

Chapter 20

Accounting for Income Tax

LECTURE OUTLINE

The material in this chapter can be covered in three class periods. The conceptual issues in this chapter are difficult and the accounting procedures complex. **Illustrations 20-1** and **20-2** can aid in demonstrating the recognition of deferred tax liabilities and assets and the calculation of income tax expense. **Illustration 20-3** provides examples of temporary and permanent differences. Point out to the students how these examples result in different basis for book and tax purposes.

A. Taxable Income and Financial Income.

1. Taxable income is calculated in accordance with prescribed tax regulations and rules.
2. Financial income is measured and reported in accordance with generally accepted accounting principles.
3. Differences between taxable income and financial income occur because tax regulations and GAAP are frequently different.

B. Deferred Income Taxes.

1. A **temporary difference** is the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in **taxable amounts** or **deductible amounts** in future years when the asset is recovered or the liability is settled.
 - a. Taxable amounts increase taxable income.
 - b. Deductible amounts decrease taxable income.
2. **Deferred income taxes** are the future tax effects of temporary differences.

C. Deferred Tax Liability.

Teaching Tip

Illustration 20-1 provides a numerical example of the recording of a deferred tax liability.

1. A **deferred tax liability** represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year.
2. Calculation of deferred tax liability.
 - a. Book basis—tax basis of asset or liability = cumulative temporary difference; cumulative temporary differences x enacted tax rate.
 - b. Scheduling of future taxable amounts.
3. Income tax expense (benefit) has two components:
 - a. **Deferred tax expense (benefit)** is the increase (decrease) in the deferred tax liability balance from the beginning to the end of the accounting period.
 - b. Current tax expense (benefit) which is equal to the amount of income taxes paid or payable for the period.
4. Discuss whether a deferred tax liability meets the definition of a liability under *SFAC No. 6*.
 - a. Results from a past transaction.
 - b. Is a present obligation.
 - c. Represents a future sacrifice.

D. Objectives of accounting for income taxes under the asset-liability approach.

1. Recognize the amount of taxes payable or refundable for the current year.
2. Recognize deferred tax liabilities and assets for the future tax consequences of events recognized in financial statements or tax returns.

E. Deferred Tax Asset.

Teaching Tip

Illustration 20-2 provides a numerical example of the recording of a deferred tax asset, including a valuation allowance.

1. A **deferred tax asset** represents the increase in taxes refundable (saved) in future years as a result of deductible temporary differences at the end of the current year. Discuss why the FASB decided that deferred tax assets meet the definition of an asset.
 - a. Results from a past transaction.
 - b. Gives rise to a probable future benefit.
 - c. Controls access to the benefits.
2. Calculation of deferred tax asset.
 - a. Book basis—tax basis of asset or liability = cumulative temporary difference; cumulative temporary difference x enacted tax rate.
 - b. Scheduling of deductible amounts.

3. Income tax expense.
 - a. Deferred tax expense (benefit) is the decrease (increase) in the deferred tax asset balance from the beginning to the end of the accounting period.
 - b. Current tax expense (equal to income taxes payable).
4. Deferred tax assets should be reduced by a **valuation allowance** if it is more likely than not that some portion or all of the deferred tax asset will not be realized.
 - a. Evaluate available evidence, both positive and negative.
 - b. Probability of nonrecognition (slightly more than 50%).

F. Income Statement Presentation of Income Tax Expense.

1. Current tax expense.
2. Deferred tax expense.

Teaching Tip

Illustration 20-3 provides examples of both temporary and permanent differences.

G. Temporary and Permanent Differences.

1. Provide examples of temporary differences.
 - a. **Originating** temporary differences. The initial difference between the book basis and tax basis of an asset or liability.

- b. **Reversing** temporary differences. Occurs when a temporary difference that originated in prior periods is eliminated and the related tax effect removed from the deferred tax account.
 - 2. Provide examples of permanent differences.
(There are no defined tax consequences to be recognized.)
 - a. Items recognized for accounting but **not** for taxes.
 - b. Items recognized for tax but **not** for accounting.
- H. Discuss the tax rates used to compute deferred income tax amounts.
 - 1. Current tax rate. Use when currently enacted tax rate will not change.
 - 2. Future enacted tax rates. Use when known.
 - 3. Revisions of future tax rates and effects on the deferred tax accounts. Record effect as soon as change is enacted. Treat as an adjustment to income tax expense in the period of the change.
 - 4. Average tax rates. Use when graduated tax rates exist.
- I. Accounting for Net Operating Losses.
 - 1. Illustrate loss carryback (3 years).
 - a. Refund is recorded and reported as a receivable on the balance sheet.

