Mastering Accounting for Income Taxes

AIT4/25/V1

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Update on the Tax Landscape and Other Current Events

Update on the Tax Landscape and Other Current Events

Learning objective

After completing this chapter, you should be able to:
- Discuss advanced practice and reporting issues a practitioner currently may encounter.

I. Update on Inflation Reduction Act (IRA) and Secure 2.0 Act

A. The Secure 2.0 Act

On December 20, 2019, The Setting Every Community Up for Retirement Enhancement Act (SECURE 1.0) was signed into law. SECURE 1.0 was the most significant retirement legislation passed in over a decade and included 30 provisions primarily aimed at expanding access to retirement-savings programs. On December 29, 2022, The SECURE 2.0 Act of 2022 (SECURE 2.0) was signed into law as part of The Consolidated Appropriations Act, 2023. It includes over 100 retirement-related provisions.

1. Expanding automatic enrollment in retirement plans

Under pre-SECURE 2.0 rules, enrollment in an employer retirement plan was **optional**. Starting in 2025, SECURE 2.0 **requires** new 401(k) and 403(b) plans to automatically enroll participants in the plans upon becoming eligible at an initial automatic enrollment amount of at least 3 percent but not to exceed 10 percent. For each following year, the automatic enrollment amount is to increase by 1 percent until it reaches at least 10 percent but not to exceed 15 percent.

Employees may opt out of plan participation within 90 days. Exceptions apply for small businesses (10 or fewer employees), new businesses (in business less than 3 years), church plans, and governmental plans. Note that all current 401(k) and 403(b) plans are grandfathered. Although many exceptions apply to the automatic enrollment requirement, it is important to note that this is a significant change, as prior to SECURE 2.0, retirement plans were **permitted, but not required**, to implement automatic enrollment. The SECURE 2.0 automatic enrollment provision is effective for plan years beginning after December 31, 2024.

B. ASU No. 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*

1. Reason for issuance

This ASU was issued to help investors "better understand an entity's exposure to potential changes in jurisdictional tax legislation and the ensuing risks and opportunities." It will allow investors to better assess income tax information that relates to cash flow forecasts and capital allocation decisions and will also aid investors in identifying potential opportunities to increase future cash flows.

2. Entities affected

The ASU affects all entities, public and private, subject to ASC Topic 740.

3. Main provisions

The ASU improves transparency and expands what public and private entities must disclose regarding rate reconciliations, income taxes paid, amounts surrounding the disaggregation of foreign and domestic income before taxes, and income tax expense or benefit from continuing operations disaggregated by foreign, federal, and state. Public entities must disclose specific categories in the rate reconciliation and expand disclosures for all reconciling items that meet a quantitative threshold for items that are greater than or equal to 5 percent of pretax income (loss) by the applicable statutory income rate. Private entities require qualitative, not quantitative, disclosure about categories of reconciling items and tax jurisdictions that result in a "significant difference" between the statutory tax rate and the effective tax rate.

All entities must disclose "the amount of income taxes paid (net of refunds received) disaggregated by federal (national), state, and foreign taxes." They also must disclose "the amount of income taxes paid (net of refunds received) disaggregated by individual jurisdictions in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received)." The ASU also provides that entities must disclose (1) income (or loss) from continuing operations before income tax expense (or benefit), disaggregated between domestic and foreign, and (2) income tax expense (or benefit) from continuing operations disaggregated by federal (national), state, and foreign.

Lastly, the ASU eliminates the requirement for all entities to (a) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months or (b) make a statement that an estimate of the range cannot be made.

4. Effective date

ASU No. 2023-09 is effective for public entities for fiscal years beginning after December 15, 2024; for private entities, the effective date is for fiscal years beginning after December 15, 2025. Early adoption and retrospective application are permitted.

C. The One Big Beautiful Bill Act (OBBBA) of 2025

On July 4, 2025, the One Big Beautiful Bill Act (OBBBA) was signed into law, making several provisions of the Tax Cuts and Jobs Act (TCJA) permanent and introducing new tax changes. The individual income tax system retained the seven-bracket structure (10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent), with income thresholds now indexed for inflation starting in 2025.

OBBBA permanently extended the increased standard deduction introduced under the TCJA. For businesses, OBBBA expanded section 179 expensing by increasing both the dollar limitation and the phase-out threshold for tax years beginning after 2024. The qualified business income deduction under section 199A was also made permanent, removing its prior expiration date.

Another significant provision altered the gain exclusion rules for qualified small business stock under section 1202. For stock acquired after July 4, 2025, partial gain exclusions of 50 percent and 75 percent apply to stock held at least three or four years, respectively. The 100 percent exclusion remains for stock held at least five years. These changes affect long-term capital gain planning and may influence deferred tax considerations under ASC 740 if stock-based compensation or investments are material.

While OBBBA does not directly change the accounting for income taxes under U.S. GAAP, these legislative updates can significantly impact effective tax rates, deferred tax asset realizability, and income tax disclosures, especially in light of the requirements introduced by ASU 2023-09.

Under ASC 740-10, the financial statement effects of tax legislation must be recognized in the reporting period that includes the enactment date. Because the OBBBA was signed into law on July 4, 2025, calendar-year companies must reflect its impacts in their third-quarter 2025 financial statements. All deferred tax assets (DTAs) and deferred tax liabilities (DTLs) must be remeasured using the newly enacted tax rates and provisions expected to apply when temporary differences reverse. These effects are recorded as discrete items in the income tax provision, not spread across interim periods. While many provisions are effective in later years, companies must evaluate whether changes to projections of future taxable income or indefinite-lived DTAs affect valuation allowance assessments as of the enactment date.

II. OECD initiatives

A. The Organization for Economic Co-operation and Development

Headquartered in France, the Organization for Economic Co-operation and Development (OECD) is an international organization that, among other goals, aims to minimize Base Erosion and Profit Shifting (BEPS) as a result of mismatches between the tax systems of different countries. These mismatches generally arise from different countries' approaches to taxation.

Countries generally have either a territorial tax system or worldwide tax system:

a. In a territorial system, income is taxed in the jurisdiction it is earned.
b. In a worldwide system, both domestic and foreign income is taxed, but credits are provided for foreign income taxes paid to avoid double taxation.

As a result of the 2017 Tax Reform, the U.S. has neither a true territorial nor true worldwide system, but rather a "hybrid" system that incorporates attributes from both systems. Prior to the 2017 Tax Reform, the U.S. had a worldwide tax system with the ability to defer foreign earnings until such earnings were repatriated to the U.S. However, when U.S. tax-paying companies reduce taxable earnings in the U.S. through claiming deductions or other mechanisms while shifting profits to low-tax jurisdictions, the U.S. tax base is eroded. While legal, this is generally achieved by transferring taxable income in intangible assets to low or no tax jurisdictions.

Through several of its taxing schemes, but particularly the proposed 15-percent minimum tax on U.S. GAAP earnings the U.S. Congress has sought to reduce the effects of tax rate differential among countries.

B. Existing tax legislation addressing lower-taxed foreign earnings

Two taxing schemes were introduced into the IRC through 2017's Tax Cuts and Jobs Act to address this issue.

Global Intangible Low-Taxed Income, commonly referred to as GILTI, was created through the 2017 Tax Reform as an anti-base erosion provision to ensure that companies pay a minimum level of income tax, irrespective of its origin.

GILTI is calculated regardless of actual dividends paid from foreign subsidiaries. It intends to target income on intangible assets, like copyrights, patents, or trademarks, and discourage companies from using such intellectual property to shift profits out of the U.S.

Generally, the lowest applicable tax rate on GILTI is 13.125 percent after all available deductions, exemptions, and credits. However, it is likely that the effective tax rate for most companies is higher than 13.125 percent.

The TCJA also introduced a new minimum tax on international payments, the Base Erosion and Anti-Abuse, or BEAT tax. The BEAT tax created an alternative tax that was calculated after adding back certain payments made to an entity's subsidiaries in lower-taxed jurisdictions.

The BEAT tax applies to entities with gross receipts over $500M and base erosion payments exceeding three percent of deductible expenses. The BEAT tax rate is five percent for 2018, 10 percent until 2026, and then 12.5 percent. The tax reduces the ability of multinationals to erode U.S. tax base through deductible related party payments. The BEAT tax is imposed when the tax calculated under the BEAT provisions exceeds the entity's regular tax liability, after application of certain credits. The BEAT tax is measured on modified taxable income (taxable income after adding back base erosion payments).

Base erosion payment is a payment to a related foreign person that results in a U.S. tax deduction, resulting in lower taxable income.

So, the topic of global taxation is not new, and neither is the desire for a coordinated approach. These efforts focus on the ways that multinational corporations attempt to reduce their global income:

a. Move revenue and profit to low or no tax jurisdictions (such as the Cayman Islands, Ireland, Bermuda, etc.).
b. Move expenses to high-tax jurisdictions (such as the U.S.)

As we saw, both the GILTI and BEAT tax were designed as part of 2017 TCJA to remedy such movements for U.S. taxpayers. The OECD has taken the lead in coordinating such efforts globally. Legislation to adopt minimum tax stalled in U.S. Congress. The Green Book proposal is to replace BEAT with UTPR.

In July 2021, and updated in February 2023, the OECD reached a framework among its approximately 140 members that constituted two pillars:

a. Pillar 1 – Nexus and profit allocation.
b. Pillar 2 – Global minimum tax rules.

An example of the tax avoidance scheme the OECD is attempting to neutralize is the tax planning strategy known as the "Double Irish," whereby the Irish tax code was modified in such a way that created a significant tax incentive for companies to locate operations in Ireland. The practice has been subsequently discontinued by the Irish government.

The "Double Irish" taxing scheme exploits the different definitions of corporate tax residency in Ireland and the U.S. Ireland taxes companies if they are controlled and managed in Ireland while the U.S. definition of tax residency is based on where a corporation is registered, not managed.

