ACCOUNTABLE TALENT

Accounting For Income Taxes

JANUARY 31, 2019

Course Objective

Basic course designed to teach the terminology, general concepts and calculations used in preparing an income tax provision calculation and footnote disclosure in accordance with ASC740.

Agenda

Time (EST)	
10:00 – 10:35	General Concepts and Terminology
10:35 – 10:50	Current Tax Calculation
10:50 – 11:00	Case Study and break
11:00 – 10:15	Review Case Study Solution
11:15 – 10:50	Deferred Tax Calculation
11:50 – 12:00	Case Study and break
12:00 – 12:15	Review Case Study Solution
12:15 – 12:30	Valuation Allowance
12:30 – 12:45	Rate Reconciliation
12:45 – 1:00	Footnote Disclosure

ACCOUNTABLE TALENT

General Concepts and Terminology

ASC 740 Objectives

Capture Current Year Events

Capture Future Year Events

Report in Financial Statements

Recognize the amount of taxes payable or refundable for the current year

Recognize the amounts of deferred tax liabilities and assets for the future tax consequences of events that have been recognized in a company's financial statements or tax returns

Scope of ASC 740

Taxes Included in ASC 740	Taxes Not Included in ASC 740
• Only applies to taxes based on income • ASC 740 defines "income taxes" as "domestic and foreign federal (national), state and local taxes based on income" Note: Taxes based on income are generally reported "below the line."	"Above the line" taxes such as the following: • Sales and use taxes • Property taxes • Payroll taxes • Excise taxes • VAT taxes • Capital (equity) based franchise taxes

Why is ASC 740 Needed?

Mr. Bigbucks wants to purchase Without740 Corporation. He reviews the balance sheet of Without740 Corporation and offers to purchase the company from Mr. Seller for its net book value of $260. The offer is accepted. Without740 Corporation never implemented ASC 740 because they did not understand how to calculate and report it.

Why is ASC 740 Needed?

Fixed Assets	**$1,000**		**Bank Loan**	**$740**
			Equity	**$260**
Total	**$1,000**		**Total**	**$1000**

Additional Facts:

- Assume the tax rate is 26% (blended federal and state)
- The tax basis of then fixed assets is $0 due to accelerated depreciation

The day after the purchase is complete, Mr. Bigbucks decides to sell all the fixed assets for $1,000 (the net book value). He expects to use the proceeds to repay the bank loan and have $260 to buy inventory. His accountant informs him that he will need to use the remaining $260 to pay the taxes resulting from the $1,000 gain on sale of the fixed assets.

Mr. Bigbucks calls Mr. Seller and claims that the financial statements of Without740 Corporation were incorrect and he will be hearing from his attorney, F. Lee Fasbey! You are Mr. Bigbuck's consultant. Briefly explain to your client what is missing from the financial statements?

Solution

The financial statements of Without740 Corporation are missing deferred taxes.

- The book basis of the fixed assets of Without740 Corporation are $1,000 higher than the tax basis.
- The future tax liability of $260 associated with the tax gain in excess of the book gain needs to be recorded on the financial statements, and equity needs to be reduced to zero. (This liability should have been accrued as the accelerated depreciation was taken with the offsetting debits to deferred tax expense.) The revised balance sheet is shown below.

Fixed Assets	**$1,000**		**Bank Loan**	**$740**
			Deferred Tax Liability	**$260**
			Equity	**0**
Total	**$1,000**		**Total**	**$1000**

Book/Tax Difference

	Book	Tax	Book>Tax basis
Fixed assets	$1,000	0	$1,000
Blended Fed/State tax rate			26%
Deferred tax liability (not reported in example)			$260

Journal entry to record deferred taxes:

Deferred Tax Expense	$260	
Deferred Tax Liability		$260

POLLING QUESTION

ASC 740 Terminology

- Temporary Differences
- Deferred Tax Expense (Benefit)
- Deferred Tax Asset/ Liability
- Rate Reconciliation
- Permanent Differences
- Current Tax Expense (Benefit)
- Return to Provision True-Up
- Valuation Allowance
- Current Payable
- Total Tax Expense/ Provision
- Effective Tax Rate
- FIN 48 (ASC 740-10)

Temporary vs. Permanent Differences

Temporary Differences	Permanent Differences
Temporary differences give rise to deferred taxes.	Permanent difference impact the effective tax rate.
Differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the amount reported in the financial statements is recovered or settled.	Refers to items of income that are not taxable or expenses that are not deductible currently and will not result in taxable or deductible amounts in the future and/or cannot be anticipated in future periods.

Current and Deferred Tax Expense

Current tax expense/benefit (Current Provision)

- Tax liability or refund expected on the current year tax return
- Includes
  - Tax liability projected for current year (on tax return)
  - Prior year return-to-accrual adjustment
  - Change in FIN 48 liability for open tax years

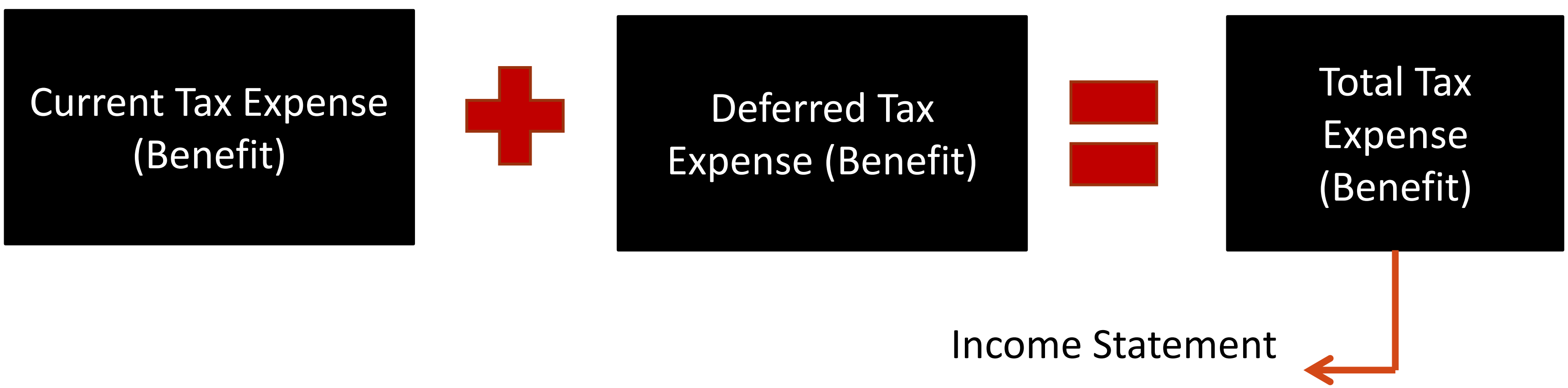
Deferred tax expense/benefit (Deferred Provision)

