INCOME TAXES

Cross-Reference to CFA Institute Assigned Reading #37

The tax return is prepared to calculate taxes payable to the authorities. Taxes payable result in an outflow of cash from the firm, so firms try to minimize taxes payable and retain cash. This objective is achieved by recognizing *higher* expenses on the tax return, which leads to *lower* taxable income and consequently, *lower* taxes payable.

Financial statements are prepared to report the company's operating performance over the year to shareholders, financial institutions and other stakeholders. For financial reporting purposes, companies try to show healthy performance and profitability. This objective is achieved by recognizing *lower* expenses on the income statement, which leads to *higher* pretax income, and (despite *higher* income tax expense) *higher* net income than on the tax return.

- The **tax base** of an asset or liability is the amount that is recognized on the balance sheet for tax purposes
- The **carrying value** is the amount recognized on the balance sheet for financial reporting.

Determining the Tax Base of an Asset Vol 3, pg 391

An asset's tax base is the amount that will be expensed on the income statement in the future as the economic benefits are realized from the asset. For example, if the historical cost of the asset is $10,000, and $4,000 worth of accumulated depreciation has already been charged against it on *tax returns* over previous years, the asset's tax base equals $6,000. This amount will be depreciated in future periods (expensed on the tax return) as the asset is utilized over its remaining life (economic benefits of the asset are realized).

The carrying value of the asset is simply the historical cost of the asset minus the accumulated depreciation charged against over previous years on the company's *financial statements*.

Determining the Tax Base of a Liability Vol 3, pg 393

Two types of liabilities can result from accrual accounting; unearned revenues and accrued expenses. The *carrying value* of these liabilities is the amount recognized on the balance sheet in the financial statements. The rules for calculating the *tax base* of liabilities are given below.

1. Tax base of accrued *expense* liability = Carrying amount of the liability on the balance sheet (financial reporting) minus amounts that have **not** been expensed for tax purposes yet; but **can** be expensed (are tax-deductible) in the future.

2. The tax base of unearned *revenue* liability = Carrying value of the liability minus the amount of revenue that **has already been taxed**, and therefore, will **not** be taxed in the future.

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Deferred Tax Liabilities

A deferred tax liability usually arises when:

- *Higher* expenses are charged on the tax return as compared to the financial statements.
- Taxable income is *lower* than pretax or accounting profit.
- Taxes payable are *lower* than income tax expense.
- An asset's tax base is *lower* than its carrying value.

Accounting Entries for an Increase in Deferred Tax Liabilities

- Any *increase* in deferred tax liabilities **increases total liabilities** on the balance sheet.
- The increase in deferred tax liabilities is added to taxes payable in the calculation of income tax expense, so it decreases net income, retained earnings and **reduces owners' equity.**

Deferred Tax Assets

A deferred tax asset usually arises when:

- *Higher* expenses are charged on the financial statements than on the tax return.
- Taxable income is *higher* than pretax or accounting profit.
- Taxes payable are *higher* than income tax expense.
- A liability's tax base is *lower* than its carrying value.

Accounting Entries for an Increase in Deferred Tax Assets

- Any *increase* in deferred tax assets **increases total assets** on the balance sheet.
- The increase in deferred tax assets is subtracted from taxes payable in the calculation of income tax expense, so it **increases net income, retained earnings and equity**.

Effects of Changes in Tax Rates Vol 3, pg 395

When tax rates *rise*, the balances of both deferred tax assets and liabilities *rise*. When tax rates *fall*, the balances of both deferred tax assets and liabilities *fall*.

Income tax expense = Taxes payable + Change in DTL - Change in DTA

- If a company has a net DTL (excess of DTL over DTA), a reduction in tax rates would *reduce* liabilities, *reduce* income tax expense, and *increase* equity.
- If the company has a net DTA (excess of DTA over DTL), a reduction in tax rates will *reduce* assets, *increase* income tax expense, and *decrease* equity.
- If a company has a net DTL, an increase in tax rates would *increase* liabilities, *increase* income tax expense, and *reduce* equity.
- If the company has a net DTA, an increase in tax rates will *increase* assets, *decrease* income tax expense, and *increase* equity.