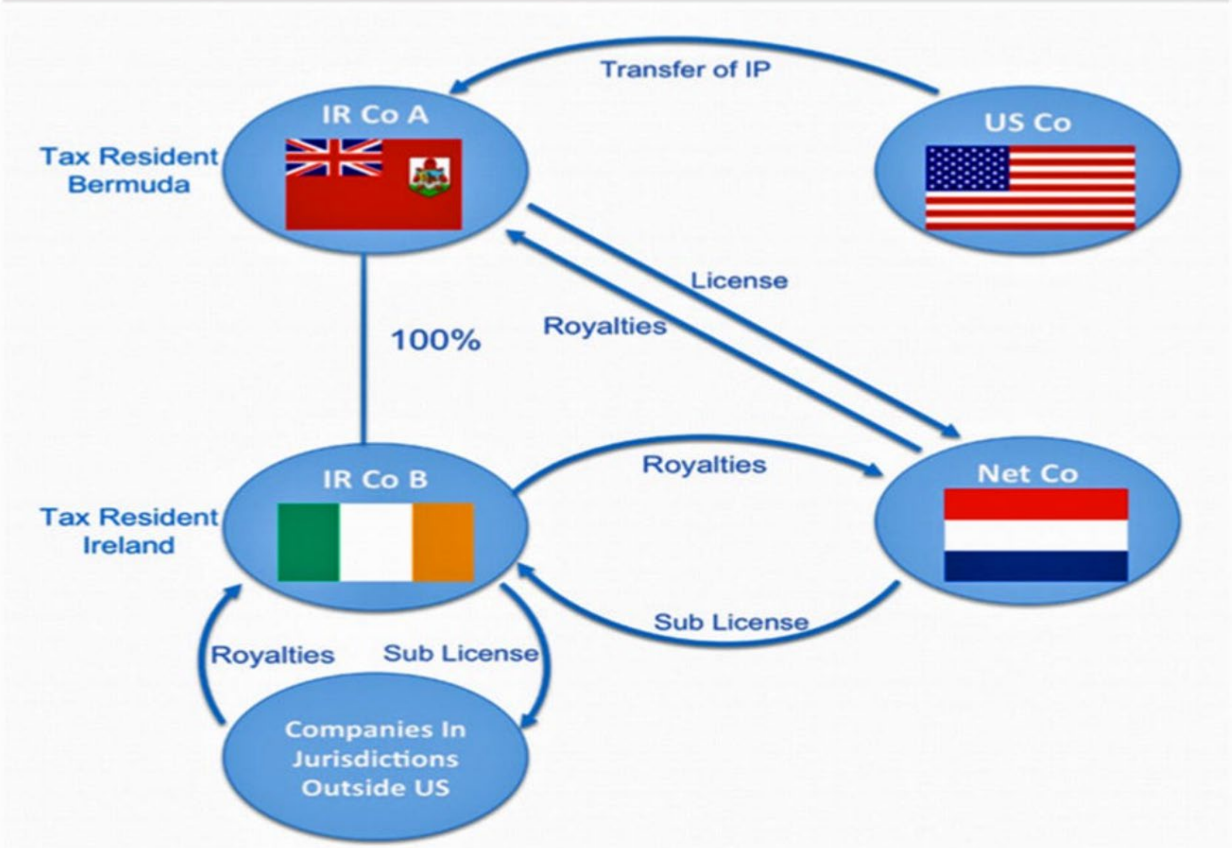
Companies exploiting the “Double Irish” would put their intellectual property into an Irish-registered company that is controlled from a tax haven such as Bermuda. Under the “Double Irish” scheme, Ireland considers the company to be tax-resident in Bermuda, thereby paying little to no income tax on the intangible earnings derived from its intellectual property, while the U.S. considers the entity to be tax-resident in Ireland, thereby not subject to the higher U.S. corporate tax rate.

As a result of this scheme, when royalty payments related to such intellectual property are sent to the company, such payments are not taxed unless or until the money is eventually sent home to the U.S. parent company. As a result, such earnings remained in the Irish subsidiary and were used to fund new or increased operations in Ireland.

Tax law changes in Ireland resulted in the discontinuance of new “Double Irish” arrangements, with existing “Double Irish” arrangements ending in 2020.

The following diagrams detail the cash flows associated with the “Double Irish” scheme, with the intellectual property earnings also being transferred to the Netherlands, another low-tax jurisdiction.

Exhibit 1: Illustration of the double Irish and Dutch sandwich



Source: Pearse Trust, Morgan Stanley Research

C. OECD/Global 20 inclusive framework

It is schemes like the “Double Irish” that the OECD is attempting to address wholistically.

The 141 member countries of the OECD have been working to reach an agreement on global taxation. The OECD members believe a global approach to corporate taxation is necessary due to the following:

a. The digitalization of the economy has increased the significance of intellectual property and its taxation.

b. Determination of nexus – Unlike a plant or distribution center, intellectual property is very fungible, being easily located, and relocated for legal and tax advantage.

Almost all members of the OECD agreed to its framework, including the U.S., although the U.S. still has not adopted the framework.

Let’s discuss these two pillars in greater detail.

1. Pillar 1 – Nexus and profit allocation rules

Nexus is a relationship between a taxing authority, such as a state, and a business. A nexus must exist before a taxing authority can impose a tax on the enterprise, and it requires that there be a substantial link between the jurisdiction and the business. Per the U.S. Constitution, nexus requires substantial presence, with nexus generally being interpreted as the entity requiring a physical presence, such as the entity’s having any of the following:

a. Maintaining an office;

b. Employing workers; and/or

c. Storing products or supplies in a warehouse.

In the brick-and-mortar economy, determining nexus, given the above examples, was generally fairly straightforward. However, determining nexus is more challenging in the digital economy, where there is a separation between physical presence and operations, such as in the case of online sales.

The U.S. Supreme Court changed its consideration of nexus in its South Dakota vs. Wayfair decision, which held that states could tax online sales on purchased goods that had no presence in the state.

So, the current changes in the global economy, as well as the changing legal environment have complicated the determination of nexus for income tax purposes for companies that not only operate in different countries, but in different states as well.

Nexus is typically created for income tax purposes if an entity meets any of the following criteria:

a. Derives income from sources within the state;
b. Owns or leases property there;
c. Has employees there who are engaged in activities that exceed "mere solicitation"; and/or
d. Has capital assets or property located there.

Multinational corporations establish nexus in low-tax jurisdictions by creating subsidiaries to house their intellectual property. They route transactions and income through low-tax jurisdictions, thereby paying little to no income tax on the royalties paid on their intellectual property. This was the approach used by Ireland with its "Double Irish" scheme.

2. Pillar 2 – Global minimum tax (GMT)

Pillar 2 of the OECD's proposal would create rules that ensure large, multinational businesses pay a minimum effective tax rate of at least 15 percent. This proposal would be applicable to companies with consolidated revenues of at least 750 million euros (835 million USD) in at least two of the prior four years, with countries being able to apply lower threshold to groups headquartered in their countries.

The proposal states that income inclusion rule (IIR) and undertaxed payment rule (UTPR) will be used for "top-up" taxes, with the effective tax rate calculations based on financial statements (book income), and the following adjustments:

a. 5 percent return on tangible assets and payroll.
b. 7.5 percent in five-year transition period.

Pillar 2 of the OECD would also, subject to local tax law, allow limited course taxation on related party interest, royalties, and a defined set of other payments.

3. Recent updates to Pillar 2

In June 2025, a major development occurred when the G7 nations – including the United States – reached a finalized agreement that exempted U.S.-parented multinational groups from the application of the Pillar Two Income Inclusion Rule (IIR) and the Undertaxed Profits Rule (UTPR). This exemption was granted in recognition of the U.S. domestic minimum tax regimes, including GILTI and the Corporate Alternative Minimum Tax (CAMT). As a result, the U.S. formally withdrew its earlier proposal to replace the Base Erosion and Anti-Abuse Tax (BEAT) with the UTPR, and the existing BEAT framework remains in place for now. However, companies should continue to monitor for further developments as the OECD and U.S. Treasury coordinate efforts to align domestic and global tax regimes. While these changes do not currently impact deferred tax accounting under ASC 740, they may influence future disclosures and effective tax rate planning for multinational corporations.

Overview of ASC Topic 740 – Income Taxes

Overview of ASC Topic 740 – Income Taxes

Learning objectives

After completing this chapter, you should be able to:
- Recall the scope of ASC Section 740;
- Recall attributes of taxes that are not based on income;
- Identify issues related to state income taxes;
- Recall the overall objectives of accounting for income taxes;
- Identify other issues related to accounting for income taxes;
- Identify the overall objective of accounting for taxes on income; and
- Recall the basic principle of accounting for income taxes and relevant exceptions.

I. Executive summary

Accounting for income taxes continues to be one of the more challenging areas of financial accounting. Though the standard that comprises most of the ASC Topic on Accounting for Income Taxes, Topic 740, has been applicable since the early 1990s, its complexity continues to challenge virtually all entities that apply it. Deficiencies in applying the standard continue to be a leading source of material weaknesses in audits of internal controls over financial reporting.

The reasons for these difficulties are many, with the greatest being the underlying complexity of the tax schemes for which Topic 740 is attempting to account. Taxes on income inherently incorporate political overtones. The rules on which they are based are generally very detailed and rule based, often requiring significant time and effort to determine the amount of income subject to taxation. Given this complexity, the final amount due to the taxing authorities is often not known under several years after the end of the tax year, due to the need for audits and reviews by the tax authorities. Such reviews are an ongoing feature at many larger, multinational corporations and even consume a large amount of time at many smaller entities.

Further complicating the accounting for income taxes is the multiple taxing jurisdictions that tax an entity's income. Based on the complexity of the tax scheme, when applying the guidance of Topic 740, entities must first determine whether accounting for the taxing scheme is even under the scope of Topic 740. Next, entities must deal with the various taxing approaches that each jurisdiction, be it either state or federal in the U.S. or other jurisdictions for entities operating internationally, implement.

Further complicating this assessment is the wide use of administrative regulation and litigation used by tax authorities to implement their tax schemes. For example, in addition to applying the U.S. Tax Code, itself a daunting feat, an entity must apply the implementation rules promulgated by the U.S. Internal Revenue Service (IRS) as well as any legal precedents established by the large amount of litigation that generally accompanies tax enforcement; and this effort must be replicated for each taxing jurisdiction.

In addition to the underlying complexity of the tax code itself, the guidance in Topic 740 is itself very complex, with detailed rules on such topics as valuation allowances, interim reporting of tax liabilities, and intraperiod allocations, just to name a few.

The enactment of the OBBBA in July 2025 introduced multiple tax law changes that entities must reflect in their financial statements under ASC 740. Notably, the legislation altered interest deduction rules, restored 100 percent bonus depreciation, and permitted immediate expensing of R&D costs – each of which may significantly impact temporary differences and valuation allowance assessments. Additionally, the effective date of ASU 2023-09 (enhanced income tax disclosures) will require public business entities to include expanded reconciliations and cash tax payment disclosures beginning with 2025 reporting. Nonpublic entities follow in 2026. These changes increase the importance of accurate deferred tax measurement and disclosure under Topic 740.

Our goal in this course will be to provide an overview of the basic model for accounting for income taxes under Topic 740. Our topics will include the following:

a. An overview of the Topic 740 Accounting for Income Taxes model;
b. Temporary differences;
c. Recognition and measurement of income tax expense/income and related income tax assets and liabilities, including the determination of the need for valuation allowances;
d. Accounting for changes in tax laws, rates, and tax status;
e. Intraperiod allocations; and
f. Presentation and disclosure.

Then, we will take a look at an area of financial accounting where accounting for the income tax effect of the transaction is very prominent, stock-based compensation.

We will wrap up with a review of the accounting for uncertain tax positions and interim reporting before concluding with a quick review of some of the proposed changes in accounting for income taxes and related disclosures.

Accounting for income taxes can be very complex. Our goal is to give a general overview of the basic module under Topic 740. Certain types of complex transactions that impact income taxes, such as recording business combinations as well as certain “inside-outside” basis differences, given their more limited applicability, will not be discussed in this course.

Let us start with a review of the overall accounting model for accounting for income taxes under Topic 740.