- Tax liability or refund that will eventually be paid or received
- Change in net deferred tax asset or liability (beginning of year to end of year)
- Calculated using the expected tax rate when the temporary difference is expected to reverse

Total Income Tax Expense

Total income tax expense/provision

- Total income tax expense on a book basis
- Total tax that will ever be paid (or refunded) in connection with income, expenses and events captured in this period's financial statements
- Separate calculations for each tax jurisdiction in which company operates – U.S. federal, one or more states, one or more foreign jurisdictions, etc.



Balance Sheet Accounts

Current Payable (Liability)

- The amount of income taxes payable for the current year = tax returns

Deferred tax asset or liability

- Tax effect of future taxable or deductible amounts, including loss and credit carryforwards
- Deferred tax assets and liabilities are grouped separately in ASC740 analysis
- Compute tax effects using enacted tax laws and expected to apply when the underlying differences reverse
- Perform calculations by tax-paying enterprise (legal entity) in each jurisdiction

Financial Statements Example

Company Income Statement For the period ended December 31, 2017	
Income	
Sales	15,000
Total Income	15,000
Expenses	
Supplies	5,000
Contract labor	2,000
Meals and ent.	1,000
Depreciation	2,000
Total Expenses	10,000
Provision for Income Taxes	1,500
Net Income/(Loss)	3,500

Company Balance Sheet December 31, 2017		
Assets		
Cash	9,000	
Equipment	10,000	
Accumulated Depreciation	(2,000)	
Deferred Tax Asset	2,000	(Non-Current Asset)
Total Assets	19,000	
Liabilities and Owner's Equity		
Liabilities		
Deferred Revenue	5,000	
Income Tax Payable	1,000	(Current Liability)
Deferred Tax Liability	3,000	(Non-Current Liability)
Total Liabilities	9,000	
Equity		
Common Stock	5,000	
Retained Earnings	5,000	
Total Equity	10,000	
Total Liabilities and Owner's Equity	19,000	

What about an income tax receivable? When might a company have that on their balance sheet?

Balance Sheet Accounts

Valuation Allowance

- Contra asset account
- The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.
- Valuation allowance must be recognized to the extent that it is **more likely than not** that some or all of the deferred tax asset will **not** be realized.

FIN 48 (ASC 740-10)

- Requires businesses to analyze and disclose income tax risks. A business may recognize an income tax benefit only if it is more likely than not that the benefit will be sustained.

A Few More Terms….

Return-to-provision adjustment/Prior year true-up

- After the prior year return is completed and filed, compare the prior year current payable calculation per the provision with the finalized tax return

Effective tax rate

- Total income tax expense for the period divided by pretax financial income

Rate reconciliation

- Schedule reconciling domestic federal statutory rate of 21% with “actual” effective tax rate

POLLING QUESTION

Balance Sheet Approach

1. Compute the current tax asset or liability (estimating the current year tax return)
2. Compute the deferred tax asset or liability (temporary book vs. tax basis of assets and liabilities and tax attributes/carryforwards)
3. Adjust the general ledger accounts to computed balances

Balance sheet approach

- Deferred tax expense not calculated directly
- Deferred tax assets (DTAs) and liabilities (DTLs) are calculated based on differences in book and tax bases of assets and liabilities + future tax benefits of carryovers
- Deferred tax expense generally equals difference between BOY net DTA or DTL and EOY net DTA or DTL

Example of Balance Sheet Approach

At the beginning of the current year, Company X has a net deferred tax liability of $100,000 recorded on its balance sheet. At the end of year, the calculated net deferred tax liability reported on X's balance sheet is $140,000.

What is Company X's deferred tax expense?

Back to the Basic Calculation…

Current Tax Expense (Benefit) + Deferred Tax Expense (Benefit) = Total Tax Expense (Benefit)

Complete separate calculations for each tax jurisdiction in which company operates – U.S. federal, state and foreign jurisdictions.

Understanding the Parts

Current Tax Expense/Benefit	Deferred Tax Expense/Benefit	Total Tax Expense/Benefit
• Tax liability or refund expected on the current year tax return • Impacted by both permanent book/tax differences and temporary book/tax differences	• Change in net deferred tax asset or liability (beginning of year to end of year) • Only impacted by temporary book/tax differences. • Generally, deferred taxes are recognized for all temporary differences	• Amount reported on the income statement. • Total tax that will ever be paid (or refunded) in connection with income, expenses and events captured in this period's financial statements

Steps in Applying ASC 740

1. Determine current income tax expense for each jurisdiction in which taxpayer operates.
2. Identify and account for cumulative temporary differences at end of current year.
3. Identify loss and tax credit carryforwards.
4. Perform the provision-to-return reconciliation.
5. Determine appropriate tax rate(s) to utilize in computing deferred taxes.
6. Compute DTL for taxable temporary differences
7. Compute DTA for deductible temporary differences + carryforwards

Steps in Applying ASC 740

8. Determine need to reduce DTA by valuation allowance.
9. Determine that uncertain tax positions (FASB ASC 740-10-25 (FIN 48)) are properly accounted for.
10. Determine deferred tax expense, generally equal to change in net DTA or DTL during year.
11. Determine total income tax expense = current tax expense.
 (step 1) + deferred tax expense (step 10)

12. Address financial statement reporting issues.
    - Balance sheet classification/presentation of DTA/DTL
    - Footnote disclosures
    - Intraperiod tax allocation
    - FASB ASC 740-10-25 (FIN 48) disclosure

POLLING QUESTION

Current Tax Provision Calculation

Book Income vs. Taxable Income

Book income: Computed based on U.S. GAAP

Taxable income: Computed based on the Internal Revenue Code

Book Income ≠ Taxable Income

- Permanent differences impact the effective tax rate
  - Refers to items of income that are not taxable or expenses that are not deductible currently and will not result in taxable or deductible amounts in the future and/or cannot be anticipated in future periods. Permanent difference impact the effective tax rate
- Temporary differences give rise to deferred taxes
  - Are differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the amount reported in the financial statements is recovered or settled. Temporary differences give rise to deferred taxes

Identifying Book/Tax Differences

Understanding how and where items are reported for financial reporting purposes will help you effectively apply ASC 740

Review the detailed trial balance/general ledger

- Any new accounts? Need to determine tax method of accounting.

