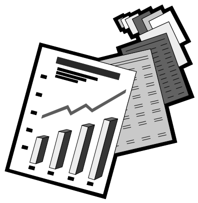
Accounting for Income Taxes

Chapter 19



ABOUT THIS CHAPTER!

BE ALERT! WE ARE GOING TO BE BUSY AND MOVING FAST. THIS IS NOT THEORY AND IS BEST TAUGHT WITH A LOT OF EXAMPLES.

YOUR BRAIN WILL STRAIN BUT KEEP WITH ME, IT WILL BE WORTH IT!

The jist of it

GAAP income is not always the same as tax. Accordingly there is a difference between the amount of "net income" in the financial statements and "taxable income" in the tax return.

- **These items usually "reverse" over time.**
- **Until they reverse an asset or liability must be recorded on the financial statements in order for the tax entries to balance. The balance sheet account used to do this is called deferred tax asset/ liability.**

This is called the "balance sheet" approach and is required by FAS 109.

Quick & simple illustration

CORPORATE TAX RATE:	35%		
	BOOK/ GAAP	**TAX/ IRC**	**DIFFERENCE**
Sales	100,000	100,000	-
COS	75,000	75,000	-
SG&A	8,000	8,000	-
Depreciation	10,000	12,000	(2,000)
INCOME BEFORE INCOME TAX	7,000	5,000	2,000
Income tax rate	35%	35%	35%
Income tax provision	have to solve	1,750	700
NET INCOME	need to know tax provision	N/A	N/A

The depreciation difference will "reverse" over time, but we need to do something about it right now! Since this is a balance sheet approach, we first find the balance sheet amounts then solve for the tax expense to record. We are getting more of a deduction for dep. than we expense (this year) for GAAP. This creates a deferred tax Liability because we will be recording more expense in the future. We compute the deferred tax asset as follows:

Book/Tax difference	2,000
Effective rate	35%
DEFERRED TAX Liability	700
We owe Uncle Sam	1,750

ENTRY:

Deferred tax liability		700
Income tax payable		1,750
Income tax provision	2,450	

NOTE that the income tax expense of $2,450, which was a plug for us, works out to be 35% of the GAAP income before income tax!! For those math folks out there, this is because the income tax rate used for computing the "deferreds" is 35% and is the same as that used in computing the tax amount owed (consequently ends up with the same effective tax rate).

PS Good way to check your computation is to look at the end of it all and see if the effective tax rate you come up with makes sense!

Book vs. Tax Difference

GAAP Reporting	2000	2001	2002	Total
Revenues	$130,000	$130,000	$130,000	$390,000
Expenses (S/L depreciation)	30,000	30,000	30,000	90,000
Pretax financial income	$100,000	$100,000	$100,000	$300,000
Income tax expense (40%)	$40,000	$40,000	$40,000	$120,000

Tax Reporting	2000	2001	2002	Total
Revenues	$130,000	$130,000	$130,000	$390,000
Expenses (MACRS depreciation)	40,000	30,000	20,000	90,000
Pretax financial income	$90,000	$100,000	$110,000	$300,000
Income tax payable (40%)	$36,000	$40,000	$44,000	$120,000

Book vs. Tax Difference

Comparison	2000	2001	2002	Total
Income tax expense (GAAP)	$40,000	$40,000	$40,000	$120,000
Income tax payable (IRS)	36,000	40,000	44,000	120,000
Difference	$4,000	$0	$(4,000)	$0

Are the differences accounted for in the financial statements? **Yes**

Year	Reporting Requirement
2000	**Deferred tax liability account increased to $4,000**
2001	**No change in deferred tax liability account**
2002	**Deferred tax liability account reduced by $4,000**

Difference Reporting in F/S

Balance Sheet (2000)

Assets:

Liabilities:
- **Deferred taxes** (4,000)
- **Income tax payable** (36,000)

Equity:
- **Retained earnings** 40,000

Income Statement (2000)

Revenues:

Expenses:

Income tax expense 40,000

Net income (loss) (40,000)

Where does the "deferred tax liability" get reported in the financial statements?