II. Scope of Topic 740

The scope of Topic 740 applies to all entities, including not-for-profits (NFPs) in accounting for income-based tax structures, including those of domestic, foreign, state, and local tax jurisdictions. Additionally, Topic 740 applies to all entities that are part of the reporting group. For example, the reporting group of an NFP entity may contain a for-profit subsidiary. Even though the consolidated entity is not subject to income taxes, the accounting for the income tax expense and related balance sheet accounts of the for-profit subsidiary should be included in the consolidated entity’s results.

However, there are several types of taxes that are exempt from the accounting guidance of Topic 740, including franchise taxes based on capital (though a franchise tax based on income would be in scope) and a withholding tax for the benefit of the recipient of a dividend. If a tax is based on the higher of a capital-based franchise tax or an income tax, Topic 740 would apply for the tax in excess of the franchise tax.

While seemingly straight forward guidance, questions concerning the applicability of Topic 740 do arise. For example, taxes on gross receipts, if defined as just revenues, would not be in the scope of Topic 740, while taxes on "modified gross receipts" based on revenue less certain expense adjustments, would be considered an income tax and subject to Topic 740.

As taxing jurisdictions continue to create new and varied ways of taxing entities, you should continually assess all new taxes or changes to current tax laws to ensure that Topic 740 applies when accounting for the tax.

The form of the legal entity also needs to be assessed to determine if Topic 740 applies. Certain entities, by their structure are not subject to income tax, at least at the U.S. Federal level. These include limited liability corporations, partnerships, and real estate investment trusts (REITS) and regulated investment companies (RICs) if they meet certain requirements. You should understand the legal structure of each entity in the reporting group and its related taxes applicable to it when determining whether Topic 740 applies. Similarly, these types of entities are the ones that frequently challenge tax determinations in court, requiring that you also keep up to speed on the relevant case law that exists with regard to taxing these entities.

Lastly, remember to make this assessment for all jurisdictions, including states, as the conclusion reached for an entity may differ by taxing authority and jurisdiction.

III. Objectives and basic principles of accounting for income taxes

While complex in its application, the objectives of Topic 740 are fairly straight forward. Using the balance sheet approach, an entity should perform the following:

a. Recognize taxes payable or receivable in current year; and
b. Recognize deferred taxes payable or receivable for tax consequences of events that have been recognized in entity's financial statements or tax return.

The amount of current tax expense would consist of the amount paid during the year, increased, or decreased by the amount of the income tax currently payable or receivable. This amount would be taken directly from the entity's current year income tax return.

For example, if the entity paid $1,000,000 in taxes during the year and accrued an additional liability for its current taxes due of $250,000, its current income tax expense for the year would be $1,250,000.

A deferred tax liability or asset would represent the future tax effects of temporary differences or carryforwards. The tax effects of these future taxable items must be calculated using the tax rates in the enacted law as of the balance sheet date. Entities must reflect changes from recent tax legislation, such as the OBBBA, in the period of enactment. However, deferred tax assets, representing the future tax benefits from the reversal of temporary differences, would be reduced by any benefit that is not expected to be realized. Deferred income tax expense or benefit for the period consists of the change in the deferred tax balance sheet accounts from the beginning of the year to the end of the year.

For example, an entity may take accelerated depreciation as a credit on its current year income tax return, thus reducing its current year tax liability. However, the reversal of this deduction in future years would result in greater taxable income, and thereby income tax expense in later years. While over the depreciable period, these differences will equal out, in the year of the excess benefit for tax, the entity would record a deferred tax liability in the amount of the excess of the tax deduction over the book depreciation expense, multiplied by the currently exacted tax rate.

Similarly, an entity may receive cash for a good or service in the current year, with the amount received being subject to income tax in that period. However, the entity may not report that cash as revenue, and thereby as income, until a later period for book accounting purposes. In this instance, the entity would record a deferred tax asset in the amount of the excess income recorded for tax purposes over that recorded for book purposes, multiplied by the currently enacted tax rate. Next, the entity would need to determine if this tax benefit would be realized in future years by its having sufficient taxable income against which to offset this benefit. If not, the entity would not record the benefit in the current year. We will discuss such valuation allowances later in the course.

Note that prior legislation, such as the Tax Cuts and Jobs Act (TCJA), required certain entities to conform their book and tax accounting policies for revenue recognition. More recent legislative changes under OBBBA may further affect the book-tax conformity rules, which could reduce or alter the timing of temporary differences. We will discuss this change further later in the course.

IV. Exceptions to the basic principles

One of the challenges in applying Topic 740 is the existence of exceptions to these basic principles. Often these exceptions are driven by provisions in the underlying tax law itself. We will talk about a few of these exceptions now.

Topic 740 states that deferred taxes should not be recognized for certain specified temporary differences unless it becomes apparent that the difference will reverse in the foreseeable future. Perhaps the most common example of such a situation would be the excess of the book over tax “outside basis” difference in an entity’s investment in a foreign subsidiary.

To step back, “basis” is the value of an asset to be used when determining its gain or loss when it is sold. The book basis of an asset, such as an investment in a foreign subsidiary, for U.S. tax purposes, would be its GAAP accounting book value, while its tax basis would be determined by applying applicable tax laws. For book purposes, the basis of an entity’s investment in a foreign subsidiary would increase or decrease based on the subsidiary’s current year earnings as well as other factors. However, its tax basis could differ. For example, the taxpaying entity’s tax basis of such an investment would not be adjusted for the subsidiary’s current year earnings if the subsidiary does not remit those earnings back to the taxpaying entity in the form of a dividend.

If such earnings are deemed to be permanently reinvested in the subsidiary, no deferred taxes would be recorded on this outside basis difference. While the tax on this basis difference would eventually be paid if the subsidiary is sold, the income that drives the difference is not taxable until the subsidiary is sold, or the profits are remitted to the parent. Accordingly, no deferred taxes are recorded on the earnings of the subsidiary if certain conditions are met.

Such unremitted earnings are why some extremely profitable entities have an effective tax rate that is much below the statutory rate in the U.S. These entities earn a portion of their income in foreign jurisdictions which have lower income tax rates than that of the U.S. As long as they do not remit those earnings, they are only taxed at the lower foreign rate, resulting in an overall lower effective tax rate for the consolidated entity.

With TCJA, the U.S. moved to a territorial system of taxation through the introduction of a 100 percent dividend-received deduction for certain foreign earnings. Under OBBBA, additional international tax reforms further reduced the tax inefficiencies of repatriating foreign income. While these provisions limit U.S. tax on foreign earnings, entities must continue to assess whether outside basis differences exist in foreign subsidiaries and whether an assertion of permanent reinvestment remains supportable under current law.

Additionally, given that OBBBA reduced the benefit of deferring repatriation even further, entities previously asserting permanent reinvestment may need to reevaluate those positions in light of the current economic and legal environment.

While an assertion of permanent reinvestment under ASC 740-30-25-17 is still permitted, entities must support the position with robust documentation. Recent enforcement trends and interpretations emphasize contemporaneous evidence, and this assertion may be less defensible in light of recent international tax law changes.

Another exception to the basic Topic 740 rules relates to leveraged leases. Entities enter into these extremely complicated transactions in order to specifically obtain certain tax benefits. While the leverage lease accounting designation has been discontinued under Topic 842, the current leverage leases are grandfathered.

A further exception to the basic Topic 740 accounting model relates to non-deductible goodwill. As background, certain goodwill, that which is acquired by an entity, is amortizable and thereby deductible for tax purposes while other, created goodwill, is not deductible. No deferred tax liability is recorded for non-deductible goodwill, as, under accounting for business acquisitions, its recording would merely increase the amount of goodwill recorded as a result of the transaction, thus resulting in further goodwill.

There are other similar though less frequently occurring events that are also exceptions to the general principles of Topic 740 which we will not discuss further in this course.

V. Other considerations in accounting for income taxes

In wrapping up this chapter, let us discuss a few other aspects of the Topic 740 accounting model.

Though it may take years for temporary differences to totally reverse, Topic 740 specifically prohibits entities from discounting deferred tax assets or liabilities. Discounting such amounts would add much more complexity to an accounting model that is already complex enough.

Entities with global operations must assess the implications of OECD Pillar Two minimum tax legislation, particularly for jurisdictions that have enacted local rules. While the U.S. has not adopted Pillar Two directly, the G7 agreement finalized in June 2025 exempts U.S.-headquartered multinationals from Pillar Two's Income Inclusion Rule and Undertaxed Profits Rule due to the existence of GILTI and CAMT. However, financial statement disclosures may still be required under ASC 275 and ASC 740-10-50 if local legislation has material effects on expected tax obligations or deferred tax realizability.

OBBBA introduced rate adjustments and structural changes that may trigger significant deferred tax remeasurements, leading to volatility in effective tax rates for affected entities. For example, the impact on deferred taxes of accounting for changes in tax rates or even new tax laws could introduce great volatility into the calculation of an entity's effective tax rate in the year of the changes. Further, a change in the assessment of the need for a valuation allowance against deferred tax assets could also add volatility to the effective rate calculation. While explainable, entities will need to effectively disclose the occurrence of such events in the financial statements.

In July 2025, the IRS issued Notice 2025-27, clarifying how large corporations determine their applicable status under the Corporate Alternative Minimum Tax (CAMT). Under this guidance, domestic corporations with average AFSI below $800 million (or $80 million for members of a foreign-parented multinational group) may qualify for a simplified safe harbor test and avoid CAMT classification. While CAMT remains a current-period tax and does not generate deferred tax liabilities under ASC 740, it may produce credit carryforwards that generate deferred tax assets and influence valuation allowance assessments.

As the generation of deferred balances arises from temporary differences, we will explore the causes of and accounting for temporary differences in depth in our next chapter.

VI. Applying the learning

Answer the following questions concerning the basic principles of Topic 740 as either True or False.

1. ______ When computing deferred tax assets or liabilities, entities should use the tax rates that they expect to be in effect when the temporary difference reverses.

2. ______ An entity would look to its tax return to determine the amount of current income tax payable or receivable.

3. ______ An entity would record a valuation allowance when it believes it will not realize a future deferred tax benefit.

4. ______ The scope of Topic 740 includes accounting for income taxes assessed by U.S. jurisdictions but not by non-U.S. jurisdictions, which apply the guidance in Topic 750.

5. ______ An investment's basis is the amount that an entity would use when determining the gain or loss when selling the investment.

6. ______ Accelerated depreciation used for tax purposes would result in a deferred tax liability being recorded for the excess of the tax deduction for depreciation over the GAAP expense for depreciation.

7. ______ Entities can discount deferred tax liability and asset balances if the reversal of the temporary differences that create them will occur over a five-year or greater period.

8. ______ Deferred tax benefit or expense for a given year would consist of the change in the deferred tax accounts between the beginning and end of the year.

VII. Applying the learning – Solution

1. __F__ When computing deferred tax assets or liabilities, entities should use the tax rates that they expect to be in effect when the temporary difference reverses.

