$	Book Value \$	Deprec Claimed \$	Book Value \$	Deprec Claimed \$	Book Value \$
Plant and equipment	15 % pa	300000	45000	255000	45000	210000	45000	165000	45000	120000	45000	75000
Motor vehicles	20 % p a	400000	80000	320000	80000	240000	80000	160000	80000	80000	10000	70000
Computer equipment	33 1/3 p a	100000	33333	66667	33333	33334	17334	16000	4000	12000	2000	10000
Computer software	33 1/3 p a	100000	33333	66667	33333	33334	17334	16000	4000	12000	2000	10000
Furniture and fittings	15 % p a	160000	24000	136000	24000	112000	24000	88000	24000	64000	24000	40000
		<u>1060000</u>	<u>215666</u>	<u>844334</u>	<u>215666</u>	<u>628668</u>	<u>183668</u>	<u>445000</u>	<u>157000</u>	<u>288000</u>	<u>83000</u>	<u>205000</u>

The tax value of the fixed assets for the first five years are as below: -

Tax returns	Annual tax Allowance	Cost \$	1st Year	1st Year	2nd Year	2nd Year	3rd Year	3rd Year	4th Year	4th Year	5th Year	5th Year
			Tax Allow Claimed \$	Tax Value \$	Tax Allow Claimed \$	Tax Value \$	Tax Allow Claimed \$	Tax Value \$	Tax Allow Claimed \$	Tax Value \$		
Plant and equipment	25 % p a	300000	75000	225000	75000	150000	75000	75000	74990	10	0	10
Motor vehicles	25 % p a	400000	100000	300000	100000	200000	100000	100000	99998	2	0	2
Computer equipment	33 1/3 % p a	100000	33333	66667	33333	33334	33334	0	0	0	0	0
Computer software	50 % p a	100000	50000	50000	50000	0	0	0	0	0	0	0

Furniture and fittings	25 % p a	160000	40000	120000	40000	80000	40000	40000	39990	10	0	10
		<u>1060000</u>	<u>298333</u>	<u>761667</u>	<u>298333</u>	<u>463334</u>	<u>248334</u>	<u>215000</u>	<u>214978</u>	<u>22</u>	<u>0</u>	<u>22</u>

Accounting value exceeds the tax value by: -			<u>82667</u>		<u>165334</u>		<u>230000</u>		<u>287978</u>		<u>204978</u>	
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Reconciliation

Brought forward from prior year		0		82667		165334		230000		287978		
Change current year			82667		82667		64666		57978		-83000	
Yearend balance carried forward			<u>82667</u>		<u>165334</u>		<u>230000</u>		<u>287978</u>		<u>204978</u>	

Deferred tax to be provided on year movement			20667		20667		16167		14494			Total 71995
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Deferred tax to be reduced												-20750
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Deferred tax provided over 5-year period - remaining balance												<u>51245</u>
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The proof is the tax rate multiplied by excess of accounting value over the tax value of \$ 204 978 after five years												<u>51245</u>
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It is important to note that the deferred tax provision increases for five years and then from the fifth year the provision is reduced as the book values are reduced by depreciation provided in the financial statements as the possible disposal values are reduced. No disposal value is accorded to computers as they are generally out of date after three years and impossible to find an interested purchaser, plus the fact that confidential information is stored in the computer, and it is easier to just store the old computers in a safe place.

The value of the fixed assets will gradually decrease in value going forward until such time they are sold or discarded.

The reconciliation - Year 5

Taxation computation for year 5	Year 5	Year 4
	\$	\$
Income per financial statements	400000	400000
Add Depreciation	83000	157000
	<u>483000</u>	<u>557000</u>
Deduct Capital allowance / wear and tear	0	-214978
	<u>483000</u>	<u>342022</u>
Tax on \$ 483 000 at 25 %	120750	85506
Tax rate on \$ 400 000 at 25 %	-100000	100000
Transfer from / to deferred to tax to account	<u>20750</u>	<u>14494</u>

The note to be included in the financial statements on the tax charge for the year would be

	Year 5	Year 4
	\$	\$
Taxation charge for year at 25 %	120750	85506
Timing difference		
Transfer from / to deferred taxation account	20750	14494
	<u>100000</u>	<u>100000</u>

The tax deduction as reflected in the income statement

The full \$ 100 000 would be deducted from the income before taxation in the financial statements

	Year 5	Year 4
	\$	\$
Net income before taxation	400000	400000
Deduct taxation	<u>100000</u>	<u>100000</u>
Net income after taxation	<u>300000</u>	<u>300000</u>

In the balance sheet you would show the following under current liabilities

	Year 5	Year 4
Current liabilities		
Accounts payable	xxxx	xx
Taxation	120750	85506
Deferred taxation	<u>51245</u>	<u>71995</u>

In the reconciliation of the deferred taxation account, you can clearly see where the cross cast from year 1 to year 4 totals \$ 71 995 and then the reversal of \$ 20 750 reduces this balance to \$ 51 245. This is verified by applying the tax rate of 25 % to the amount of \$ 204 978 being the excess of the book value of the assets over tax values at the end of year 5. To comply with IFRS we would need to show the movement on the deferred taxation account but since we are more interested in the arithmetical calculations and the correctness of the balancing and reconciliation of the financial statements we will deal with this at a later stage.

General note on deferred taxation

The Revenue services over the years have arrived at certain rules to prevent taxpayers making false tax deduction claims and some of these which apply in some countries but not in other countries: -

Excessive provisions where the expense is incurred and invoiced to the business in the following year and is therefore disallowed. An exception would be where the tax act may provide for the deduction of such expenditure such as goods bought after the year end in respect of invoices raised in the prior year and included in the income for that year.