Discuss discrete transactions that happened during the reporting period

- Were there any mergers, acquisitions or divestitures?

Look for recurring adjustments

- Make certain to include continuing differences (prior years tax returns and provisions calculations).

Permanent Differences

Permanent Differences

- Differences that arise from statutory provisions under which specified revenues are exempt from taxation and certain expenses are not allowable as deductions in determining taxable income
  - Non-taxable income (tax-exempt interest)
  - Non-deductible expense (fines & penalties)
  - Limited expenses (meals 50% & entertainment 100%)
- ASC 740 does not define or even refer to the term permanent differences. This is a term used in earlier pronouncements.
- Considered when measuring taxes payable or refundable (current tax expense)
- These differences are generally found on the income statement

Common Permanent Differences

Permanent Difference	GAAP Treatment	Tax Treatment
Meals and entertainment – **change in 2018 with TCJA**	Expensed	50% Meals non-deductible and entertainment expenses 100% non-deductible (as of 2018)
Fines and penalties	Expensed	Not deductible
Tax exempt interest income (municipal bond interest)	Includible in income	Not includible in income
Dividend received deduction	Includible in income	Percentage may be excluded from income.
Country club dues	Expensed	Not deductible

POLLING QUESTION

Temporary Differences

Definition in ASC 740 – "a difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively"

Common causes of temporary differences

- Recognition of income or expenses in different periods for book and tax purposes (cumulative book-tax differences)
- Business combinations (assets recorded at FMV for book and adjusted basis for tax)
- Changes in accounting method (§ 481(a) adjustment creates deferred income item for tax which does not exist for book)

Temporary Differences

Questions to be answered concerning temporary differences:

- Does a temporary difference exist?
- Is the temporary difference a taxable temporary difference or a deductible temporary difference?
- Do deferred taxes need to be provided with respect to the temporary difference?

Identifying Temporary Differences

Best practice: Construction of tax basis balance sheet and comparison with book balance sheet

Alternative method: Cumulative summation (i.e., rollforward) of book-tax temporary differences, adjusted for business combinations and other items identified in ASC 740 as creating temporary differences

- *NOTE: DTAs and DTLs are computed based on cumulative temporary differences at end of current year (not just the current year book-tax difference)*

Common Temporary Differences

Temporary Difference	GAAP Treatment	Tax Treatment
Allowance for doubtful accounts	Expense when estimated	Deductible when fixed and determinable
Depreciation	Typically expensed using straight line method	MACRS or another accelerated depreciation method
Accrued vacation, salaries, bonuses, deferred compensation	Expense when accrued	Expense when paid (deductible if payment made within 2.5 months.
Prepaid expenses	Expense ratably over period expense relates	May be deductible at the time of payment
Deferred revenue	Recognized as services are performed/property delivered	Recognized when cash is received.
Interest – **New with TCJA**	Expense costs when incurred	May not be able to expense based on calculated thresholds. Carryforward to future tax years.

Calculate Current Expense/Payable

Book Income before tax (US GAAP)

+/- Permanent Items

+/- Temporary Differences

= **Current Taxable Income**

X Enacted Current Tax Rate

= **Current Tax Expense (Liability)**

(Less: Payments Made)

= Current Payable/Receivable

Compute Current Payable/Receivable

Current income taxes payable or receivable for a particular tax year usually includes the tax consequences of most events that are recognized in the financial statements for that year.

Differences arise between the amount of taxable income and pretax financial statement income for a year and the tax bases of assets or liabilities and their reported amounts in the financial statements

Equivalent to preparing the current year tax return

Contains virtually all items that impact the overall tax rate

- Identify the permanent items (will affect payable and expense)
- Identify the temporary items (will affect payable and deferreds)
- Credits
- Return to accrual adjustments related to permanent items
- Jurisdictions and rates

No real guidance provided by ASC 740 – This is just applying tax law to the current year results

POLLING QUESTION

Case Study

Case Study

KELLY Corporation reports pre-tax book income for 20CY of $1,000,000. Deducted in arriving at this number was meals (100 percent) of $20,000. Tax depreciation for 20CY exceeds book depreciation by $75,000. KELLY's balance sheet reflects accrued bonuses of $100,000 at the beginning of the year and $125,000 at the end of the year. Accrued bonuses are paid six months after the close of the year in which it is accrued.

Prior year tax depreciation schedules reflect an excess of tax over book depreciation of $100,000, $75,000 and $75,000 in the years 20PY2, 20PY1 and 20PY, respectively. KELLY's balance sheet at December 31, 20PY, reflected a net deferred tax liability of $60,900 (which is comprised of $15,000 state and $28,350 federal).

KELLY's tax returns for 20PY1 and 20PY each reflected taxable income of $0. Currently, KELLY has no uncertain tax positions.

The federal tax rate is 21 percent and KELLY operates in a single state that imposes tax at a flat rate of 10 percent. This state follows federal law.

For the year 20CY, KELLY made state and federal estimated tax payments of $80,000 and $150,000, respectively.