2. __T__ An entity would look to its tax return to determine the amount of current income tax payable or receivable.

3. __T__ An entity would record a valuation allowance when it believes it will not realize a future deferred tax benefit.

4. __F__ The scope of Topic 740 includes accounting for income taxes assessed by U.S. jurisdictions but not by non-U.S. jurisdictions, which apply the guidance in Topic 750.

5. __T__ An investment's basis is the amount that an entity would use when determining the gain or loss when selling the investment.

6. __T__ Accelerated depreciation used for tax purposes would result in a deferred tax liability being recorded for the excess of the tax deduction for depreciation over the GAAP expense for depreciation.

7. __F__ Entities can discount deferred tax liability and asset balances if the reversal of the temporary differences that create them will occur over a five-year or greater period.

8. __T__ Deferred tax benefit or expense for a given year would consist of the change in the deferred tax accounts between the beginning and end of the year.

Temporary Differences Under ASC Topic 740

Temporary Differences Under ASC Topic 740

Learning objectives

After completing this chapter, you should be able to:

- Recall what a temporary difference is; and
- Apply accounting for basic temporary differences.

I. Executive summary

Temporary differences are those items that are recognized in the financial statements of an entity at a different time than when they are included in the entity's tax return as either revenue or expense. As such, they are the basis of the calculation of deferred taxes under the balance sheet approach of Topic 740. An entity records either a deferred tax benefit or expense for the future impact on income taxes payable when these temporary items are ultimately included on the entity's tax return or financial statements, whatever the case may be.

A temporary item whose reversal will result in additional taxable income on the tax return generates deferred tax liabilities while a temporary item whose reversal will result in a reduction of taxable income will result in a deferred tax asset.

Given the number of differences between GAAP accounting rules and the various tax codes where entities operate, many entities have numerous temporary differences, which results in a very complex calculation of deferred taxes. The determination of deferred taxes for entities that operate in multiple taxing jurisdictions is that much more challenging, as is the determination of taxable income from foreign subsidiaries.

In the section, we will review some of the largest drivers of temporary differences that most entities will face. We will also review the basic accounting model under Topic 740 in accounting for the deferred taxes related to temporary differences. However, your entity may experience other temporary differences that are not discussed here. If that is the case, just remember to apply the same basic principles, understand the differences between the applicable tax treatment and book treatment of the transaction, and determine when the temporary difference will reverse. This basic approach should allow you to account for most temporary differences which you will face.

II. Common temporary differences

The underlying assumption in accounting for temporary differences under Topic 740 is that the differences between taxable income and GAAP pre-tax income will reverse. If the difference will not reverse, the difference is not a temporary difference, and no deferred taxes need to be recorded for the difference. Examples of such differences would be interest income on tax exempt investments, and goodwill that is deductible for tax purposes but not for book purposes. These items are deemed permanent differences and factor into the reconciliation between the statutory tax rate that the entity is subject to and the effective rate it actually pays (determined by dividing income tax expense calculated under Topic 740 by pre-tax income, determined on a GAAP basis). As with all items related to income tax accounting, it is vital to have a strong understanding of the underlying tax law in the jurisdictions in which the entity operates.

Now let us focus on the nature of those differences that will actually reverse.

Topic 740 lists eight common temporary differences. The first four relate to pure timing differences between including the revenue or expense related to a transaction in taxable income as opposed to recognizing them for book purposes. As these are the most common temporary differences for most companies, we will focus most of our efforts on understanding the accounting for the following:

a. **Revenues or gains that are taxable after they are recognized in the financial statements.** For example, an installment sale where revenue is recognized for book purposes when the sale occurs but is recognized for tax when the cash is received. This would result in a deferred tax liability. As we will discuss later, the Tax Cuts and Jobs Act will, in certain circumstances, require entities to conform their book and tax revenue recognition policies.
b. **Expenses or losses that are deductible after they are recognized in financial income.** An example would be a warranty liability which is recorded for book purposes on an accrual basis but recorded on a tax basis when the warranty amount is paid. This would result in a deferred tax asset.
c. **Revenues that are taxable before they are recognized in the financial statements.** An example would be an advance payment for such an item as a magazine subscription. Such an item would result in a deferred tax asset.
d. **Expenses or losses that are deductible before they are recognized in the financial statements.** Probably the best-known example of this temporary difference, as well as the one that generates the largest deferred tax liability in the financial statements of entities with significant capital bases is depreciation. This is due to the accelerated depreciation that the tax code allows, which generally results in much quicker depreciation of fixed assets than for book purposes.

The last four are of a more specialized nature, resulting in differences between the book and tax basis of assets and liabilities that reverse when the asset is recovered or the liability is settled. These situations may not be applicable to many entities, as they arise from very specific circumstances:

a. **A reduction in the tax basis of depreciable assets because of tax credits.** Because of the credit, there is a difference between the book and tax basis of the asset upon its acquisition, which will be taxable when the asset is recovered.
b. **Investment tax credits accounted for on the deferral method.** This specific deferral method results in a tax deduction when the asset is recovered.
c. **Increase in the tax basis of assets because of indexing whenever the local currency is the functional currency.**
d. **Basis differences due to the accounting for a business combination.** The differences will result in a taxable event when the reported amounts of the assets and liabilities are recovered and settled, respectively.

Note that while the accounting for uncertain tax positions impacts the accounting for deferred taxes, we will discuss the specifics of accounting for such items separately in the course.

Also, with the applicability of ASC Topic 606, *Revenue from Contracts with Customers*, entities may see changes in the timing of their revenue recognition. Such timing differences could result in a related deferred tax impact when accounting for revenue under Topic 606. Further, when adopting the new accounting guidance, entities will need to determine the impact on deferred taxes when using the modified retrospective approach.

A. Other types of transactions generating deferred tax assets or liabilities

While the above transactions are common examples of temporary differences due to timing and basis differences, there are many other examples of such differences.

Here are a few other transactions that drive such differences.

1. Debt instruments

Book and tax basis differences can occur with certain types of debt instruments. This is due to both the manner in which the liability is expected to be settled and whether settlement is within the entity's control.

For example, assume an entity issues contingently convertible debt that is convertible into common stock when the entity's stock price reaches a certain threshold. Federal tax law allows an entity to elect to deduct a different amount of interest expense than that paid to bond holders. It can elect to deduct interest equal to that of comparable fixed-rate, nonconvertible debt. The entity would thereby be recording additional interest expense for tax purposes than for book purposes. However, this excess is recaptured if the debt is retired or converted to stock with a value of less than the adjusted tax basis of the debt. As the reversal that triggers the recapture is not within the control of the entity, it should provide deferred taxes on this difference. We will compare this treatment to that for the remittance of foreign earnings a bit later in this section. The concept of control is essential in determining whether deferred taxes should be recorded for the reversal of a temporary difference or not.

There are similar other complex debt transactions where the deductibility of interest is based on the outcome of a future event. If your entity has one of these types of debt instruments, it is vital to have a strong understanding of the applicable tax law in order to determine the proper accounting for all payments made to bond holders, including interest payments.

2. Accelerated depreciation

As we discussed in our earlier discussion of common temporary differences, differences in the timing of depreciation expense for book and tax purposes drive the generation of large deferred tax liabilities at many entities. For U.S. Federal tax purposes, the Internal Revenue Service (IRS) uses the modified accelerated cost recovery system (MACRS) to determine depreciation expense. Under MACRS, there are two depreciation schemes, the general depreciation system (GDS) and the alternative depreciation system (ADS). Most entities will use the GDS system as ADS applies in only certain identified situations.

Under GDS, an entity will depreciate most of its fixed assets using either a 150 percent or 200 percent declining balance approach which can yield substantially more depreciation expense for tax purposes than for book in the early years following the acquisition of the asset, as many entities use a straight-line method. Further, the useful life categories used in the MACRS system are generally shorter than those which an entity will use for book purposes, resulting in a further acceleration of depreciation expense for tax purposes. The net effect of this acceleration are temporary differences that will reverse over the depreciable life of the fixed asset. Given the magnitude of fixed asset purchases for many entities, especially manufacturers and other capital-intensive industries, the deferred tax liabilities that these types of entities record can be large.

In addition to the tax benefits available under MACRS, an entity may also elect a §179 deduction for its purchase of certain qualifying fixed assets. The One Big Beautiful Bill Act (OBBBA), enacted in 2025, permanently expanded the §179 deduction and investment limitation thresholds for tax years beginning after 2024. These increased thresholds are indexed for inflation and continue to allow eligible taxpayers to fully deduct the cost of qualifying property in the year of acquisition. Although this accelerates the tax benefit, the deduction still creates a temporary difference compared to book depreciation, resulting in a deferred tax liability under ASC 740.

3. Stock-based compensation

The accounting for both the fair value of stock-based compensation awards and its related tax consequences can be complex. We will discuss these in detail later in the course. However, as an overview, an entity records a book expense for the fair value of the award over the award's vesting period. As this expense, with certain exceptions, will not be deductible for tax purposes until the award is exercised, this timing difference between the recording of the book and tax expense results in a temporary difference that must be accounted for under Topic 740. Since the book expense will generate a future tax deduction, the net result is the recording of a deferred tax asset.

Complicating the recording of the income tax effects of these transactions is that the amount of the tax deduction is based on the value of the award at exercise, which will almost always be a different amount than the book expense. This difference drives the creation of the windfall tax pool, which is used to smooth out the effect of these differences on income tax expense. Recently issued FASB ASU No. 2016-09 has resulted in changes to the accounting model for windfall tax excesses and short falls. This update will make the accounting for such excesses and short falls easier once the Update is effective.

4. Foreign earnings

Prior to the effective date of the Tax Cuts and Jobs Act, one major difference between U.S. corporate tax law and that of most other countries is that the U.S. taxes entities on their global earnings while other countries tend to tax corporations on just the profits generated within their tax jurisdictions. U.S. corporate taxpayers can take a credit for the taxes paid to the foreign jurisdiction when paying their U.S. taxes on these earnings. Further, they are taxed on these profits only when they are remitted back to the U.S.

Accordingly, for U.S tax paying entities, such earnings generate temporary differences between book income and that for tax purposes, for which deferred tax liabilities should be established. This occurs because the remittance of the earnings will generate future taxable income.

However, if an entity pledges to permanently reinvest these earnings in the foreign subsidiary and not remit the earnings to the U.S., then these differences do not represent temporary differences, as the earnings will never be remitted back to the U.S. and thereby never taxable. No deferred taxes would be recorded by an entity making this permanent reinvestment assertion. This is another example of where the actions of the taxpaying entity can determine whether a temporary difference exists related to a transaction. This highlights that it is important to understand management's intention with regard to not only remittance of foreign earnings, but all strategic decisions of management in order to advise them of the tax consequences of such actions.

As stated, even after the passage of the Tax Cuts and Job Act, entities will still need to account for differences between the book and tax basis of foreign subsidiaries, though such basis differences will likely be much smaller.