Difference Reporting in F/S

Balance Sheet (2001)

Assets:
- **Cash** (36,000)

Liabilities:
- **Deferred taxes** (4,000)
- **Income tax payable** (40,000)

Equity:
- **Retained earnings** 80,000

Income Statement (2001)

Revenues:

Expenses:

Income tax expense 40,000

Net income (loss) (40,000)

Where does the "deferred tax liability" get reported in the financial statements?

Assumes the 2000 taxes paid in 2001

Difference Reporting in F/S

Balance Sheet	2002
Assets:	
Cash	**(76,000)**
Liabilities:	
Deferred taxes	**0!!!**
Income tax payable	**(44,000)**
Equity:	
Retained earnings	**120,000**

Income Statement	2002
Revenues:	
Expenses:	
Income tax expense	**40,000**
Net income (loss)	**(40,000)**

Where does the "deferred tax liability" get reported in the financial statements?

Assumes the 2001 taxes paid in 2002

Difference Reporting in F/S

Balance Sheet	2003
Assets:	
Cash	**(120,000)**
Liabilities:	
Deferred taxes	**0!!!**
Income tax payable	**paid**
Equity:	
Retained earnings	**120,000**

Income Statement	2003
Revenues:	
Expenses:	
Net income (loss)	

Where does the "deferred tax liability" get reported in the financial statements?

Assumes the 2002 taxes paid in 2003

Temporary Difference Examples

A Temporary Difference is the difference between the tax basis of an asset or liability and its reported (carrying or book) amount in the financial statements that will result in taxable amounts or deductible amounts in future years.

Future Taxable Amounts

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.

Future Deductible Amounts

Deferred Tax Asset represents the increase in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year.

Illustration 19-22 Examples of Temporary Differences
(Text page 974)

Permanent Difference

Permanent differences are caused by items that (1) enter into pretax financial income but never into taxable income or (2) enter into taxable income but never into pretax financial income.

Congress has enacted a variety of tax law provisions in an effort to attain certain political, economic, and social objectives.

Permanent differences affect only the period in which they occur, they NEVER reverse!
They are RARELY seen.
There are no deferred tax consequences to be recognized.

Illustration 19-24 Examples of Permanent Differences
(Text page 975)

Future Taxable or Deductible Amounts

Do the following generate:
Future Deductible Amount = Deferred Tax Asset
Future Taxable Amount = Deferred Tax Liability
A Permanent Difference

1. The MACRS depreciation system is used for tax purposes, and the straight-line depreciation method is used for financial reporting purposes.	Future Taxable Amount
2. A landlord collects some rents in advance. Rents received are taxable in the period when they are received.	Future Deductible Amount
3. Expenses are incurred in obtaining tax-exempt income.	Permanent Difference
4. Costs of guarantees and warranties are estimated and accrued for financial reporting purposes.	Future Deductible Amount

Future Taxable or Deductible Amounts

Do the following generate:
Future Deductible Amount = Deferred Tax Asset
Future Taxable Amount = Deferred Tax Liability
A Permanent Difference

5. Sales of investments are accounted for by the accrual method for financial reporting purposes and the installment method for tax purposes.	Future Taxable Amount
6. Proceeds are received from a life insurance company because of the death of a key officer (the company carries a policy on key officers).	A Permanent Difference
7. Estimated losses on pending lawsuits and claims are accrued for books. These losses are tax deductible in the period(s) when the related liabilities are settled..	Future Deductible Amount

Exercise 19-1

E20-1 South Carolina Corporation has one temporary difference at the end of 1999 that will reverse and cause taxable amounts of $55,000 in 2000, $60,000 in 2001, and $65,000 in 2002. South Carolina's pretax financial income for 1999 is $300,000 and the tax rate is 30% for all years. There are no deferred taxes at the beginning of 1999.

Instructions

a. Compute taxable income and income taxes payable for 1999.
b. Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 1999.
c. Illustrate how the journal entry is reflected on the financial statements for 1999.

ACCOUNTING ENTRY:

Deferred tax liability		54,000
Income tax payable		36,000
Income tax provision (plug)	90,000	

NOTE: 90,000 is 30% of the FINANCIAL income of $300,000.

Exercise 19-1, requirement "c"

Balance Sheet

	1999
Assets:	
Liabilities:	
Income tax payable	**36,000**
Deferred tax liability	**54,000**
Equity:	
Retained earnings	**210,000**

Income Statement

	1999
Revenues:	
Expenses:	
Income before tax	300,000
Income tax expense	**90,000**
Net income (loss)	210,000

c. Illustrate how the journal entry is reflected on the financial statements for 1999.

