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.
### Book vs. Tax Difference

#### GAAP Reporting

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues (S/L depreciation)</td>
<td>$130,000</td>
<td>$130,000</td>
<td>$130,000</td>
<td>$390,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Pretax financial income</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Income tax expense (40%)</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

#### Tax Reporting

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues (MACRS depreciation)</td>
<td>$130,000</td>
<td>$130,000</td>
<td>$130,000</td>
<td>$390,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>40,000</td>
<td>30,000</td>
<td>20,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Pretax financial income</td>
<td>$90,000</td>
<td>$100,000</td>
<td>$110,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Income tax payable (40%)</td>
<td>$36,000</td>
<td>$40,000</td>
<td>$44,000</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

### Difference Reporting in F/S

#### Balance Sheet

<table>
<thead>
<tr>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
</tr>
<tr>
<td>Liabilities:</td>
</tr>
<tr>
<td>Deferred taxes (4,000)</td>
</tr>
<tr>
<td>Income tax payable (36,000)</td>
</tr>
<tr>
<td>Equity:</td>
</tr>
<tr>
<td>Retained earnings 40,000</td>
</tr>
</tbody>
</table>

#### Income Statement

<table>
<thead>
<tr>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues:</td>
</tr>
<tr>
<td>Expenses:</td>
</tr>
<tr>
<td>Income tax expense 40,000</td>
</tr>
<tr>
<td>Net income (loss) (40,000)</td>
</tr>
</tbody>
</table>

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

Assumes the 2000 taxes paid in 2001
Where does the "deferred tax liability" get reported in the financial statements? Assumed the 2001 taxes paid in 2002

Where does the "deferred tax liability" get reported in the financial statements? Assumed the 2002 taxes paid in 2003

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

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.
2. A landlord collects some rents in advance. Rents received are taxable in the period when they are received.
3. Expenses are incurred in obtaining tax-exempt income.
4. Costs of guarantees and warranties are estimated and accrued for financial reporting purposes.

Future Taxable or Deductible Amounts

5. Sales of investments are accounted for by the accrual method for financial reporting purposes and the installment method for tax purposes.
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).
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.

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
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"

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td>1999</td>
</tr>
<tr>
<td>Revenues:</td>
<td>1999</td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
</tr>
<tr>
<td>Income tax payable 36,000</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability 54,000</td>
<td></td>
</tr>
<tr>
<td>Equity:</td>
<td></td>
</tr>
<tr>
<td>Retained earnings 210,000</td>
<td></td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Income before tax</td>
<td>300,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>90,000</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>210,000</td>
</tr>
</tbody>
</table>

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:


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"

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:


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"
Exercise 19-4

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


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**

<table>
<thead>
<tr>
<th>Item</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>16,000</td>
</tr>
<tr>
<td>Rent</td>
<td>22,000</td>
</tr>
<tr>
<td>Fines for pollution</td>
<td>11,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>49,000</td>
</tr>
<tr>
<td><strong>Temporary differences</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Rate</strong></td>
<td>30%</td>
</tr>
<tr>
<td><strong>Tax</strong></td>
<td>26,100</td>
</tr>
</tbody>
</table>

**Deferred Tax Asset**

- CO deduction: 6,600
- Rate: 30%
- **Deferred tax asset** 6,600

**Deferred Tax Liability**

- CO deduction: 4,800
- Rate: 30%
- **Deferred tax liability** 4,800

**Income Statement**

- **Revenues**: 70,000
- **Expenses**: 24,300
- **Net income (loss)** 45,700

**Balance Sheet**

- **Assets**: 2004
  - Deferred tax asset 6,600
- **Liabilities**
  - Income tax payable 26,100
- **Equity**
  - Retained earnings 45,700

**IN-CLASS EXPANSION OF E19-4**

Say that in 2005:
- GAAP income is $100,000;
- Tax depreciation is less than book by $4,000;
- Rent collected on tax return exceeds book by $25,000;
- No other factors.

Compute the tax provision and prepare the journal entry for 2005.
Exercise 19-9

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Pretax Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>$160,000</td>
</tr>
<tr>
<td>2000</td>
<td>250,000</td>
</tr>
<tr>
<td>2001</td>
<td>80,000</td>
</tr>
<tr>
<td>2002</td>
<td>(160,000)</td>
</tr>
<tr>
<td>2003</td>
<td>(380,000)</td>
</tr>
<tr>
<td>2004</td>
<td>120,000</td>
</tr>
<tr>
<td>2005</td>
<td>100,000</td>
</tr>
</tbody>
</table>

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

E-19-9 ANSWER

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Tax Refund Receivable</th>
<th>Income Tax Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>72,000</td>
<td>Income Tax Expense</td>
</tr>
<tr>
<td></td>
<td>($160,000 X 45%)</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>32,000</td>
<td>Benefit Due to Loss Carryback</td>
</tr>
<tr>
<td></td>
<td>($380,000 X 45%)</td>
<td>Income Tax Expense</td>
</tr>
<tr>
<td>2004</td>
<td>48,000</td>
<td>Deferred Tax Asset (45%) X $120,000</td>
</tr>
<tr>
<td></td>
<td>(Income Tax Expense)</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>40,000</td>
<td>Deferred Tax Asset ($100,000 X 45%)</td>
</tr>
</tbody>
</table>

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 $110,000 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**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative tax asset differences</td>
<td>450,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>12/31/04 deferred tax asset</td>
<td>180,000</td>
</tr>
<tr>
<td>Already on books</td>
<td>150,000</td>
</tr>
<tr>
<td>Adjustment</td>
<td>30,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>820,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
</tr>
<tr>
<td>Income tax</td>
<td>328,000</td>
</tr>
</tbody>
</table>

**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:
Income tax expense 298,000

Expenses:
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:
Income tax expense 298,000

Expenses:
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:
Income tax expense 328,000

Expenses:
Net income (loss) (328,000)

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