Entities may still assert that foreign earnings are permanently reinvested under ASC 740-30-25-17, but doing so now requires strong and well-documented support. Regulators increasingly expect contemporaneous evidence to justify the assertion, making it harder to defend, especially as global tax rules evolve. Developments such as the OECD's Pillar Two minimum tax and the ongoing application of GILTI have increased scrutiny. Although ASC 740 does not require deferred taxes for Pillar Two top-up taxes, entities must evaluate whether disclosure is necessary when the impact is material. Additionally, OBBBA did not eliminate the need to evaluate GILTI inclusion impacts or foreign tax credit limitations. While ASC 740 continues to prohibit deferred tax recognition for GILTI unless an accounting policy election is made, entities should consider enhanced disclosures when exposure to GILTI or foreign minimum tax regimes is material, particularly in light of increased transparency requirements and the global shift toward minimum effective tax standards.

In March 2025, the OECD released updated administrative guidance confirming that Pillar Two top-up taxes are not treated as income taxes under IAS 12 or ASC 740. Therefore, these taxes do not give rise to deferred taxes. However, entities operating in jurisdictions implementing Pillar Two must evaluate whether additional qualitative or quantitative disclosures are required under ASC 740. If exposure to top-up taxes is material, entities should disclose the potential impact on future cash flows, effective tax rate, and tax strategy.

Although the FY 2025 Green Book originally included a proposal to replace the Base Erosion and Anti-Abuse Tax (BEAT) with a Pillar Two-aligned Undertaxed Profits Rule (UTPR), that replacement has not been enacted. Importantly, prior proposals for a retaliatory "revenge tax" under section 899 were formally withdrawn in June 2025 following a G7 agreement exempting U.S.-based multinationals from Pillar Two. As a result, BEAT remains effective at its current rate, and companies should continue to treat BEAT as a current-period tax under ASC 740 – not a deferred tax concern – while monitoring any future legislative changes.

III. Accounting for temporary differences

As you can see, identifying temporary differences can be complex; accounting for them can be as well. We will now review the basic approach for doing so.

The key in accounting for temporary differences is to determine the book and tax bases for all assets and liabilities. These bases differences should be scheduled out until the book and tax basis of the asset or liability are the same. Remember, if they will never be the same, then the differences are not temporary differences under Topic 740. Differences between the two should be evaluated to determine if they result from temporary differences. If so, the difference should be multiplied by the currently enacted tax rate that is expected to be applicable at the time when the temporary difference reverses. This would be performed for all years in the analysis. This amount represents the deferred tax asset or liability for that account in that particular tax jurisdiction. There are complex netting rules that must be followed to determine the financial statement presentation of these deferred tax amounts; plus, the deferred tax amounts can be classified as either current or long-term, based on certain rules. ASU No. 2015-17 requires public entities and permits all other entities to present all deferred tax assets and liabilities as noncurrent on the balance sheet. This change simplifies the classification requirements under ASC 740 and eliminates the need to allocate deferred taxes between current and long-term categories.

Previously, if an entity reported a loss in continuing operations but income in other components (such as other comprehensive income), a special exception limited the tax benefit that could be allocated to continuing operations. ASU 2019-12 removed this exception. Now, total tax expense or benefit is first allocated to continuing operations without restriction, and any remaining amounts are then allocated to other components.

While the book balance sheet can be generated from the entity's GAAP financial statements, a separate balance sheet must be generated for each tax jurisdiction, as deferred tax amounts are determined at the legal entity and taxing jurisdiction level. While challenging, nonetheless this information should be available from the entity's general ledger and/or consolidation financial reporting system or a separate tax reporting system.

However, such tax-basis balance sheets require a detailed understanding of the tax law in each taxable jurisdiction. Based on the complexity of an entity's operations, this will require both experts in the tax laws of each jurisdiction as well as tax accounting financial reporting systems that prepare account level financial results based on the tax legislation in each jurisdiction in which the entity operates.

A further complication can occur when enacted tax laws have different rates for different tax years. This may result when tax legislation introduces a tax rate that will take effect at some point in time in the future. Additionally, this situation may apply when a tax rate or tax credit expires at a point in time in the future.

ASC 740-10-30-8 states that the deferred tax asset or liability should be measured using the enacted tax rate expected to apply to taxable income in the period in which the deferred tax asset or liability is expected to be settled or realized. Accordingly, the deferred taxes could be recorded at different tax rates, depending on the enacted rate for each year in which the temporary difference reverses. That rate would be applied to the amount of the temporary difference that reverses in that given year, assuming that the reversal impacts taxes payable or refundable.

In December 2023, the FASB issued ASU 2023-09, *Improvements to Income Tax Disclosures*, which updates income tax disclosures under Topic 740. For public business entities, the amendments are effective for annual periods beginning after December 15, 2024. For entities other than public business entities, the amendments are effective for annual periods beginning after December 15, 2025. Companies must provide enhanced disaggregated disclosures, including a tabular reconciliation of the effective tax rate in both percentages and dollar amounts. Reconciling items that equal or exceed 5 percent of the statutory tax amount must be disaggregated by nature and jurisdiction. Additionally, entities must disclose income taxes paid, categorized by federal, state, and foreign jurisdictions. These changes improve transparency and may require additional tracking of data by jurisdiction for both current and deferred tax reporting.

To illustrate this point, let us review the following scenario.

Assume that an entity has the following book and tax balance sheet. Assume that the tax legislation has passed in the taxing jurisdiction where the entity operates that reduces the corporate income tax rate from 25 percent to 20 percent. However, the rate reduction does not occur until after Year 3.

The following would be the calculation of book and tax depreciation, by year, for this asset, which was acquired on July 1, Year 1, as well as the related deferred tax liability for the asset. The asset has a 10-year life and will be depreciated on a straight-line basis for book purposes. The asset also has a 10-year life for tax purposes and will be depreciated using MACRS, with a 200 percent declining balance approach. A ½ year convention will be used for both depreciation methods.
In this scenario, the reversal of the temporary difference would result in a deferred tax liability, as the accelerated tax depreciation will result in greater taxable income in later years.

Note that calculations are for illustrative purposes only.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
Book Basis, eoy	950,000	850,000	750,000	650,000	550,000	450,000	350,000	250,000	150,000	50,000	0
Tax Basis, eoy	900,000	720,000	576,000	460,800	368,600	294,900	229,400	163,900	98,300	32,800	0
Book dep.	50,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	50,000
Tax dep.	100,000	180,000	144,000	115,200	92,200	73,700	65,500	65,500	65,600	65,500	32,800
C/Y excess – Tax or (Book)	50,000	80,000	44,000	15,200	(7,800)	(26,300)	(34,500)	(34,500)	(34,500)	(34,500)	(17,200)
Cum. Basis Difference	50,000	130,000	174,000	189,200	181,400	155,100	120,600	86,100	51,700	17,200	0
Enacted Tax Rate	25%	25%	25%	20%	20%	20%	20%	20%	20%	20%	20%
Deferred Tax Liability, at end of year *	$10,000	26,000	34,800	37,840	36,280	31,020	24,120	17,220	10,340	3,440	0

* In this scenario, the difference between the book and tax basis of this asset continues to grow through Year 4. Beginning in Year 5, more depreciation is taken for book purposes than for tax purposes, resulting in the beginning of the reversal of this temporary difference. This results in the entity paying more taxes related to this transaction in Year 5 and beyond, thus settling the established deferred tax liability. The enacted tax rate in Year 5 and beyond is 20 percent. Accordingly, per the guidance above, the deferred tax liability should be measured at the rate that is enacted when the liability expects to be settled. The enacted rate from Year 5 through the remainder of the life of the asset is 20 percent. This rate should be used to measure the deferred tax liability. As no portion of the deferred tax liability settles in years when the enacted rate is 25 percent, that rate is not used in measuring the deferred tax liability.

Further, as you can see, the deferred tax liability continues to increase as long as annual tax depreciation exceeds book depreciation. As annual book depreciation begins to exceed tax depreciation, the deferred tax liability is reduced as the temporary difference reverses.

Let us review a few more examples.

Assume an entity has recorded an accrued expense on its GAAP financial statements related to a legal liability in the amount of $500,000. However, per the appropriate tax law in the jurisdiction where this entity operates, this amount is only deductible for taxes in the year when the liability is paid. The tax rate in this jurisdiction is 15 percent. The liability is not expected to be paid for two years.

While you could prepare a similar schedule as the above one, the determination of the deferred tax impact of this transaction is more straightforward.

In the financial statements for the year of the legal settlement, in addition to the legal liability, the entity would record a deferred tax asset in the amount of $75,000 ($500,000 x 15 percent). This amount arises from the difference in the book and tax basis of the liability ($500,000 book basis and $0 tax basis) at the end of Year 1.

This asset would remain unchanged until the year when the legal judgment is paid. The entity would record the deduction for the payment in that year's tax return. At the end of that year, there would no longer be any basis difference between the amount of the liability recorded for book and tax purposes.

Let us look at another example that reviews the reverse of the above scenario. Assume that an entity incurred $100,000 in non-capitalizable costs related to its issuance of debt, which occurred on December 31 of that year. For book GAAP accounting purposes, these costs would be expensed, resulting in a book basis of $0 for these costs. However, for tax purposes, their costs are capitalized and amortized over a five-year period. Accordingly, at the end of Year 1, on a tax basis, the asset representing these costs would have a tax basis of $100,000. As these costs will represent future tax deductions as they are amortized for tax purposes, the entity would record a deferred tax asset in the amount of $15,000, assuming the same 15 percent tax rate is in effect.

As we wrap things up, the timing of the reversal is not a consideration in accounting for the temporary difference. Though it may take over 20 years for temporary differences related to accelerated depreciation to reverse, there is no need to discount any deferred tax asset or liability resulting from temporary differences. However, entities will need to assess the recovery of deferred tax assets. As the utilization of these assets is dependent on it having future taxable income against which to apply them, an entity must estimate whether it will have such taxable income in future periods. If not, it will establish a valuation allowance against the asset, effectively writing down its value. We will discuss assessing the need for and accounting for valuation allowances later in the course.

Starting in 2023, certain large corporations are subject to a 15 percent corporate alternative minimum tax (CAMT) on adjusted financial statement income. Under ASC 740, entities do not remeasure deferred tax assets or liabilities using the 15 percent rate. Instead, CAMT is treated as a current-period income tax. If a CAMT liability arises, it may generate a deferred tax asset for a CAMT credit carryforward. This deferred tax asset is evaluated for realizability like any other DTA.

IV. Accounting for the income tax effects of intraentity transfers

Sometimes members of a consolidated group transfer goods or services between themselves. For instance, consolidated entity A (A) may sell inventory to consolidated entity B (B). Also, B may sell machinery or intellectual property to A. Any pre-tax gain or loss on these sales would be eliminated in consolidation. However, entities still need to consider the income tax implications of these types of transactions. In our example, assuming A and B are in different tax jurisdictions, the gain on the sale of inventory or the machinery would be a taxable event in one jurisdiction, while the other entity would get a tax deduction in its jurisdiction when it sells the inventory or takes depreciation expense. The gain would generally be taxable in the period of the transaction, while the deduction could be taken in a later accounting period. This created a potential mismatch between recording the income tax expense and related income tax benefit from the forthcoming deduction.

