Deferred tax liability

Letters: 1989, 1986 · Difficulty: Intermediate

Summary

When stocks rise in value, Berkshire records a **deferred tax liability** for the tax that would be owed if they were sold. Buffett explains that this liability is real, but it is paid only when a gain is realized, so it works like an interest-free loan from the government.

1989 letter

A new accounting rule is likely to be adopted that will require companies to reserve against all gains at the current tax rate, whatever it may be. With the rate at 34%, such a rule would increase our deferred tax liability, and decrease our net worth, by about $71 million - the result of raising the reserve on our pre-1987 gain by six percentage points. Because the proposed rule has sparked widespread controversy and its final form is unclear, we have not yet made this change.

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Obviously not - despite the fact that both items have exactly the same effect on audited net worth, reducing it by $1.1 billion. On the other hand, is this liability for deferred taxes a meaningless accounting fiction because its payment can be triggered only by the sale of stocks that, in very large part, we have no intention of selling? Again, the answer is no.

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This "loan" is peculiar in other respects as well: It can be used only to finance the ownership of the particular, appreciated stocks and it fluctuates in size - daily as market prices change and periodically if tax rates change. In effect, this deferred tax liability is equivalent to a very large transfer tax that is payable only if we elect to move from one asset to another. Indeed, we sold some relatively small holdings in 1989, incurring about $76 million of "transfer" tax on $224 million of gains.

1986 letter

At yearend, we had $1.2 billion of such unrealized gains in our equity investments. The effect of the new law on our balance sheet will be delayed because a GAAP rule stipulates that the deferred tax liability applicable to unrealized gains should be stated at last year's 28% tax rate rather than the current 34% rate. This rule is expected to change soon. The moment it does, about $73 million will disappear from our GAAP net worth and be added to the deferred tax account. o Dividend and interest income received by our insurance companies will be taxed far more heavily under the new law.

First, all corporations will be taxed on 20% of the dividends they receive from other domestic corporations, up from 15% under the old law.

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Assuming any premium is left after current assets are adjusted, the next step is to adjust fixed assets to current value. In our case, this adjustment also required a few accounting acrobatics relating to deferred taxes. Since this has been billed as a simplified discussion, I will skip the details and give you the bottom line: $68.0 million was added to fixed assets and $13.0 million was eliminated from deferred tax liabilities. After making this $81.0 million adjustment, we were left with $24.3 million of premium to allocate.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1989, 1986 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.