Case Study

Using the facts provided, prepare the following for KELLY Corporation

a. Current state income tax expense for 20CY
b. Current federal income tax expense for 20CY
c. Current federal income taxes payable at December 31, 20CY
d. Current state income taxes payable at December 31, 20CY

Deferred Tax Provision Calculation

Deferred Taxes

Deferred tax liabilities exist because they will require the entity's cash to settle and are the best estimate of the amount of cash that will be used in the future

Deferred tax assets represent the best estimate of what amount will be realized in cash for the asset

- If the amount of the deferred tax asset is not at least "more likely than not" to be realized (i.e., at least 50% probability of being realized), it is treated as impaired and a valuation allowance is recorded to reduce the deferred tax asset to an amount that is "more likely than not" able to be realized

Deferred Tax Asset

A deferred tax asset is recognized for **temporary differences** that will result in deductible amounts in future years and for carryforwards *(At the time of the reporting period, book has taken more deductions than tax).*

Future benefit of cash inflows based on an event that has already occurred.

Common DTAs:

- Deferred Revenue
- UNICAP - IRC 263A
- Accrued Vacation
- Carryforwards (NOLs, Tax Credits (state and federal)

Deferred Tax Asset

Deferred Tax Assets also include tax attributes which are NOLs and income tax credits (both federal and state).

Item	Normal Federal Carryback/Carryforward Period
Net operating losses	Indefinite carryforward – no carryback
Capital losses	Back – 3 years; forward – 5 years
General business credits	Back – 1 year; forward – 20 years (generally)
Foreign tax credits	Back – 1 year; forward – 10 years
Minimum tax credit	Repealed and refundable for companies with existing credits

Deferred Tax Liability

- A deferred tax liability is recognized for **temporary differences** that will result in taxable amounts in future years *(At the time of the reporting period, tax has taken more deductions than book).*
- Future payment responsibility for an obligating event that has already occurred.

Common DTLs:

- Depreciation
- Prepaid expenses
- LIFO/FIFO inventory methods

Deferred Tax Asset/Liability

Deferred Tax Asset	Deferred Tax Liability
Represent future deductible items	Represent future taxable items
Deferred tax consequences attributable to deductible temporary differences and carryforwards (tax credits, NOL)	Deferred tax consequences attributable to taxable temporary differences
Future benefit of cash inflows based on an event that has already occurred	Future payment responsibility for an obligating event that has already occurred

POLLING QUESTION

Recognition of Deferred Taxes

General rule – Deferred taxes are recognized for all temporary differences.

Examples of Exceptions:

- Excess of book over tax basis of a foreign subsidiary where difference is not expected to reverse in foreseeable future
- Undistributed earnings of a domestic subsidiary that were accumulated in pre-1993 years where the difference is not expected to reverse in the foreseeable future
- Other specified items

Deferred Tax Rollforward

- Generally, this means rolling deferred tax balances forward from their beginning balances
- Temporary differences current activity will also post to gross deferred balances (considered in the current payable calculation also)
- Make sure all temporary differences are identified
- Make sure all tax attributes (losses and credits) are reflected
- Consider other adjustments to deferreds (acquisitions/divestitures)
- Determine tax rate at which to measure deferreds. This is the enacted rate expected to apply when the underlying differences reverse
- Assess deferred tax assets for realizability (need for valuation allowance)

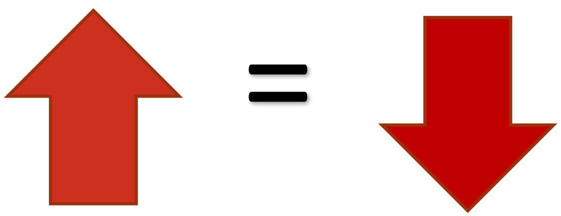
Basic Deferred Tax Rollforward Schedule

Assets and Liabilities - US Taxes		Beginning Balance	Current Activity	Ending Balance	Tax Rate	DTA/DTL
Deferred Tax Assets						
	Allowance for Uncollectible Accounts	350	150	500	21%	105
	Deferred Revenue	125	25	150	21%	32
	Accrued Vacation	650	55	705	21%	148
	Inventory Allowance	400	-	400	21%	84
	Sub Total	1,525	230	1,755		369
Deferred Tax Liabilities						
	Depreciation	(1,250)	250	(1,000)	21%	(210)
Net						**159**

Does this company have a net DTA or a net DTL?

Understanding the Relationship

Deferred Tax Asset



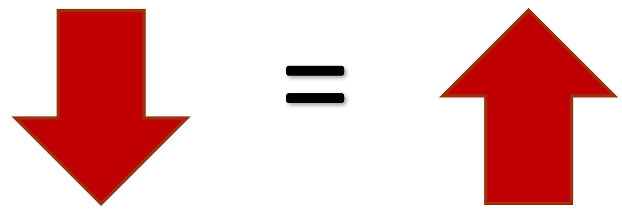
Deferred Tax Expense

Journal Entry to Record:

Debit DTA

Credit Tax Expense

Deferred Tax Expense



Deferred Tax Asset

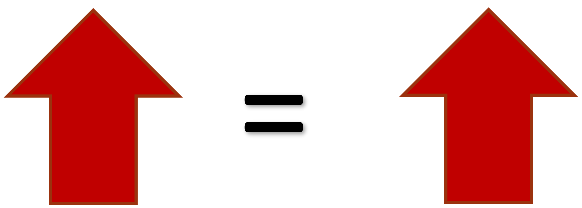
Journal Entry to Record:

Debit Tax Expense

Credit DTA

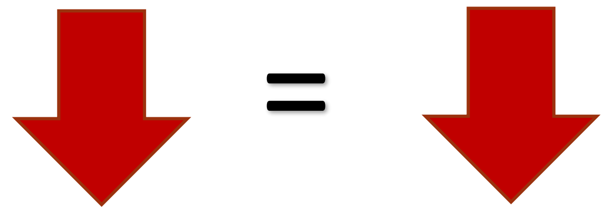
Understanding the Relationship

Deferred Tax Liability   Deferred Tax Expense



Journal Entry to Record:

Debit Tax Expense
Credit DTL



Deferred Tax Liability   Deferred Tax Expense

Journal Entry to Record:

Debit DTL
Credit Tax Expense

Computation of DTA/DTL

General formula for deferred tax liability

- DTL = taxable temporary differences x applicable tax rate

General formula for deferred tax asset

- DTA = [(deductible temporary differences + loss and deduction carryforwards) x applicable tax rate] + tax credit carryforwards

Tax Rate = Blended US and State Rate

Computation of DTA/DTL

Generally…

	Net DTA or DTL at EOY
Less:	(<u>Net DTA or DTL at BOY)</u>
Equals:	Deferred Income Tax Expense/(Benefit)

- Decrease in net DTA/increase in net DTL = expense
- Increase in net DTA/decrease in net DTL = benefit
- Exceptions with Other Comprehensive Income and Purchase Accounting

Tax Rates for Deferred Taxes

ASC 740 – "enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to reverse"

U.S. federal tax jurisdiction

- Flat 21%

State Tax Rates

State jurisdictions

- Rates vary from jurisdiction to jurisdiction
- May be possible to combine states with similar rates or insignificant amounts of income and utilize “blended” state rate

Federal/state interaction

- State rate is effectively reduced by fact that state taxes are deductible for federal purposes
- General formula for “effective” state rate is [state rate – (state rate x federal rate)]
- In some cases, it may be reasonable to utilize a “blended” rate where “effective” state rate is added to federal rate

Provision to Return Differences

Occur as a result of *actual numbers* utilized in preparing the tax return differing from *estimates* utilized in preparing the tax provision

True-up process in *subsequent* year

- Permanent differences – Adjust **income tax expense** in **current** year to reflect impact of discrepancy of amount paid in **prior** year
- Temporary differences – Adjust **DTA** and **DTL** in **current** year to reflect impact of discrepancy on amount of tax paid in **prior** year
- Evaluate true-up items to determine if the change from provision to return was an error or change in estimate

Income Tax Benefit/Receivable

Some companies (e.g. startups/small private companies) generate losses instead of income resulting in tax benefits and refunds rather than tax expense and payable.

Journal entry to record income tax benefit/refund:

Debit Income tax payable/receivable

Credit Income tax expense/(benefit)

Typically net operating losses (NOLs) are not refundable for federal/state purposes, therefore the NOL becomes a NOL DTA that is reported with the other DTAs on the balance sheet and is carried over to offset taxable income in future tax periods.

Journal entry to record the NOL DTA:

Debit DTA – NOL

Credit Income tax payable/receivable

POLLING QUESTION

ACCOUNTABLE TALENT

Putting it All Together…

Example 1 – NO B/T Differences

Year 1					
				Tax Rate	Tax Expense
Pre-Tax Book Income/(Loss)			**10,000**	21%	**2,100**
Permanent Differences					
	Meals and Entertainment		-	21%	-
Temporary Differences					
	Deferred Revenue - Book	-			
	Deferred Revenue - Tax	-	-	21%	-
	Depreciation Expense - Book	-			
	Depreciation Expense - Tax	-	-	21%	-
Taxable Income/(Loss)			**10,000**	21%	**2,100**

Example 1 – NO B/T Differences

- Income tax expense per books = Income tax expense per tax return and tax payable
- Calculate the total tax provision:

CTE	+	DTE	=	Total Tax Expense
$2,100		- 0 -		$2,100

- Effective Tax Rate (2,100/10,000) 21%= Federal Statutory Rate 21%
- Journal entry to record tax expense:

Debit Income Tax Expense $2,100 (Income Statement)

Credit Income Tax Payable $2,100 (Balance Sheet)

Example 2 – Only Perms

Year 1					
				Tax Rate	**Tax Expense**
Pre-Tax Book Income/(Loss)			**10,000**	21%	**2,100**
Permanent Differences					
	Meals and Entertainment		500	21%	105
Temporary Differences					
	Deferred Revenue - Book	-			
	Deferred Revenue - Tax	-	-	21%	-
	Depreciation Expense - Book	-			
	Depreciation Expense - Tax	-	-	21%	-
Taxable Income/(Loss)			**10,500**	21%	**2,205**

Example 2 – Only Perms

- Income tax expense per books = Income tax expense per tax return and tax payable
- Calculate the total tax provision:

CTE	+	DTE	=	Total Tax Expense
$2,205		- 0 -		$2,205

- Effective Tax Rate (2,205/10,000) 22.05% = Federal Statutory Rate 21%
- Journal entry to record tax expense:

Debit Income Tax Expense $2,205 (Income Statement)

Credit Income Tax Payable $2,205 (Balance Sheet)

Example 3 – Only Temps

Year 1					
				Tax Rate	Tax Expense
Pre-Tax Book Income/(Loss)			**10,000**	21%	**2,100**
Permanent Differences					
	Meals and Entertainment		-	21%	-
Temporary Differences					
	Deferred Revenue - Book	-			
	Deferred Revenue - Tax	5,000	5,000	21%	1,050
	Depreciation Expense - Book	(2,000)			
	Depreciation Expense - Tax	(5,000)	(3,000)	21%	(630)
Taxable Income/(Loss)			**12,000**	21%	**2,520**

A

A = Net increase in DTA of $420 = decrease in tax expense

Example 3 – Only Temps

- Income tax expense per books < Income tax expense per tax return and tax payable: Tax expense per books = $2,100 and Tax expense per tax return = $2,520
- Calculate the total tax provision:

CTE	+	DTE	=	Total Tax Expense
$2,520		($420)		$2,100

- Effective Tax Rate (2,100/10,000) 21% = Federal Statutory Rate 21%
- Journal entry to record tax expense:

Debit Deferred Tax Asset $420 (Balance Sheet)

Debit Income Tax Expense $2,100 (Income Statement)

Credit Income Tax Payable $2,520 (Balance Sheet)

Example 4 – Temps and Perms

Year 1					
				Tax Rate	Tax Expense
Pre-Tax Book Income/(Loss)			**10,000**	21%	**2,100**
Permanent Differences					
	Meals and Entertainment		500.00	21%	105
Temporary Differences					
	Deferred Revenue - Book	-			
	Deferred Revenue - Tax	5,000	5,000	21%	1,050
	Depreciation Expense - Book	(2,000)			
	Depreciation Expense - Tax	(5,000)	(3,000)	21%	(630)
Taxable Income/(Loss)			**12,500**	21%	**2,625**

