Shareholder Letters: Accounting Themes

Deferred tax liability

Berkshire letters: 1989, 1986

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What the Letter Says

> *“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.”*
>
> Warren E. Buffett, 1989 letter

- Key letters: 1989, 1986
- Course fit: ACC250 — · ACC531 — · Difficulty: Intermediate

Step 1: An Unrealized Gain

EX. Stocks bought for $500 are now worth $1,500. None sold.

	Amount
Fair value	$1,500
− Cost	(500)
Unrealized gain	$1,000

Step 2: Record the Tax That Would Be Owed

	Amount
Unrealized gain	$1,000
× Tax rate	21%
Deferred tax liability	$210

Dec 31:	Income Tax Expense (+E)	210	
	Deferred Tax Liability (+L)		210

Step 3: When Is It Paid?

- Only when the stocks are **sold** and the gain is realized.
- Until then: like an interest-free loan from the government that stays invested.

Back to the Letter

- Buffett (1989): the deferred tax liability works like a large transfer tax, payable only if Berkshire moves from one asset to another.
- It is a real liability, but its timing is under Berkshire's control.

Questions

1. Berkshire holds stocks with an unrealized gain of $1,000 million. At a 21% tax rate, what deferred tax liability is recorded ($ millions)?
2. When would that deferred tax actually be paid?

   A. Every year

   B. Never

   C. When dividends are received

   D. When the stocks are sold and the gain is realized

Sources

- Warren E. Buffett, 1989 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 1986 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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