Payments in advance which are allowed since the money has been outlaid.

Advance receipts from debtors where these amounts are taxed in the year of receipt, here the revenue usually allow a deduction especially if it is in respect of goods still to be supplied. (This is to prevent the non-invoicing of income earned in one year being rolled forward into the following year.)

Provisions for bad debts where the revenue services may only allow say 25 % or 50 % of the provision.

In the above cases the expense is disallowed in the year it is claimed, but it is allowed in the year the expense is incurred. The reversal of the provision is allowed if the original claim is not allowed

Certain countries do not allow deductions of entertainment expenses especially if food and drink are involved.

Others do not allow the deduction of traffic fines and other fines as these are not considered to be an expense in the production of income

Where certain provisions are made in one year for accounting purposes and the accountant is aware that these will not be allowed for taxation then the prudent course of action is not to claim this amount for taxation purposes, but provide for deferred taxation on those amounts to keep the books in line with the taxation liability. Advance payments would also be included in the taxable income calculation for the current year but claimed as a deduction in the following year.

A provision is an estimate of expenditure to be incurred at some time in the future and is made to reduce the profits available for distribution in a current period to provide for such expenditure should it occur.

NB Regarding any examples in this website, it will be stated as to the possible tax treatment to be applied. It is impossible to provide for different tax jurisdictions throughout the world and the reader needs to refer to the specific tax laws in their own country when writing examinations and dealing with tax authorities in their own jurisdiction.

The calculation and reconciliation of the deferred taxation provision can be very time consuming and mind blowing and when there is more than one expense or income type then it is a very good idea to use a spreadsheet and reflect the balances brought forward in the first column, the movement in the second column, and the final balance in the right-hand column.

In the example below the following applies: -

	\$
Income per accounts	
Year ended 31s December 2018	1000000
Year ended 31st December 2017	800000
Year ended 31st December 2016	600000
Book value of plant and equipment exceeds tax values:	
Year ended 31s December 2018	300000
Year ended 31st December 2017	200000
Year ended 31st December 2016	100000
Bad debts provision in respect of debtors not allowed for taxation deduction at year end: -	
Year ended 31s December 2018	300000
Year ended 31st December 2017	100000
Year ended 31st December 2016	60000

The tax rate is 25 % for the 2016-year, 2017 year and the 2018 year

Taxation computation for year ended 31st December 2018

	2018	2017
Income per accounts	1000000	800000
Deduct: Increase in accelerated tax allowances over prior year	-100000	-100000
	900000	700000
Add: Increase in bad debt provision disallowed by Revenue	200000	40000
Taxable income	1100000	740000
		\$
Taxation thereon at 25 %	\$ 275000	185000
	Book Values	Deferred Tax values
Book value of plant and equipment exceeds tax value: -		
Year ended 31s December 2018	300000	75000
Year ended 31st December 2017	200000	50000

Year ended 31st December 2016	100000	25000
Bad debts included in debtors not allowed for taxation deduction at year end: -		
Year ended 31s December 2018	300000	75000
Year ended 31st December 2017	100000	25000
Year ended 31st December 2016	60000	15000

Deferred tax provisions reconciliation

	2016 Brought forward Balance	Movement During Year	2017 Brought forward Balance	Movement During Year	2018 Closing Balance
Depreciation exceeds tax allowances	-25000	-25000	-50000	-25000	-75000
Expenditure not allowed for tax deduction	15000	10000	25000	50000	75000
Bad debts disallowed	<u>-10000</u>	<u>-15000</u>	<u>-25000</u>	<u>25000</u>	<u>0</u>

Check to ensure that taxation calculations are correct	2018
Tax at 25 % on taxable income as per calculation above	<u>275000</u>
Tax at 25 % on income per Income statement	<u>250000</u>
Taxation due as per computation	275000
Deduct Transfer to net tax deferred assets	25000
Agrees with taxation as per accounts - at 25%	<u>250000</u>

We now must match the tax calculated as per the income statement with the additional tax in respect of the disallowed bad debt provision reduced by the accelerated taxation allowances resulting from the difference in taxation and depreciation rates claimed on the fixed assets

The disclosure notes in the financial statements

Notes

1 Taxation

	2018	2017
	\$	\$
Normal taxation current year - 25 %	275000	185000
Deferred taxation current year - timing differences		
- Accelerated tax allowance	25000	25000
- Provisions for bad debts disallowed for taxation	-50000	-10000
	<u>250000</u>	<u>200000</u>

NB

The entry in the " Comprehensive Statement of Income " is the opposite to the entry raising the deferred tax liability or asset. It is the movement that is reflected in the reconciliation working that is shown in the taxation note to the income statement and it is the closing balance that is reflected in the balance sheet or "Statement of financial position " as it is now known.

2 Deferred taxation

	2018	2017
	\$	\$
Deferred tax assets		
The balance comprises:		
Provision for bad debts	<u>75000</u>	<u>25000</u>
Balance at beginning of the year	25000	15000
Temporary difference	50000	10000
Balance at end of year	<u>75000</u>	<u>25000</u>
Deferred tax liabilities		
The balance comprises:		
Accelerated taxation allowances	<u>75000</u>	<u>50000</u>
Balance at beginning of the year	50000	25000
Temporary difference	25000	25000
Balance at end of year	<u>75000</u>	<u>50000</u>

Extract from: - Comprehensive Statement of Income for year ended 31st December 2018

	Notes	2018 \$	2017 \$
Retained income before taxation		1000000	800000
Deduct: Taxation	1	250000	200000
		<u>750000</u>	<u>600000</u>