A

A = Net increase in DTA of $420 = decrease in tax expense

Example 4 – Temps and Perms

- Income tax expense per books < Income tax expense per tax return and tax payable: Tax expense per books = $2,205 and Tax expense per tax return = $2,625
- Calculate the total tax provision:

CTE	+	DTE	=	Total Tax Expense
$2,625		($420)		$2,205

- Effective Tax Rate (2,205/10,000) 22.05% = Federal Statutory Rate 21%
- Journal entry to record tax expense:

Debit Deferred Tax Asset $420 (Balance Sheet)

Debit Income Tax Expense $2,205 (Income Statement)

Credit Income Tax Payable $2,625 (Balance Sheet)

Example 5 – Loss/No VA

Year 1					
				Tax Rate	Tax Expense
Pre-Tax Book Income/(Loss)			**(10,000)**	21%	**(2,100)**
Permanent Differences					
	Meals and Entertainment		500.00	21%	105
Temporary Differences					
	Deferred Revenue - Book	-			
	Deferred Revenue - Tax	5,000	5,000	21%	1,050
	Depreciation Expense - Book	(2,000)			
	Depreciation Expense - Tax	(5,000)	(3,000)	21%	(630)
Taxable Income/(Loss)			**(7,500)**	21%	**(1,575)**

A

A = Net increase in DTA of $420 = decrease in tax expense

Example 5 – Loss/No VA

- Income tax benefit per books > Income tax loss per tax return and tax receivable: Tax benefit per books = $1,995 and Tax benefit per tax return = $1,575
- Calculate the total tax provision:

CTE	+	DTE	=	Total Tax Expense/(Benefit)
($1,575)		($420)		($1,995)

- Effective Tax Rate [(1,995)/(10,000)] 19.95% = Federal Statutory Rate 21%
- Journal entry to record tax expense:

Debit Deferred Tax Asset $420 (Balance Sheet)

Debit Income Tax Receivable $1,575 (Balance Sheet)

Convert to NOL DTA if no actual receivable from the taxing authorities.

Credit Income Tax Benefit $1,995 (Income Statement)

POLLING QUESTION

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Case Study

Case Study

KELLY Corporation reports pre-tax book income for 20CY of $1,000,000. Deducted in arriving at this number was meals (100 percent) of $20,000. Tax depreciation for 20CY exceeds book depreciation by $75,000. KELLY's balance sheet reflects accrued bonuses of $100,000 at the beginning of the year and $125,000 at the end of the year. Accrued bonuses are paid six months after the close of the year in which it is accrued.

Prior year tax depreciation schedules reflect an excess of tax over book depreciation of $100,000, $75,000 and $75,000 in the years 20PY2, 20PY1 and 20PY, respectively. KELLY's balance sheet at December 31, 20PY, reflected a net deferred tax liability of $60,900 (which is comprised of $15,000 state and $28,350 federal).

KELLY's tax returns for 20PY1 and 20PY each reflected taxable income of $0. Currently, KELLY has no uncertain tax positions.

The federal tax rate is 21 percent and KELLY operates in a single state that imposes tax at a flat rate of 10 percent. This state follows federal law.

For the year 20CY, KELLY made state and federal estimated tax payments of $80,000 and $150,000, respectively.

Case Study

Using the facts provided, prepare the following for KELLY Corporation

a. Gross deferred tax asset at December 31, 20CY
b. Gross deferred tax liability at December 31, 20CY
c. Deferred federal income tax expense for 20CY
d. Deferred state income tax expense for 20CY
e. Total tax expense for 20CY – **Challenge: Can you calculate it more than one way?**

POLLING QUESTION

Valuation Allowance

Overview

Valuation allowance must be recognized to the extent that it is more likely than not that some or all of the deferred tax asset will not be realized.

The valuation allowance amount is based on the evaluation of all available evidence and professional judgement.

ASC 740-10-30(e): "Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized."

Fundamentals

Required	• Recognition or non-recognition of a valuation allowance is not optional (There is a presumption that the asset should be recognized and subject to an impairment test.)
Measurement	• Valuation allowance should reduce DTA to the amount that is “more likely than not” to be realized
Evaluation	• Evaluate all positive and negative evidence regarding the ability to use the DTA in future periods
Timing	• A valuation allowance must be adjusted as circumstances change • Without a discrete transaction, Companies generally evaluate the valuation allowance annually

Financial Statement Impact

Balance sheet impact of valuation allowance

- Decreases amount of deferred tax asset (valuation allowance is a contra asset account)

Income statement impact of valuation allowance

- Increase in valuation allowance – Generally increased tax expense/decreased net book income
- Decrease in valuation allowance – Generally decreased tax expense/increased net book income

Evaluating the Evidence

Evaluate positive and negative evidence regarding the ability to use the DTA in future periods.

Examples of Positive Evidence	Examples of Negative Evidence
Future reversal of existing taxable temporary differences	Cumulative losses in recent years
Strong earnings history	Brief carryback and carryforward periods
Appreciated <u>net</u> asset values	History of carryforwards expiring unused
Availability of tax planning strategies	Management historically unable to accurately forecast future earnings
Favorable recent developments	Going-concern issues
Sales back logs	Unfavorable trends, developments, or contingencies

*Note: Can the evidence be validated?

Sources of Income

If evidence of one or more sources of taxable income is sufficient to support conclusion that no valuation allowance is needed, it is generally not necessary to consider other potential income sources

Taxable income in prior years and future reversals of temporary differences is generally more objective than projections of future taxable income

Strong Evidence

Sources of income

- Taxable income in carryback years
- Future reversals of existing temporary differences
- Forecasted future taxable income exclusive of reversing temporary differences and carryforwards
- Tax planning strategies

Weak Evidence

Analyze by Jurisdiction

Need for valuation allowance must often be determined separately for each jurisdiction due to differing carryback/carryover rules.

Even within a single jurisdiction, need for valuation allowance with respect to different types of carryovers must often be evaluated individually due to different carryback/carryover periods and differing limitations on utilization.

