## DEFERRED TAXATION ACCOUNTING

## A SIMPLE EXAMPLE

**Assume:**

- Item of plant purchased for $1,000
- Accounting depreciation – 'Straight Line' over life of 20 years
- Tax depreciation – 'Diminishing Value' at 30% pa
- Profit before depreciation $500 every year
- Tax rate 30%

**Deferred Tax in Profit and Loss Account**

| | Accounting Books | Tax Books | Accounting Books (after providing for deferred tax) | |
|---|---|---|---|---|
| **After One Year** | | | | |
| Profit before depreciation | 500 | 500 | | 500 |
| Depreciation | (50) | (300) | | 50 |
| | 450 | 200 | | 450 |
| Tax - Current | (60) | (60) | (60) | |
| - Deferred | - | - | (75) | (135) |
| Profit After Tax | $390 | $140 | | $315 |
| **After Two Years** | | | | |
| Profit before depreciation | 500 | 500 | | |
| Depreciation | (50) | (210) | | |
| | 450 | 290 | | |
| Tax - Current | (87) | (87) | (87) | |
| - Deferred | - | - | (48) | (135) |
| Profit After Tax | $363 | $203 | | $315 |

Notes:

1. The deferred tax adjustment ensures that the accounting profits show a 30% tax charge.
2. Net profit after tax is not distorted by 'timing' differences between accounting and tax depreciation.

**Deferred Tax Liability in Balance Sheet**

| | Accounting Books | Tax Books | Accounting Books (after providing for deferred tax) |
|---|---|---|---|
| After One Year | N/A | N/A | 75 |
| After Two Years | N/A | N/A | 123 |

Notes:

3. After two years the deferred liability has increased to $123 – this represents 30% of the difference between the Net Book Value of the Plant for tax purposes ($1,000 minus $300 minus $210 = $490) and Accounting purposes ($1,000 minus $50 minus $50 = $900).
4. The liability is real – if the plant is sold after two years for the accounting value of $900, tax will be payable on depreciation recovered of $900 minus $490 = $410 @ 30% = $123).
5. Over time, as the tax depreciation becomes less than the accounting depreciation, the Deferred Tax liability will decrease and even become an asset. The tax shown in the published Profit and Loss Account will remain at $135 (all other factors remaining the same).

**Why is the required Deferred Tax on tax non depreciable buildings different?**

If a building purchased for $1,000 is depreciated for accounting purposes for say 10 years at $20 pa and then sold for the above book value of $800, no tax is payable on depreciation recovered. Indeed no tax is payable if sold above cost, as New Zealand has no Capital Gains Tax.

The international accounting standard liability requirement is apparently based on the premise that provision should be made for tax on probable profits generated from the use of the building in the future but only in respect of existing assets – not post budget building acquisitions!

Prepared by Rob Challinor

19 August 2010