Under current GAAP, the tax effects of intraentity transfers of assets (intercompany sales) are deferred until the asset is ultimately sold to a third party or recovered through use. This approach is an exception to the general recognition principles of ASC 740 that would require recognition of both current and deferred taxes on such transactions.

However, in October 2016, the FASB issued ASU No. 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*. The Update impacts all entities which account for income taxes under Topic 740. This amendment was issued as part of the FASB's simplification initiative that is aimed at reducing complexity in financial reporting.

The amendments in this Update would recognize such tax effects for all such transfers, except that of inventory, in the period in which the transaction occurs. This approach would improve the transparency of accounting for such transactions, as their tax effects would be recorded in the same period in which the transfer took place. Additionally, the Update reflects financial statement preparer concerns about the additional burden of recording these effects for all such transactions. As the increased burden would result from primarily from transfers of inventory, exempting such transfers from the scope of this Update mitigates these concerns.

Under the amendments in this Update, the tax effects of intraentity asset transfers, except for those of inventory, would be recorded in the period in which the transfer occurs. The tax effects of intraentity transfers of inventory would continue to be deferred until the inventory is sold to a third party.

This guidance would generally result in the recognition of both current and deferred, as applicable, income tax expense in the jurisdiction of the seller of the asset while any deferred tax asset that would arise from the transaction would also be recognized in the same period.

While the pre-tax impact of the transaction would be eliminated in consolidation, the effect of the Update could result in an increase in the entity's effective tax rate in the period of the transfer. Assume that an entity sold an asset in an entity in a higher tax jurisdiction to an entity in a lower tax jurisdiction. While there would be no pre-tax impact of this transaction, the transaction would result in additional income tax expense, thus raising the effective tax rate of the entity on a consolidated basis.

The Update is effective for annual financial statements issued for fiscal years beginning after December 15, 2017, including interim periods for public entities and one year later for non-public entities, including interim periods within that year.

Early application is permitted, but only in the first interim period of the year of adoption.

The Update should be applied on a modified retrospective basis in the year of adoption, with the adjustment to beginning retained earnings in the period of adoption consisting of the following:

a. The write-off of any unamortized tax expense previously deferred; and
b. The recognition of any previous unrecognized deferred tax asset, net of any necessary valuation allowance.

V. Applying the learning

A. Exercise 1

For the following transactions resulting in temporary differences, determine if the transaction will generate a deferred tax asset (DTA) or a deferred tax liability (DTL). In each instance, assume that the entity is a cash basis taxpayer.

1. ________ The entity records accelerated depreciation for tax purposes over that which it records for book purposes.

2. ________ The entity receives cash for the renewal of magazine subscriptions which will be delivered over the course of the next two years.

3. ________ The entity records an accrual on its financial statements for the expected costs of product maintenance that it expects to pay out on the warranty that it provides to all customers of its products.

4. ________ The entity recorded its annual expense for the cost of post-retirement benefits which it provides to its retirees. However, the applicable tax law allows for a deduction only after the amount has been transferred to an eligible trust, which pays the benefits. The entity has not transferred any amounts to the trust.

5. ________ The entity offers its customers delayed payment terms on their purchases from the entity. At year end, the entity recorded installment sales on its financial statements for which it will not receive the cash until the following year.

6. ________ The entity records its expense related to non-qualified stock options which it grants to senior executives. The options are not yet vested and cannot be exercised until a later period.

7. ________ In its consolidated financial statements, the entity includes the income of its foreign subsidiaries. Due to its forecasted cash flow needs and borrowing capacity, the entity expects to remit the earnings of its foreign subsidiaries back to its U.S. jurisdiction tax paying parent over the course of the next two years.

8. ________ On December 31, an entity received an upfront cash payment from its customer for an order which it will be fulfilling over the next six months. Under the provisions of ASC Topic 606, the entity recognizes revenue over the period of time which it fulfills its promises related to the contract, which will be over the next six months.

B. Exercise 2

An entity has purchased a fixed asset with a five-year useful life for both book and tax purposes for $25,000. It depreciates its fixed assets on a straight-line basis and uses a ½ year convention for recording depreciation in the year of acquisition. Assume that there is no expected salvage value for the fixed asset and an enacted tax rate of 10 percent.

The applicable depreciation percentages for MACRS five-year property are as follows:

Year 1 – 20 percent
Year 2 – 32 percent
Year 3 – 19.2 percent
Year 4 – 11.52 percent
Year 5 – 11.52 percent
Year 6 – 5.76 percent

Question 1 – Determine the annual book and tax depreciation expense.

Question 2 – Determine the deferred tax liability related to the accelerated depreciation of this fixed asset at each year end.

VI. *Applying the learning – Solutions*

A. Exercise 1

1. __DTL__ The entity records accelerated depreciation for tax purposes over that which it records for book purposes.

   In this situation, the entity would record a deferred tax liability related to the accelerated depreciation.

2. __DTA__ The entity receives cash for the renewal of magazine subscriptions which will be delivered over the course of the next two years.

   As the entity will be recording taxable income before it records book income related to the subscriptions, it should record a DTA.

3. __DTA__ The entity records an accrual on its financial statements for the expected costs of product maintenance that it expects to pay out on the warranty that it provides to all customers of its products.

   As the entity will get a future tax deduction when it actually pays the costs related to the warranty, it should record a DTA.

4. __DTA__ The entity recorded its annual expense for the cost of post-retirement benefits which it provides to its retirees. However, the applicable tax law allows for a deduction only after the amount has been transferred to an eligible trust, which pays the benefits. The entity has not transferred any amounts to the trust.

   As the entity will get a future tax deduction when it actually funds the post-retirement benefit trust, it should record a DTA.

5. __DTL__ The entity offers its customers delayed payment terms on their purchases from the entity. At year end, the entity recorded installment sales on its financial statements for which it will not receive the cash until the following year.

   As the entity will record book income before it records taxable income, it should record a DTL.

6. __DTA__ The entity records its expense related to non-qualified stock options which it grants to senior executives. The options are not yet vested and cannot be exercised until a later period.

   As the entity will get a future tax deduction upon exercise of the option, it should record a DTA.

7. **DTL** In its consolidated financial statements, the entity includes the income of its foreign subsidiaries. Due to its forecasted cash flow needs and borrowing capacity, the entity expects to remit the earnings of its foreign subsidiaries back to its U.S. jurisdiction tax paying parent over the course of the next two years.

   As the expected remittance of these earnings represent future taxable income, the entity should establish a DTL.

8. **DTA** On December 31, an entity received an upfront cash payment from its customer for an order which it will be fulfilling over the next six months. Under the provisions of ASC Topic 606, the entity recognizes revenue over the period of time which it fulfills its promises related to the contract, which will be over the next six months.

   As the cash received is taxable in the year of receipt but less in future periods, the entity would record a DTA.

B. Exercise 2

Question 1 – Determine the annual book and tax depreciation expense.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Book Dep.	$2,500	$5,000	$5,000	$5,000	$5,000	$2,500
Tax Dep.	$5,000	$8,000	$4,800	$2,880	$2,880	$1,440

Question 2 – Determine the deferred tax liability related to the accelerated depreciation of this fixed asset at each year end.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Book Basis	$22,500	$17,500	$12,500	$7,500	$2,500	$0
Tax Basis	$20,000	$12,000	$7,200	$4,320	$1,440	$0
Difference	$2,500	$5,500	$5,300	$3,180	$1,060	$0
Deferred Tax Liability, eoy	$250	$550	$530	$318	$106	$0

The Model for Computing Deferred Taxes Under ASC Topic 740

The Model for Computing Deferred Taxes Under ASC Topic 740

Learning objectives

After completing this chapter, you should be able to:

- Recall method for computing deferred taxes to achieve desired effects of ASC 740;
- Recall objectives of five-step approach for recording income taxes;
- Identifications of all temporary differences;
- Measurement of temporary differences using proper tax rate;
- Assessment of need for valuation allowance;
- Apply five-step approach for recording temporary differences; and
- Recall that deferred tax balances are determined for each tax-paying component in each jurisdiction.

I. Executive summary

Temporary differences are just one of several considerations for entities when computing their deferred taxes under Topic 740. There are actually three main objectives when computing deferred taxes:

a. Identification of all temporary differences, tax loss carryforwards, and tax credit carryforwards;
b. Measurement of the temporary differences at the proper applicable tax rates; and
c. Assessment of the need for a valuation allowance.

These objectives need to be achieved in computing deferred taxes for each tax paying component in each tax jurisdiction.

To assist in the achievement of these objectives, we will review a five-step model for computing deferred taxes. The steps are as follows:

1. Identify temporary differences and tax loss carryforwards;
2. Identify tax loss carryforwards and tax credits;
3. Determine the applicable tax rate to use;
4. Calculate the deferred tax assets and liabilities; and
5. Evaluate the need for a valuation allowance.

We have already considered some of these steps in our previous discussions, but we will introduce the remainder of these steps in this chapter as well as wrap them together into an integrated five-step model.

Also, remember that deferred taxes are just one component of the income tax provision. The other consists of taxes currently due, as taken from the tax return. It is this amount, plus the changes in the deferred tax balances, that together consist of an entity's total provision for income taxes.

Before we get into the model, let us start our discussion with a review of how to determine the current portion of the income tax provision.

II. Determining the current portion of income taxes expense

An entity's income tax expense consists of two parts, the amount of the current tax that it owes for the given year, plus the future tax consequences of events that have been recognized in either the financial statements or the tax returns.

In order to determine the taxes that are currently payable, an entity must be able to estimate its current year taxable income, based on information that is currently available to it, at the same time that it is preparing its financial statements for the same period of time. Actually, as the determination of taxable income cannot be completed until the general ledger is closed, this computation of the current year tax provision must be condensed into an even shorter period of time. Given the short period of time for public companies to file their financial statements with the SEC at year-end, there is the need for effective coordination between the financial reporting and tax departments at this critical period of time.

The entity's calculation of taxes currently payable at this time is frequently just an estimate. For calendar year-end taxpayers, the corporate tax return is not due until March 15 of the following year. In reality, many entities request the available six-month extension for filing their final tax return with the IRS, which is generally available to all entities, as long as they make an estimate and payment of the amount of taxes that they expect to owe upon filing the final return when filing for the extension.

That said, there is considerable overlap in the period of time for an estimated amount of taxes payable to be developed for book purposes and that for the request for an extension in filing the final tax return. While some adjustments may be made to these preliminary amounts, they will very often only vary from the amounts in the final return by small amounts.

So, to summarize, even though the final income tax return will not be filed for several months after year-end, an entity still needs to estimate its taxable income for financial reporting purposes. It must have both financial and tax reporting systems and an approach that will allow it to make reasonable estimates that will not materially impact the amount recorded on the final income tax return. In doing so, the entity should assume the settlement of all assets and liabilities at their carrying amounts.

Finally, most taxing jurisdictions require entities to make estimated payments of taxes due over the course of the year. The amount of the current tax provision is the sum of these estimated payments, plus any additional amounts due, based on the total amount of tax due or receivable, per the return.