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Temporary versus Permanent Differences Vol 3, pg 397

- Temporary differences arise because of differences between the tax base and carrying amounts of assets and liabilities.
- Permanent differences are differences between tax and financial reporting of revenues and expenses that *will not* reverse at any point in the future. Examples of the items that give rise to permanent differences include:

1. Revenue items that are not taxable.
2. Expense items that are not tax deductible
3. Tax credits for some expenses that directly reduce taxes.

The important thing to remember is that permanent differences do not result in deferred taxes. They result in a difference between effective and statutory tax rates and should be considered in the analysis of effective tax rates. A firm's reported effective tax rate is given by:

$$\text{Effective tax rate} = \frac{\text{Income tax expense}}{\text{Pretax income}}$$

Temporary differences can be divided into two categories:

Taxable temporary differences

Taxable temporary differences result in deferred tax liabilities. They are expected to result in future taxable income. Deferred tax liabilities arise when:

- The carrying amount of an asset *exceeds* its tax base; or
- The carrying amount of a liability is *less* than its tax base.

Deductible temporary differences

Deductible temporary differences result in deferred tax assets. They are expected to provide tax deductions in the future. Deferred tax assets arise when:

- The tax base of an asset *exceeds* its carrying amount; or
- The tax base of a liability is *less* than its carrying amount.

Treatment of Temporary Differences Vol 3, pg 399

Balance Sheet Item	Carrying value vs. tax base	Results in…
Asset	Carrying amount is greater.	DTL
Asset	Tax base is greater.	DTA
Liability	Carrying amount is greater.	DTA
Liabi lity	Tax base is greater.	DTL

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Valuation Allowance Vol 3, pg 403

Deferred tax assets must be evaluated at each balance sheet date to ensure that they will be recovered. If there are any doubts regarding their realization, their carrying value should be reduced to the expected recoverable amount. Doubts regarding realization of deferred tax assets may stem from the expectation of insufficient future taxable income to recover the tax assets (prepaid taxes).

DTA are reduced by creating a contra-asset account known as the **valuation allowance**. An increase in the valuation allowance reduces deferred tax assets. The negative change in deferred tax assets causes an increase in income tax expense. Higher income tax expense translates into lower net income, retained earnings and equity. Subsequently, if the likelihood of realizing deferred tax assets increases, the previous reduction in DTA is reversed by reducing the valuation allowance.

Since the timing and amount of a reduction in value of DTA is rather subjective in nature, analysts should carefully scrutinize these changes. Analysts should also forecast a company's financial performance going forward and determine whether deferred tax assets are likely to be realized.

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	IFRS	U.S. GAAP
ISSUE SPECIFIC TREATMENTS		
Revaluation of fixed assets and intangible assets.	Recognized in equity as deferred taxes.	Revaluation is prohibited.
Treatment of undistributed profit from investment in subsidiaries.	Recognized as deferred taxes except when the parent company is able to control the distribution of profits and it is probable that temporary differences will not reverse in future.	No recognition of deferred taxes for foreign subsidiaries that fulfill indefinite reversal criteria. No recognition of deferred taxes for domestic subsidiaries when amounts are tax-free.
Treatment of undistributed profit from investments in joint ventures.	Recognized as deferred taxes except when the investor controls the sharing of profits and it is probable that there will be no reversal of temporary differences in future.	No recognition of deferred taxes for foreign corporate joint ventures that fulfill indefinite reversal criteria.
Treatment of undistributed profit from investments in associates.	Recognized as deferred taxes except when the investor controls the sharing of profits and it is probable that there will be no reversal of temporary differences in future.	Deferred taxes are recognized from temporary differences.
DEFERRED TAX MEASUREMENT		
Tax rates.	Tax rates and tax laws enacted or substantively enacted.	Only enacted tax rates and tax laws are used.
Deferred tax asset recognition.	Recognized if it is probable that sufficient taxable profit will be available in the future.	Deferred tax assets are recognized in full and then reduced by a valuation allowance if it is likely that they will not be realized.
DEFERRED TAX PRESENTATION		
Offsetting of deferred tax assets and liabilities.	Offsetting allowed only if the entity has right to legally enforce it and the balance is related to a tax levied by the same authority.	Same as in IFRS.
Balance sheet classification.	Classified on balance sheet as net noncurrent with supplementary disclosures.	Classified as either current or noncurrent based on classification of underlying asset and liability.

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