ANOTHER EXERCISE

Columbia Corporation has one temporary difference at the end of 1999 that will reverse and cause deductible amounts of $50,000 in 2000, $65,000 in 2001, and $40,000 in 2002. Columbia's pretax financial income for 1999 is $200,000 and the tax rate is 34% for all years. There are no deferred taxes at the beginning of 1999. Columbia expects profitable operations to continue in the future.

Instructions

a. Compute taxable income and income taxes payable for 1999.
b. Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 1999.
c. Illustrate how the journal entry is reflected on the financial statements for 1999.

ACCOUNTING ENTRY:

Deferred tax ASSET	52,700	
Income tax payable		120,700
Income tax provision (plug)	68,000	

NOTE: 68,000 is 34% of the FINANCIAL income of $200,000.

Exercise, requirement "c"

Balance Sheet

	1999
Assets:	
Deferred tax asset	**52,700**
Liabilities:	
Income tax payable	**120,700**
Equity:	
Retained earnings	**132,000**

Income Statement

	1999
Revenues:	
Expenses:	
Income before tax	200,000
Income tax expense	**68,000**
Net income (loss)	**132,000**

c. Illustrate how the journal entry is reflected on the financial statements for 1999.

Exercise 19-3

E19-3 Bandung Corporation began 2004 with a $92,000 balance in the Deferred Tax Liability account. At the end of 2004, the related cumulative temporary difference amounts to $350,000, and it will reverse evenly over the next two years. Pretax accounting income for 2004 is $525,000, the tax rate for all years is 40%, and taxable income for 2004 is $405,000.

Instructions

a. Compute taxable income and income taxes payable for 1999.
b. Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 1999.
c. Illustrate how the journal entry is reflected on the financial statements for 1999.

ACCOUNTING ENTRY:

Deferred tax liability		48,000
Income tax payable		162,000
Income tax provision (plug)	210,000	

NOTE: 210,000 is 40% of the FINANCIAL income of $525,000.

Exercise 19-3, requirement "c"

Balance Sheet

	2004
Assets:	
Liabilities:	
Income tax payable	**162,000**
Deferred tax liability	**48,000**
Equity:	
Retained earnings	**315,000**

Income Statement

	2004
Revenues:	
Expenses:	
Income before tax	525,000
Income tax expense	**210,000**
Net income (loss)	**315,000**

c. Illustrate how the journal entry is reflected on the financial statements for 2004.

Exercise 19-4

E19-4 Zurich Company reports pretax financial income of $70,000 for 2004. The following items cause taxable income to be different than pretax financial income:

1. Depreciation on the tax return is greater than depreciation on the income statement by $16,000.
2. Rent collected on the tax return is greater than rent earned on the income statement by $22,000.
3. Fines for pollution appear as an expense of $11,000 on the income statement.

Zurich's tax rate is 30% for all years and the company expects to report taxable income in all future years. There are no deferred taxes at the beginning of 2004.

Instructions

a. Compute taxable income and income taxes payable for 2004.
b. Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 2004.
c. Illustrate how the journal entry is reflected on the financial statements for 2004.

COMPUTATION

GAAP income	70,000		
Temporary diff's			
Depreciation	(16,000)		
Rent	22,000		
	6,000		
Permanent Diff's	11,000		
Comined diff's	17,000		
		Rate	TAX
Taxable income	87,000	30%	26,100

HINT/ CRUTCH: DEDUCTIONS FROM BOOK=LIABILITY OR REDUCTION OF ASSET, ADD'S=ASSET OR REDUX OF LIAB

Cumulative items causing DTA's @ BOY	-
Cy addition	22,000
	22,000
Rate	30%
Deferred tax asset @ EOY	6,600
Cumulative items causing DTL's @ BOY	-
Cy addition	16,000
	16,000
Rate	30%
Deferred tax liability @ EOY	4,800

NOTE, OUR EFFECTIVE RATE:		
Tax provision	24,300	
GAAP income	70,000	
Effective rate	34.71%	NOT 30%, WHY?
		PERMANENT DIFFERENCE
YOU CAN STILL CHECK!		
Tax provision	24,300	
Permanent item	(3,300)	=11,000*30%
Net of perm item	21,000	
GAAP income	70,000	
Effective rate	30%	VOILA