Not only is the determination of taxable income necessary for calculating the current year provision for income taxes, but that amount is also the basis for identifying temporary differences. These temporary differences are the starting point for the deferred tax calculations needed to complete the calculation of the entity's entire income tax provision. It is the change in these deferred tax accounts that represent the deferred tax benefit or expense for the current year. We will now turn our attention to the five-step approach used to calculate these deferred tax amounts.

III. The five-step approach to determining deferred taxes

Topic 740 requires the use of the balance sheet approach in determining deferred taxes. Under this approach, an entity estimates its deferred tax assets and liabilities, with the difference in these amounts from the beginning to the end of the year being the amount of the income statement component for deferred taxes.

While conceptually this approach is pretty straightforward, its real-world application is very complex. This is due to several reasons. First, the tax code itself is complex and very rule based. While many principles of the tax code generally follow GAAP accounting principles, it is important to remember that GAAP accounting and tax law have very different objectives. The overriding objective of GAAP accounting is to ensure that the financial statements fairly present an entity's financial position and its results of operations on an accrual basis of accounting. The objectives of a taxing scheme are varied but are inherently political in nature, reflecting the values and priorities of the taxing jurisdiction. These systems are not designed to represent the same thing. It is these differences in priorities that often drive the rules that result in the temporary differences that we need to account for under Topic 740.

There is a common five-step approach that we can follow to help account for these temporary differences:

Step 1 – Identify temporary differences and tax loss carryforwards.
Step 2 – Identify tax loss carryforwards and tax credits.
Step 3 – Determine the applicable tax rate to use.
Step 4 – Calculate the deferred tax assets and liabilities.
Step 5 – Evaluate the need for a valuation allowance.

We will look at each of these in detail.

A. Step 1 – Identify temporary differences and tax loss carryforwards

We have already talked about temporary differences and the primary causes of them so we will not review them again here. For purposes of determining deferred taxes, it is necessary to group all temporary differences into two categories:

a. **Temporary differences that will generate future tax** – These will result in deferred tax liabilities.
b. **Temporary differences that will reduce future tax** – These will result in deferred tax assets.

One of the challenges in performing Step 1 is ensuring that your list of temporary items is complete, especially if you do not have a strong background in tax law. We already talked about the need to develop the book-tax balance sheet as a way to identify basis differences. Another helpful tool is to review the reconciliation of book to tax income that is included in the *U.S. Corporation Income Tax Return*, filed on Form 1120. Specifically, this reconciliation is found on Schedule M-3 of Form 1120 and can be very helpful in this process. The next two images are excerpts from Schedule M-3 that detail this reconciliation for both income items and expense items.

Schedule M-3 Income Item Reconciliation

Part II **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return** (see instructions)

Income (Loss) Items (Attach statements for lines 1 through 12)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed . . .				
3 Subpart F, QEF, and similar income inclusions . .				
4 Gross-up for foreign taxes deemed paid				
5 Gross foreign distributions previously taxed . . .				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation .				
8 Minority interest for includible corporations . . .				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities . .				
12 Items relating to reportable transactions				
13 Interest income (see instructions)				
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (see instructions)	( )			( )
18 Sale versus lease (for sellers and/or lessors) . . .				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts . .				
22 Original issue discount and other imputed interest .				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses .				
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used . . .				
25 Other income (loss) items with differences (attach statement)				
26 **Total income (loss) items.** Combine lines 1 through 25				
27 **Total expense/deduction items** (from Part III, line 39)				
28 Other items with no differences				
29a Mixed groups, see instructions. All others, combine lines 26 through 28				
b PC insurance subgroup reconciliation totals . . .				
c Life insurance subgroup reconciliation totals . . .				
30 **Reconciliation totals.** Combine lines 29a through 29c				

Note: Line 30, column (a), must equal Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Schedule M-3 (Form 1120) (Rev. 12-2019)

Schedule M-3 Expense Item Reconciliation

Part III **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items** (see instructions)

	Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1	U.S. current income tax expense				
2	U.S. deferred income tax expense				
3	State and local current income tax expense				
4	State and local deferred income tax expense				
5	Foreign current income tax expense (other than foreign withholding taxes)				
6	Foreign deferred income tax expense				
7	Foreign withholding taxes				
8	Interest expense (see instructions)				
9	Stock option expense				
10	Other equity-based compensation				
11	Meals and entertainment				
12	Fines and penalties				
13	Judgments, damages, awards, and similar costs				
14	Parachute payments				
15	Compensation with section 162(m) limitation				
16	Pension and profit-sharing				
17	Other post-retirement benefits				
18	Deferred compensation				
19	Charitable contribution of cash and tangible property				
20	Charitable contribution of intangible property				
21	Charitable contribution limitation/carryforward				
22	Domestic production activities deduction (see instructions)				
23	Current year acquisition or reorganization investment banking fees				
24	Current year acquisition or reorganization legal and accounting fees				
25	Current year acquisition/reorganization other costs				
26	Amortization/impairment of goodwill				
27	Amortization of acquisition, reorganization, and start-up costs				
28	Other amortization or impairment write-offs				
29	Reserved				
30	Depletion				
31	Depreciation				
32	Bad debt expense				
33	Corporate owned life insurance premiums				
34	Purchase versus lease (for purchasers and/or lessees)				
35	Research and development costs				
36	Section 118 exclusion (attach statement)				
37	Section 162(r)—FDIC premiums paid by certain large financial institutions (see instructions)				
38	Other expense/deduction items with differences (attach statement)				
39	**Total expense/deduction items.** Combine lines 1 through 38. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive				

Schedule M-3 (Form 1120) (Rev. 12-2019)

As you can see from these excerpts, there are many potential differences between book and tax income. It is vital to work closely with your tax personnel in order to understand the nature of each difference, as well as to understand how and when the difference will reverse, as this could impact the classification of deferred taxes on the balance sheet.

Also note that there are permanent differences between book and tax income. These arise due to the different treatment of such items for book and tax purposes. They include such items as tax-exempt interest income and certain types of amortization, such as goodwill. These permanent differences do not result in future taxable consequences, so they do not impact the calculation of deferred taxes. Their impact is recorded in the current provision for income taxes. As part of the disclosures under Topic 740, an entity is required to reconcile its statutory tax rate to its effective tax rate, which is determined by dividing pre-tax book income by its income tax expense. These permanent items are included in that reconciliation. We will talk about required disclosures, including the rate reconciliation, under Topic 740 later in the course.

B. Step 2 – Identify tax loss carryforwards and tax credits

We briefly talked about tax credits earlier in the course. A tax credit, broadly defined, is an amount of money that a taxpayer can deduct against taxes owed to the government. Tax credits are different from tax deductions and exemptions, which reduce the amount of taxable income. Tax credits are applied after the tax liability is determined, thereby reducing an entity's tax liability on a dollar-for-dollar basis. Any tax jurisdiction can grant a tax credit. Common credits available in the U.S. Federal Tax Code include the following:

a. **Research and Experimentation (R&E) Tax Credit** – A credit for certain eligible costs spent on qualifying research activity. This credit is an attempt by the U.S. government to spur innovation and the development of new products.
b. **Foreign Tax Credits** – As we mentioned previously, U.S. corporate taxpayers are taxed on the full amount of their global income. However, they can take a credit for amounts paid in taxes to foreign jurisdictions.
c. **Alternative Minimum Tax Credit** – This credit is available to those entities that pay the Alternative Minimum Tax.
d. **Investment Tax Credits** – Many jurisdictions offer tax credits for investments in certain types of activities, such as environmental expenditures, capital expenditures, and research.

In accounting for income taxes under Topic 740, it is important to understand the provisions of how to apply these credits, particularly carryforward or carryback provisions. Often, tax credits can be carried forward to future years or back to offset previously paid income taxes if they cannot be used entirely in the current year. As such, the unused credits represent a reduction of future taxes or a recovery of past taxes paid and should be recorded as deferred tax assets.

Tax loss carryforwards are similar to tax credits but result in a reduction of pre-tax income rather than a reduction of the income tax liability. Common tax loss carryforwards are net operating loss carryforwards, where entities can take the amount of a pre-tax loss and either apply it to future taxable income or offset it against previously taxed income, and capital losses, where, due to limits on their current year use, entities can apply unused capital losses against future capital gains. Again, it is important to understand how each taxing jurisdiction allows an entity to apply each tax loss carryforwards. As these carryforwards also represent a reduction in future taxes, they also represent deferred tax assets.

The goal after the completion of Steps 1 and 2 is to have identified all possible temporary and other differences that could potentially impact future taxable income. Items that will increase future taxable income, such as the reversal of accelerated depreciation taken for tax purposes, will result in deferred tax liabilities while those items reducing future taxable income, such as tax loss carryforwards, will result in deferred tax assets. Next, the future tax impact of these items needs to be determined

C. Step 3 – Determining the applicable rate for the deferred tax calculation

We touched on this topic a bit earlier in the course. An entity should use the enacted tax rate based on the enacted tax law when computing the deferred tax asset or liability. They should use the rate that is expected to be applicable when the temporary difference is expected to impact taxable income. This may be a different period than when the temporary difference reverses or settles.

For example, the future tax benefit resulting from the reversal of a temporary difference may occur in a period in which the entity expects to have a tax loss, thereby negating the benefit of the reversal. In such instance, the entity should consider if the tax benefit will be used via a net operating loss carryforward or carryback. If the benefit is expected to be used via a carryback, the deferred tax benefit should be calculated using the rate that is enacted for the year against which the carryback will be applied. The same principle holds for loss carryforwards. If the benefit is expected to be realized through the use of the net operating loss carryforward, the enacted rate in the year when the loss carryforward is expected to be utilized should be used when calculating deferred taxes.

While that guidance is pretty straight forward, real world application can be a bit more challenging. Let us consider a few examples.

First, tax jurisdictions may tax different types of income at different rates. For example, capital gains may be taxed at a different rate than ordinary income. The applicable rate for the type of income that created the temporary difference is the one that should be used to determine the deferred tax effect of that item.

A further complication is when a jurisdiction uses a graduated income tax rate. For example, an entity may be taxed at a 10 percent rate for its first $1,000,000 of income and at a 20 percent rate for all income above $1,000,000. In such scenarios, the entity should first determine the impact of the graduated rate structure. If the impact of the graduated rate on the calculation of deferred taxes is significant, an entity may need to estimate a blended rate to use for its deferred tax calculations.

Further, based on the complexities of the tax code in the taxing jurisdiction, other challenges may arise in determining the applicable rate to use. When the order of applying the tax benefit impacts the calculation of the deferred tax effect, the reversal of the temporary difference should be considered last in determining estimated taxable income in the year of the reversal of the temporary difference.

