COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | ADVANCED

Video Transcription: Deferred Tax – What Rate to Use

This video explains one of the key challenges of doing deferred tax – choosing the correct tax rate. In a separate video, we will look at where to recognise the other side of the deferred tax entry (see "Deferred Tax – Where to Recognise Deferred Tax Adjustments"). This video is aimed at students who have been introduced to deferred tax before. Think about watching Gizelle's video where she introduces deferred tax, before watching this video, if you are feeling a bit rusty.

These videos are for all those students who think that the best two words to see in a financial accounting exam are "ignore tax". We hope these videos help you to realise that calculating deferred tax is not that difficult once you understand a few basic principles.

In South Africa, tax is levied either at the full company tax rate of 28% or at the effective CGT rate of 18.6%, which is calculated by including only 2/3 of the gains in taxable income and taxing that at 28%. How should you decide which rate to use?
The first step in answering that question is to identify the asset or liability that has caused the temporary difference, in other words where the carrying amount calculated in terms of IFRS differs from the tax base calculated in terms of the Income Tax Act.
Once you have identified the asset or liability that has given rise to the temporary difference, think about what type of event will cause that asset or liability to reduce or reverse – a term that IAS 12 refers to as "Recovering the carrying value".

For example:

- Inventory is decreased when it is sold and gives rise to sales revenue.
- Deferred revenue is reversed when the service is provided and revenue recognised.
- Machinery is reduced when it is depreciated as part of the manufacturing process.

All of the examples referred to give rise to profit items that SARS will or has taxed at the full 28%.

Everything that is consumed in the process of generating profits that are taxed at 28% will give rise to deferred tax that is calculated at 28%. Consumption implies that using the asset to generate the profits reduces the carrying value; depreciation of machinery is perhaps the best example. Assets such as land are not consumed, and therefore can only be recovered through sale.

If the carrying value of an asset is only reduced when the asset is sold, the appropriate tax rate depends on how SARS would tax the profit on sale. Sale of inventory is clearly at 28%. Sale of investments may be taxed at 28% if they are trading investments or at the capital gains tax rate of 18.6% if they are treated as capital for tax purposes. Recovery through sale does not imply that the tax rate is the capital gains tax rate – it implies that you need to consider how SARS would tax that sales transaction.

What tax rate do you think should be applied to temporary differences relating to land? Generally this would be the CGT rate, but the full rate would apply to a property developer selling land, as SARS would treat that as a trading activity. The carrying value is recovered through sale and therefore the deferred tax balance for that asset should reflect the tax that would have to be paid if that asset were sold for its carrying value – you need to understand the requirements of the Tax Act to decide whether that is at 28% or at 18.6%.

Note the reference to "sold for its carrying value". Deferred tax is not an estimate of the tax that you will have to pay in the future – it is only the tax that relates to the assets and liabilities that have already been recognised. Recognising the asset or liability triggers the requirement to recognise the related tax, based on recovery through sale or usage as is appropriate.

Sale and Use

Some assets can be recovered through sale and through use, and that may have implication with respect to the deferred tax calculation. Machinery used in the process of manufacturing is a good example to illustrate the principles. If the machine has not been revalued, the carrying amount must be less than cost.

	Accounting	**Tax base**
Cost	1 000 000	1 000 000
Accum depreciation	(250 000)	(600 000)
Book value/tax base	750 000	400 000
Temporary difference	750 000 – 400 000 = R350 000	
Deferred tax @ 28%	R98 000	

Assume an asset with a cost of R1 million and accumulated depreciation of R250 000 compared to accumulated tax allowances of R600 000. The book value of R750 000 will exceed the tax base of R400 000, giving a temporary difference of R350 000. If there is no intention to sell the asset, the carrying amount is expected to decrease as the asset is depreciated i.e. recovered through using it. Deferred tax must therefore be recognised at 28% of the temporary differences.

Similarly, if a decision was taken to sell the machinery, its entire carrying amount would be recovered through sale. Usually the carrying amount or book value is greater than the tax base, selling the machinery for its book value will therefore give rise to a recoupment, which is taxed at 28%. Recovering the carrying value through sale implies that the deferred tax balance should reflect the tax consequences of selling the machine for the book value of R750 000 i.e. a recoupment of R350 000, which will be taxed at 28%. If the carrying amount is less than the original cost, the anticipated manner of recovery is irrelevant as either way the tax implications are at 28%. Remember that it is the carrying amount, and not the anticipated proceeds that are relevant, when calculating deferred tax.

Revalued assets

What happens if you have a revalued machine that is being depreciated? Unless you plan to sell the asset, you expect to recover the depreciable amount by depreciating the asset. As that implies that the asset is expected to be used or consumed in generating taxable income, deferred tax will be recognised at 28%.