ENTRY		
Deferred tax asset	6,600	
Deferred tax liability		4,800
Income tax payable		26,100
Income tax provision (PLUG)	24,300	

Exercise 19-4, requirement "c"

Balance Sheet	2004
Assets:	
Deferred tax asset	**6,600**
Liabilities:	
Income tax payable	**26,100**
Deferred tax liability	**4,800**
Equity:	
Retained earnings	**45,700**

Income Statement	2004
Revenues:	
Expenses:	
Income before tax	70,000
Income tax expense	**24,300**
Net income (loss)	**45,700**

c. Illustrate how the journal entry is reflected on the financial statements for 2004.

IN-CLASS EXPANSION OF E19-4

Say that in 2005:

- **GAAP income is $100,000;**
- **Tax depreciation is <u>less than</u> book by $4,000;**
- **Rent collected on tax return <u>exceeds</u> book by $25,000;**
- **No other factors.**

Compute the tax provision and prepare the journal entry for 2005.

COMPUATION/ SOLUTION TO E19-4 EXPANSION

GAAP income	100,000		
Temporary diff's			
Depreciation	4,000		
Rent	25,000		
	29,000		
Permanent Diff's	none		
Comined diff's	29,000		
		Rate	TAX
Taxable income	129,000	30%	38,700

HINT/ CRUTCH: DEDUCTIONS FROM BOOK=LIABILITY OR REDUCTION OF ASSET, ADD'S=ASSET OR REDUX OF LIAB

Cumulative items causing DTA's @ BOY	22,000
Cy addition	25,000
	47,000
Rate	30%
Deferred tax asset @ EOY	14,100
Deferred tax asset on books	6,600
ADJUSTMENT	7,500
Cumulative items causing DTL's @ BOY	16,000
Cy addition	(4,000)
	12,000
Rate	30%
Deferred tax liability @ EOY	3,600
Deferred tax asset on books	4,800
ADJUSTMENT	(1,200)

NOTE, OUR EFFECTIVE RATE:

Tax provision	30,000	
GAAP income	100,000	
Effective rate	30.00%	EQUALS 30%, WHY?
		NO PERMANENT DIFFERENCE

Shortcut: Cy activity * rate= impact to this item:

Cy activity	25,000
Rate	30%
Adjustment	7,500
Cy activity	(4,000)
Rate	0
Adjustment	(1,200)

ENTRY		
Deferred tax asset	7,500	
Deferred tax liability	1,200	
Income tax payable		38,700
Income tax provision (PLUG)	30,000	

Net Operating Losses (NOL)

A net operating loss (NOL) occurs for tax purposes in a year when tax-deductible expenses exceed taxable revenues.

The federal tax laws permit taxpayers to use the losses of one year to offset the profits of other years.

Loss Carryback

Carryback two years and receive refunds for taxes paid.

Applied to earliest year first.

Any remaining loss can be carried forward 20 years.

Journal Entry:

Tax receivable	xxx
Income tax expense	xxx

Loss Carryforward

Can elect to forgo the loss carryback and only use loss carryforward option.

20 years forward.

Journal Entry:

Deferred tax asset	xxx
Income tax expense	xxx

Exercise 19-9

E20-9 The pretax financial income (or loss) figures for the Jenny Spangler company are as follows:

1999	$160,000	2003	(380,000)
2000	250,000	2004	120,000
2001	80,000	2005	100,000
2002	(160,000)		

Pretax financial income (or loss) and taxable income (loss) were the same for all years involved. Assume a 45% tax rate for 1999 and 2000 and a 40% tax rate for the remaining years.

Instructions

Prepare the journal entries for the years 2002 to 2005 to record income tax expense and the effects of the net operating loss carrybacks and carryforwards assuming Jenny Spangler company uses the carryback provision. All income and losses relate to normal operations. (In recording the benefits of a loss carryforward, assume that no valuation account is deemed necessary.)