Tax Planning Strategies

A qualifying tax planning strategy:

- Is prudent and feasible
- Is a strategy that an enterprise ordinarily might not take, but would take to prevent NOL/credit carryforward from expiring
- Would result in realization of deferred assets
- Costs associated with implementation of tax planning strategy reduces amount of tax benefit recognized from strategy

Examples?

Steps in Determining Valuation Allowance

1. Determine gross amount of DTA and DTL
2. Determine amount of taxes paid during available carryback period
3. Obtain general understanding of pattern and timing of reversals of temporary differences and length of available carryback/carryforward periods
4. Determine extent to which it is more likely than not that tax benefits of DTDs and carryforwards (DTAs) will be realized through carryback or through offsetting future TTDs
5. Determine amount and timing of future taxable income necessary to realize remaining balance of DTA

Steps in Determining Valuation Allowance

6. Determine whether evidence exists to support conclusion that it is more likely than not that future income will be sufficient to allow realization of remaining DTA
7. If necessary, perform more detailed scheduling of reversal patterns and/or obtain more detailed projections of future income
8. If necessary, consider availability of tax planning strategies
9. Consider existence of negative evidence concerning realizability of DTA
10. Reach overall conclusion concerning amount of valuation allowance required to reduce DTA to amount that more likely than not will be realized

POLLING QUESTION

Rate Reconciliation

Purpose of the Rate Reconciliation

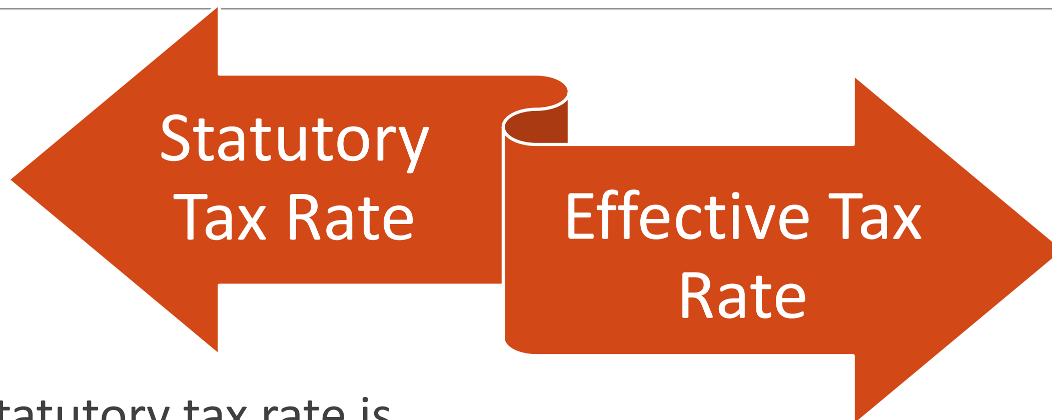
Reconciles the statutory tax rate to income tax expense per the financial statements

Used to prove income tax expense

If the tax rate does not reconcile, then the overall tax provision calculation is not finished!

Objective is to reconcile domestic federal statutory rate of 21% with "actual" effective tax rate obtained by dividing income tax expense attributable to income from continuing operations by the pre-tax book income from continuing operations

Statutory vs. Effective Tax Rate (ETR)



- The statutory tax rate is the tax imposed by law (by "statute," hence the name).
- Current US Federal statutory rate is 21%.

- The effective tax rate (ETR) is what percentage of our income we *actually* pay in taxes.
- Calculate ETR by dividing income tax expense per the financial statements by pre-tax book income.

Factors Impacting the Rate Reconciliation

Major Factors

- Permanent Differences
- State Tax Expense (net of federal benefit)
- Return to provision adjustments (permanent)
- Changes in prior years' taxes due to audits or amended returns
- Changes in tax laws or rates
- Changes in valuation allowance
- Changes in contingency (FIN48) reserves and/or related interest and penalties

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Factors Impacting the Rate Reconciliation

Return to Provision Adjustments

- Permanent differences
- Return to provision adjustments are needed to “true-up” provision to return amounts
- Commonly result from the use of estimates at the time of determining the provision, items not considered at the time of determining the provision or items which may be immaterial at the time of determining the provision

Valuation Allowance

- Reduction or release of valuation allowance
- Increase or set-up of valuation allowance

Examples of Increases and Decreases

Items commonly increasing “effective” tax rate

- State Tax Expense (net of federal benefit)
- Foreign income taxes
- Tax effect of “nondeductible expenses” (meals – note changes via TCJA)
- TCJA – 162m for privately held companies
- Sock compensation (windfalls and shortfalls)

Items commonly decreasing “effective” tax rate

- Tax effect of “nontaxable” income items (tax exempt interest income)
- Sock compensation (windfalls and shortfalls)
- Tax credits

Disclosure of Rate Reconciliation (public companies)

ASC 740 Paragraph 47

- All enterprises must disclose the nature of significant reconciling items
- Public enterprises must disclose effects of those items in percentages or dollar amounts
- Disclose “significant amounts” threshold: 5% of expected income tax expense
- $1,000 book income x 21% = $210
- Amount for which disclosure is required for any specific reconciling item: 5% of $210 = $10.5

POLLING QUESTION

Rate Reconciliation Example

- Pre-tax Income of $100,000
- Federal statutory tax rate of 21% (expected income tax expense of $21,000)
- State tax rate of 5%

Adjustments to Book Income:	**Amount**
Permanent:	
M&E	$15,000
Officer's Life Insurance	$10,000
Tax Exempt Interest	($5,000)
Total Perms	**$20,000**
Temporary:	
Depreciation	($10,000)
Total Temps	**($10,000)**
Total Adjustments:	**$10,000**

Step 1: Calculate Current Expense

Current federal income tax expense:

Pre-tax Income	100,000
Total M-1s	10,000
State Current Tax Expense	-5,500
Taxable Income	104,500
Tax Rate	21%
Current Federal Income Tax Expense	21,945

Current state income tax expense:

State Taxable Income	110,000
Tax Rate	5%
Current State Income Tax Expense	5,500

Total Current Expense: $27,745

Step 2: Calculate Deferred Expense

Provision calculation

Deferred federal income tax expense:

Favorable Temporary M-1s	10,000
Less State tax benefit	-500
Tax Rate	21%
Deferred Federal Income Tax Expense	1,995

Deferred state income tax expense:

Favorable Temporary M-1s	10,000
Tax Rate	5%
Deferred State Income Tax Expense	500

Total Deferred Expense : $2,495

Step 3: Calculate Total Tax Expense

Total Tax Expense

Current Tax Expense	$	27,445
Deferred Tax Expense	$	2,495
Total Tax Expense	**$**	**29,940**

Actual Effective Tax Rate

Reported Total Tax Expense	$	29,940
Pre-Tax Book Income	$	100,000
Effective Tax Rate		**29.94%**

Gross/Net State Tax Expense

State Tax Expense		
State – Current Tax Expense	$	5,500
State – Deferred Tax Expense	$	500
Total State Tax Expense	**$**	**6,000**

Net of federal benefit		
Total State Tax Expense	$	6,000
Adjustment for federal benefit (1 – 21%)		79%
State Tax, net of federal benefit	**$**	**4,740**

Step 4: Rate Reconciliation

		Tax Effect in $	Tax Effect in Percentage
Pre Tax Income	100,000	21,000	21%
Permanent Items			
M & E	15,000	3,150	3.15%
Officers' Life Insurance Premiums	10,000	2,100	2.1%
Tax Exempt Interest	(5,000)	(1,050)	(1.05%)
State Tax Expense	6,000	4,740	4.74%
Actual Effective Tax Rate			**29.94%**

Multiply by statutory rate

Divide by pre tax income

POLLING QUESTION

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Financial Statement Disclosures

Objective

Numerous income tax accounting matters require the use of estimates, judgments, and other subjective information that can obscure the presentation in the financial statement accounts

Understand the objective

Clarifying disclosures enable users to gain a better understanding of the reporting entity's income tax environment.

Key Disclosure Items

1. Current tax expense or benefit
2. Deferred tax expense or benefit
3. Total of all deferred tax assets and liabilities
4. Total valuation allowance and net change in valuation allowance during the year
5. Tax rate reconciliation for SEC companies (not required for privately held companies)
6. Income tax contingencies: FIN 48 disclosure (paragraph 21)
7. Amounts and expiration dates of net operating loss and tax credit carry forwards

Report by jurisdiction: federal, state and international

Public companies disclose each item in excess of 5% of total

ASU 2015 - 17

Prior to ASU 2015 -17, GAAP required companies to separate deferred tax liabilities and assets into current and noncurrent amounts.

Stakeholders informed the FASB that the requirement resulted in little or no benefit to users of financial statements because the classification does not generally align with the time period in which the recognized deferred tax amounts are expected to be recovered or settled.

ASU 2015 – 17 simplified the reporting requirements such that all deferred tax assets and liabilities are now classified as non-current.

POLLING QUESTION

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Case Study

Case Study

Utilize the figures generated in Part 1 and 2 of the case study, complete the accompanying financial statements and footnotes. Note that the footnote disclosure is a supplemental handout.

Income Statement

KELLY Corporation
Income Statement
Year ended December 31, 20CY

Net Sales	11,966,120
Cost of Goods Sold	8,486,460
Gross Profit	3,479,660
SG & A Expenses*	2,862,890
Operating Income	616,770
Interest Income	21,050
Other Income	362,180
Income Before Taxes	1,000,000
Income Tax Expense	
Net Income (Loss)	

Income Statement Solution

KELLY Corporation
Income Statement
Year ended December 31, 20CY

Net Sales	11,966,120
Cost of Goods Sold	8,486,460
Gross Profit	3,479,660
SG & A Expenses*	2,862,890
Operating Income	616,770
Interest Income	21,050
Other Income	362,180
Income Before Taxes	1,000,000
Income Tax Expense	291,890
Net Income (Loss)	708,110

Balance Sheet

Current Assets		**Current Liabilities**	
Cash	964,250	Accounts payable	946,610
Accounts Receivable	1,268,190	Income taxes payable	
Inventories	1,346,730	Accrued expenses	125,000
Other current assets	187,780	**Total current liabilities**	
Total current assets	**3,766,950**	Long term debt	1,000,000
Property plant and equip		Deferred tax liability	
Land	659,210	**Total Liabilities**	
Mach and Equip	1,660,000	**Stockholder's Equity**	
Accumulated Depreciation	(590,170)	Common stock	2,150,000
Net PP&E	1,729,040	Additional Paid in Capital	364,000
Deferred tax asset		Retained earnings	880,140
Other assets	75,000	**Total Stockholder's Equity**	3,394,140
Total non current assets			
Total Assets		**Total Liabilities and Equity**	

Balance Sheet Solution

Current Assets	
Cash	964,250
Accounts Receivable	1,268,190
Inventories	1,346,730
Other current assets	187,780
Total current assets	**3,766,950**
Property plant and equip	
Land	659,210
Mach and Equip	1,660,000
Accumulated Depreciation	(590,170)
Net PP&E	1,729,040
Deferred tax asset	36,125
Other assets	75,000
Total non current assets	**1,840,165**
Total Assets	**5,607,115**

Current Liabilities	
Accounts payable	946,610
Income taxes payable	47,440
Accrued expenses	125,000
Total current liabilities	**1,119,050**
Long term debt	1,000,000
Deferred tax liability	93,925
Total Liabilities	**2,212,975**
Stockholder's Equity	
Common stock	2,150,000
Additional Paid in Capital	364,000
Retained earnings	880,140
Total Stockholder's Equity	3,394,140
Total Liabilities and Equity	**5,607,115**

POLLING QUESTION

Thank you!

The information contained herein is not intended be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37 (a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax advisor.

Thank you!

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MERGING TODAY'S TALENT WITH TOMORROW'S OPPORTUNITIES

Accountable Talent, LLC is a professional services firm headquartered in Atlanta, Georgia that provides technical and advisory training. Our mission is to serve companies, professional service firms and individuals by providing a platform that enables today's talent to be better prepared for tomorrow's opportunities.

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