What happens if you plan to sell a revalued asset? Let's apply the principles we have discussed – recovery of the carrying value would then be through sale. Think carefully of the tax consequences of selling the asset – remember that deferred tax is based on the amounts recognised, so we need to think about the tax that would be paid if the machine were sold for its revalued amount. Remember that there will be a recoupment on the difference between the tax base and the original cost, whereas the proceeds above cost would be taxed at the CGT rate.

1. Carrying amount = R1.2m

1. Original cost = R1m

1. Tax base = R0.4m

2. Usage basis – D/T bal = (R1,2m – R0.4m) x 28% = R224 000

3. Sale basis - D/T bal = (R1,2m – R1,0m) x 18.6% + (R1.0m – R0.4m) x 28% = R205,2

3. (R1,2m – R1,0m) x 18.6% - proceeds above cost taxed at CGT rate

3. (R1m – R0.4m) x 28% - proceeds up to cost is recoupment – taxed at full rate

Assume a machine with a carrying amount of R1.2 million and an original cost of R1 million with no residual value and the tax base remains at R400 000. Unless there was a clear intention to sell the asset i.e. it was classified as held for sale, the expectation is that R1.2 million carrying amount will be written down over the remaining useful life i.e. recovered through use. Using the tax base of R400 000, the deferred tax balance would be R1.2m – R0.4m = R800 000 temporary difference x the full tax rate of 28%. Note that it makes no difference that the asset is measured on a revaluation basis; it is expected to be recovered by using it to produce taxable profits and therefore the full rate applies.

What happens if you now change your intention, and plan to sell the asset? The anticipated selling price is irrelevant – the deferred tax balance should be the amount of tax that would be paid if the asset were sold for its carrying amount of R1.2 million. That sale would give rise to a recoupment of the tax allowances previously granted i.e. R600 000 (cost – tax base = R1m – R400 000) which would be taxed at 28%. The proceeds above cost, i.e. R200 000, would be taxed at the effective capital gains tax rate of 18.6%.

Let me show you why that is correct by following through to what happens when the asset is sold. Assume the asset is sold for R1.5 million. That would give rise to a profit of R300 000. When sold, the asset and related deferred tax must be removed.

1. Year 2 – Sell asset for R1,5m

2. Profit on sale = R1,5m – R1,2m = R300 000

3. Tax

Current

- recoupment (R1m – R0,4m) x 28% = R168 000 + (R1,5m – R1m) x 18.6% = R93 000 = R261 000

(OR (R600 000 + R500 000 x 66.6%) = R261 000

Deferred tax (reversal def tax bal) =
R205.2 Cr

4. R300 000 x 18.6%
R55.8

Current tax payable would be the recoupment of R600 000 at the full tax rate of 28% i.e. the R1 million cost less the R400 000 tax base. The R500 000 proceeds above the cost would be taxed at the effective capital gains tax rate of 18.6% – giving an overall tax payable of R261 000.

When the asset is sold, the deferred tax balance would be debited and profit or loss credited with R205 200, i.e. as we calculated it based on the intention to sell the asset.

The overall tax charge is R55 800, which is what we should expect as it is the profit of R300 000, which is capital in nature multiplied by the effective capital gains tax rate of 18.6%.

As we have seen, the choice of tax rate depends on whether you consume the asset during its life i.e. by using it, which implies the use of the full 28% rate, or whether you will only reduce the carrying value when you sell it. In that case, you will then have to think about how SARS would treat that asset if it were sold.

Try and apply what we have looked at here, to equity investments – they are recovered through sale. Think about when SARS would levy tax at the full rate and when the CGT rate would be applicable. The answer to that is the answer to the tax rate that you would use to calculate the deferred tax balance for the difference between the carrying amount and the original cost.

Many students struggle with issues such as post-retirement employment benefits, bad debts allowances, deferred revenue, cash-settled, share-based payments etc – all of those are simple to deal with if you tackle them logically. When the balance is reversed, what will the tax consequences be? In all those cases, taxable income at 28% and therefore deferred tax at 28%. Remember that deferred tax relates only to assets and liabilities and therefore there is no deferred tax relating to the equity balance for share-based payments.

If you find the deferred tax question difficult, you need to identify whether you are struggling to integrate your tax and accounting knowledge or whether it really is deferred tax that you don't understand. For most students, it is the challenges of applying your tax knowledge in an accounting question. Remember that the clue to measuring the tax base and the relevant tax rate lies in the Tax Act and not in IFRS. Tackle your calculations methodically by considering the IFRS to get the carrying amount, the Tax Act to get the tax base and having determined the basis of recovering the asset or liability, the Tax Act to select the correct rate.

If you want to know where to recognise the other side of the calculation, particularly where the balance changes if you change your intention, I would recommend that you watch the video on "where to recognise the other side of the deferred tax balance" that I have prepared, to help you with that. Hope to see you again soon.