E-19-9 ANSWER

2002		
Income Tax Refund Receivable	72,000	
($160,000 X 45%-can go back 2 years and enough taxable income at 45% rate to cover entire loss)		
Benefit Due to Loss Carryback		72,000
(Income Tax Expense)		
2003		
Income Tax Refund Receivable	32,000	
Benefit Due to Loss Carryback		
(Income Tax Expense)		32,000
($80,000 X 40%)		
2003-continuation		
Deferred Tax Asset (start carry-forward)	120,000	
Benefit Due to Loss Carryforward		
(Income Tax Expense)		120,000
[40% X ($380,000 – $80,000)]		
2004		
Income Tax Expense	48,000	
Deferred Tax Asset (40% X $120,000)		48,000
2005		
Income Tax Expense	40,000	
Deferred Tax Asset ($100,000 X 40%)		40,000

Note: Benefit Due to Loss Carryback and Benefit Due to Loss Carryforward amounts are negative components of income tax expense.

Valuation Allowance on Deferred Tax Asset

Whether a deferred tax asset will be realized depends on whether sufficient taxable income exists or will exist within the carryback or carryforward period available under tax law. There is no need for a valuation allowance if it is deemed "more likely than not" that the deferred tax asset will be realized.

Taxable Income Sources

Future reversals of taxable temporary differences.

Future taxable income.

Taxable income in carryback year(s).

Tax-planning strategies.

VALUATION ALLOWANCE MECHANICS

You compute your tax activity just like you normally would. Then you establish the valuation allowance. The allowance is a contra-account to the deferred tax asset (just like the allowance for doubtful accounts is to a/r) and the expense is directly to the tax provision. Remember to do it on a cumulative basis:

If the valuation allowance is $100,000 at BOY, and you determine that it should be $110,00 at EOY, the entry required is:

Income tax provision $10,000
Valuation allowance of DTA $10,000

Exercise 19-14

E19-14 Jennifer Capriati Corp. has a deferred tax asset account with a balance of $150,000 at the end of 2003 due to a single cumulative temporary difference of $375,000. At the end of 2004 this same temporary difference has increased to a cumulative amount of $450,000. Taxable income for 2004 is $820,000. The tax rate is 40% for all years. No valuation account related to the deferred tax asset is in existence at the end of 2003.

Instructions

(a) Record income tax expense, deferred income taxes, and income taxes payable for 2004, assuming that it is more likely than not that the deferred tax asset will be realized.

(b) Assuming that it is more likely than not that $30,000 of the deferred tax asset will not be realized, prepare the journal entry at the end of 2004 to record the valuation account.

E19-14 solution

Cumulative tax asset differences		450,000
Tax rate		40%
12/31/04 deferred tax asset		180,000
Already on books		150,000
Adjustment		30,000

Taxable income	820,000	
Tax rate	40%	
Income tax	328,000	

ENTRY EXCLUDING VALUATION ALLOWANCE:

Deferred tax asset	30,000	
Income tax payable		328,000
Income tax provision (plug)	298,000	

ENTRY TO RECORD VALUATION ALLOWANCE:

Income tax provision	30,000	
Valuation adjustment, DTA		30,000

Exercise 19-14

Balance Sheet

Assets:	1999
Deferred tax asset	**30,000**
Liabilities:	
Income tax payable	**328,000**
Equity:	
Retained earnings	**298,000**

Income Statement

	1999
Revenues:	
Expenses:	
Income tax expense	**298,000**
Net income (loss)	**(298,000)**

a. Illustrate how the journal entry is reflected on the financial statements for 1999.

Exercise 19-14

Balance Sheet

Assets:	1999
Deferred tax asset	30,000
Liabilities:	
Income tax payable	328,000
Equity:	
Retained earnings	298,000

Income Statement

	1999
Revenues:	
Expenses:	
Income tax expense	298,000
Net income (loss)	(298,000)

b. Illustrate how the journal entry is reflected on the financial statements for 1999.

Exercise 20-14

Balance Sheet

Assets:	1999
Deferred tax asset	180,000
Allowance Def'd tax	**(30,000)**
Liabilities:	
Income tax payable	328,000
Equity:	
Retained earnings	**(328,000)**

Income Statement

	1999
Revenues:	
Expenses:	
Income tax expense	**328,000**
Net income (loss)	**(328,000)**

b. Illustrate how the journal entry is reflected on the financial statements for 1999.