- b. Benefit Due to Loss Carryback recorded and reported on the income statement.
2. Illustrate loss carryforward (15 years).
- a. Carryforwards expected to be realized.
 - (1) Deferred Tax Asset recognized for the future tax savings.
 - (2) Benefit Due to Loss Carryforward recorded and reported on income statement of current period as a contra-income tax expense.
 - b. Carryforwards **not** expected to be realized.
 - (1) Deferred tax asset. Recognized on the balance sheet.
 - (2) Valuation allowance. Represents that portion of the deferred tax asset which more likely than not will not be realized.

J. Financial Statement Presentation.

1. Balance Sheet.
- a. Deferred tax accounts are classified as current and noncurrent based on the classification of the related asset or liability for financial reporting.
 - (1) Net current amount is the sum of the current deferred items.
 - (2) Net noncurrent amount is the sum of the noncurrent deferred items.
 - b. Disclose types of temporary differences; net change in total valuation allowance, and carryforwards and carrybacks.

2. Income Statement.

- a. Intraproduct tax allocation.
- b. Significant components of income tax expense to be disclosed:
 - (1) Current tax expense or benefit.
 - (2) Deferred tax expense or benefit.
 - (3) Investment tax credits.
 - (4) Government grants recognized as a reduction in income tax expense.
 - (5) Operating loss carryforward benefits.
 - (6) Tax expense resulting from allocating certain tax benefits from acquiring another entity.
 - (7) Adjustments in deferred tax assets or liabilities from enacted changes in tax rates or change in company's tax status.
 - (8) Adjustments to the beginning balance of a valuation allowance because of changes in the likelihood of the realizability related to a deferred tax asset.
- c. Reconciliation of income tax expense on continuing operations with the amount that results from applying federal tax rates.

3. Disclosure of tax loss carryforwards.

K. Special Tax Allocation Issues.

1. Multiple temporary differences. Use a schedule to net future taxable and deductible amounts.
2. Necessity for a valuation allowance. Consider all positive and negative information when considering if a valuation allowance is necessary.
3. Multiple tax rates.
4. Alternative minimum tax. Used to ensure that corporations do not avoid a fair share of income taxes through various tax avoidance approaches.
5. Intraperiod tax allocation. Allocation of income tax expense (benefit) between:
 - a. Continuing operations.
 - b. Discontinued operations.
 - c. Extraordinary items.
 - d. Cumulative effect of accounting changes.
 - e. Prior period adjustments.

L. Principles of the Asset—Liability Approach.

1. Objectives.
 - a. Recognize amount of taxes payable or refundable for current year.
 - b. Recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the financial statements or tax returns.

2. Annual procedures for the computation of deferred income taxes.

Teaching Tip

Illustrations 20-4 and **20-5** summarize the procedures for the computation of deferred income taxes.

3. Unresolved conceptual issues.
 - a. Failure to discount deferred tax accounts.
 - b. Current and noncurrent classification issues.
 - c. Dual criteria for recognition of deferred tax assets.

M. Appendix 20A. Comprehensive Illustration of Interperiod Tax Allocation.

1. Multiple temporary and permanent differences for 2 years.

N. Appendix 20B. Conceptual Aspects of Interperiod Tax Allocation.

1. Allocation view points
 - a. **No allocation.** Appropriate tax reported on the income statement is the tax actually levied that year.
 - b. **Partial allocation.** Deferred income taxes are reported only if the deferred tax amounts are expected to be paid or recovered within a relevant period of time.
 - c. **Comprehensive allocation.** Recognizes deferred taxes that apply to all temporary differences, even if their reversal in future periods will be offset by new originating differences at that time.

2. Tax allocation methods

a. **Deferred method.**

- (1) Amount of deferred income tax is based on tax rates in effect when temporary differences originate.
- (2) An income statement-oriented approach.
- (3) Emphasizes proper matching of expenses with revenues in period when temporary difference originates.
- (3) Not acceptable under GAAP.

b. **Asset-liability method.**

- (1) Amount of deferred income tax is based on the tax rates expected to be in effect during the periods in which the temporary differences reverse.
- (2) A balance sheet-oriented approach.
- (3) Emphasizes the usefulness of financial statements in evaluating financial position and predicting future cash flows.
- (4) Required under GAAP.

c. **Net-of-tax method**

- (1) No deferred tax account on balance sheet.
- (2) Income tax expense on income statement is same as the current taxes payable.

- (3) Tax effects of temporary differences reported as adjustments to the carrying amounts of specific assets or liabilities and the related revenues or expenses.

- (4) Emphasizes that future taxability and tax deductibility are important factors in the valuation of individual assets and liabilities.

- (5) Not acceptable under GAAP.