A common source of deferred tax liabilities for many international entities is undistributed earnings. When determining the deferred tax liability for undistributed earnings, an entity should consider any deductions, credits for foreign taxes, and the dividend received deduction (DRD) when determining the applicable rate. Under U.S. tax law, a corporation receives a deduction of between 50 percent and 100 percent of the dividends which it receives from its investees. Note that this deduction percentage for certain dividends was lowered as part of the Tax Cuts and Jobs Act. This deduction is to prevent the triple taxation of earnings, first at the investee level, next at the investor level, as it receives dividends, and lastly by those who ultimately receive dividends from the investor corporation. Since the purpose of recording deferred taxes is to record the impact of future taxable amounts, the amount reflected in the calculation should be netted by such credits and deductions.

With the OECD's Pillar Two global minimum tax rules coming into effect in several jurisdictions beginning in 2024, companies with significant foreign operations must consider whether top-up taxes imposed under these rules will impact financial reporting. While ASC 740 does not currently require the recognition of deferred taxes for top-up taxes under Pillar Two, entities must evaluate whether such impacts are material and require disclosure. This assessment is particularly important for multinational groups with effective tax rates below 15 percent in certain jurisdictions.

As you can see, this relatively straight forward calculation can get pretty complex in a hurry. It is very important to have a good understanding of the applicable tax laws when making this calculation as well as to thoroughly understand the manner and accounting period in which the reversal or settlement of the temporary difference will impact future taxable income. Remember, you use the rate in the period in which the reversal impacts taxable income, not the period in which the reversal occurs, as these may not be the same.

D. Step 4 – Calculate the deferred tax asset or liability

Step 4 is the very mechanical step of multiplying the identified temporary difference by the appropriate rate. The result, though subject to netting of certain balances, will be the gross amount of deferred taxes recognized, before the consideration of the need for a valuation allowance. Again, as we saw in Step 3, it is important to apply the correct rate to the reversing item. Many entities have made an error in their deferred tax calculation due to an inaccurate spreadsheet formula. Given the volume of data necessary to calculate deferred taxes and the complexity of some of the calculations, entities tend to use complex spreadsheet workbooks to perform this calculation. While effective, the links in these spreadsheets can be easily broken, causing computation errors. Entities using these types of workbooks should periodically review their links to data as well as their calculations. Given their complexities, formula errors may be hard to identify, and faulty data links are hard to trace.

E. Step 5 – Evaluate the need for a valuation allowance

Deferred tax assets should be evaluated for their realizability, the actual ability to reduce future taxes payable. When it is more likely than not that the benefit of the deferred tax asset will not be realized, the entity should place a valuation allowance, effectively a reserve, against the deferred tax asset, reducing its carrying amount to realizable value. The best evidence of the realizability of a future tax benefit is forecasted future taxable income. However, in the absence of that, Topic 740 provides other alternatives that an entity can assess to determine its need for a valuation allowance.

Evaluating the need for a valuation allowance, as well as supporting a change in that determination in future years, can be complex. We will explore this process in the next chapter of the course.

IV. Accounting for changes in tax laws and rates

Accounting for deferred taxes requires measurement of deferred taxes at the rate expected to be in effect when the temporary difference reverses, based on currently enacted tax laws. Well, what happens when tax laws and rates change? ASC 740 provides guidance.

Topic 740 requires the impact of changes in tax laws as well as enacted rates to be recognized in the period in which they are enacted. This impact is recorded in the provision for income taxes from continuing operations, irrespective of the category of income in which the underlying expense or income item is recorded. While this guidance is pretty straightforward, there are some nuances in its application that we will explore in this chapter. Further, we will also review the accounting for changes in tax return accounting methods.

A. Determining the enactment date

Topic 740 requires that an entity account for the impact of a change in tax rate or tax law in the period in which it is enacted. However, Topic 740 does not define the meaning of the word "enacted." Generally, this would represent the date when the law has been subject to the full legislative process. For U.S. Federal tax purposes, this would generally be the date that the President signed the bill into law. However, enactment may occur in other ways, such as veto override. Most states follow the same type of procedure with regard to final enactment of legislation. However, foreign jurisdictions may have different approaches to signify that a law has been enacted, such as publishing the law in an official journal.

The SEC, FASB, and AICPA all believe that a law in a foreign jurisdiction cannot be considered enacted until the completion of the full legislative process. Another way to say it is that a law is enacted when it would take additional legislation to overturn the law. Until such time, an entity should not account for the impact of a change in tax rate or other changes in tax laws.

Further complicating this determination is that most taxing authorities employ a governmental agency such as the IRS to develop the regulations necessary to implement and interpret the tax laws. Such regulatory pronouncements should be classified as either interpretive or legislative in nature.

Interpretive pronouncements, which are generally issued by the IRS and Department of the Treasury, are meant to clarify the law and ease its implementation. As such, they are not part of the legislative process. Therefore, entities would not need to wait until the issuance of such guidance to account for a change in the tax code, including changes in tax rates.

However, in certain instances, the specific authority delegated to the regulatory agency may actually constitute the completion of the legislative process. In such an instance, the impact of the change in the tax rate or law would not be accounted before such regulations are issued. Entities should analyze all pieces of tax legislation to determine when the legislation process is complete and the impact of the change should be accounted for.

B. Accounting for the impact of rate changes

The total impact of the change in tax law or rates should be included in the provision for income taxes from current operations. However, new legislation may not impact the enacted law until sometime in the future. For example, a newly enacted tax law may cut a particular tax rate but not until sometime in the future. Additionally, rates enacted in the tax law will often expire after a period of time if they are not renewed. Again, entities should only account for income taxes based on the enacted rates and not anticipate renewal of preferential rates until the renewal actually occurs. Accordingly, the entity would need to schedule all of its temporary differences, accounting for some under the existing rate and others under the new rate. Remember, the impact of the reversal on the temporary rate should be recorded in the period when it impacts the payment of income taxes, which could be different from the period of its reversal. The entity should account for the impact using the rate that is in effect when the impact on the payment of taxes occurs.

Additionally, changes in tax laws require an entity to reassess its conclusions concerning the realization of deferred tax assets. The amount of such assets could go up or down, based on the impact of the enacted rate. Additionally, the tax law change may include changes in the carryforward or carryback period or another change that could have a material effect on the calculation of deferred charges. This principle also applies to the Corporate Alternative Minimum Tax (CAMT), which is effective for tax years beginning in 2023. CAMT is treated as a current tax and does not change the measurement of deferred tax assets and liabilities, though CAMT credit carryforwards may give rise to deferred tax assets.

Often, it is the very legislative process itself that causes the challenges in accounting for changes in the tax laws, not the guidance of Topic 740. For example, many common tax credits such as the R&D Tax Credit are temporary in nature and require an act of Congress to be extended. If Congress recesses for its year-end break without extending the credit, then the higher rate, or, in the instance of the credit, no credit, should be accounted for. Such a situation clearly impacts both taxes currently payable as well as potentially deferred taxes, depending on whether the credit can be carried forward or backward. In such instance, Congress frequently meets in a lame duck session to consider such extensions, with such sessions continuing into the new year. These sessions frequently result in extension of these temporary credits on a retroactive basis. Accordingly, even if the credit is expected to be extended, the entity cannot account for it until the law is actually enacted.

C. Changes in tax methods of accounting

While less frequent than changes in tax rates and laws, an entity may change its tax method of accounting. While clearly impacting the amount of taxes which it pays, such a change will also impact its accounting for temporary differences. An entity’s tax method is based on both its timing of payments and its consistency in applying the approach.

Timing relates to when the income or expense is presented on the financial statements. If a change in the timing does not occur, then no IRS approval is necessary. However, this is a different question than whether it is the proper method or not. This question gets to the question of consistency.

The use of a proper accounting method in a tax return constitutes consistency and establishes an accounting method. An improper method has been established once it has been used consistently in two consecutive returns. Any change from the accounting method requires approval from the IRS.

Changes in accounting method are deemed either automatic or non-automatic. With an automatic change, no written IRS approval of the change is necessary. The change merely goes into effect when all IRS guidance is met. With a non-automatic change, written consent for the change from the IRS is required. For both types of changes, the taxpayer files Form 3115, “Application for Change in Accounting Method,” with the IRS.

Some changes utilize the “cut-off” approach, whereby old transactions are accounted for under the old accounting method while only new transactions in the year of the change are accounted for using the new method.

However, most changes in method result in an IRS Code §481(a) adjustment, which constitutes a cumulative catch-up adjustment. Using this approach, on the first day of the year of the change, the taxpayer must account for both existing and new transactions as if they were accounted for under the new method; hence, the need for the cumulative catch-up. Reductions in taxable income are generally all taken in the year of adoption while increases in taxable income are generally taken into income ratably over a four-year period.

Accordingly, such a change both impacts taxes payable and creates temporary differences. As a result, a taxpaying entity needs to account for the impact of such a change. Changes that result in increases to taxable income, positive §481(a) adjustments, impact deferred taxes in two ways. As an increase in taxable income, any existing deferred tax accounts should be adjusted for the changes in temporary differences as a result of the method change if the change creates a book-tax basis difference or changes an existing one. Additionally, the four-year phase-in creates a future tax payment, which should be accounted for as a deferred tax liability until all such phase-in payments are made.

A change that results in a decrease in taxable income, a negative §481(a) adjustment, only requires an adjustment for the impact of the basis change, if applicable.

Some accounting treatments have several allowable methods under the tax code. For example, an entity may account for inventory on a LIFO or FIFO basis. Upon filing Form 3115, the requested change will be either automatic or non-automatic. Generally, the impact of an automatic change would be accounted for in the year in which the change is requested. However, the impact of accounting for a non-automatic change would be accounted for in the period in which IRS approval is received, as such approval is required for the change to take effect.

When determining that it has been using an error in a tax accounting method, an entity can make either a voluntary or non-voluntary change to a proper method. If it has been using an improper method, the entity needs to consider the impact of this method on its financial statements, including consideration of interest and penalties.

When making a voluntary change, the entity would submit Form 3115. In doing so, the entity receives "audit protection" for the topic for prior years, thereby preventing the IRS from raising the issue on an audit of a year prior to the change. Plus, as a positive adjustment that is additive to taxes payable, it can pay the tax over a four-year period. The entity would need to adjust its deferred taxes for the impact of the change and create a deferred tax liability, as discussed above, for the future tax liability associated with the four-year phase in. Additionally, any previous interest and penalties accrued for previous years in which the improper method was used can be reversed, as these would not be incurred given the audit protection received from such a change.

Entities generally receive less favorable terms when they make an involuntary change from an improper accounting method. In such circumstances, the IRS may require the entity to adopt a new accounting method, which it must use prospectively. However, the IRS may settle the issue on a non-accounting method change basis, whereby the entity will be able to continue to use its existing, improper method going forward.

D. Enhanced disclosure requirements under ASU 2023-09

As mentioned in previous chapters, the FASB issued ASU 2023-09 in December 2023 to improve transparency in income tax disclosures under ASC 740. This update does not change how deferred taxes are recognized or measured but requires more detailed and disaggregated information in the footnotes to financial statements.

For public business entities, ASU 2023-09 is effective for annual periods beginning after December 15, 2024, and for all other entities one year later. Key disclosure requirements include:

a. A reconciliation of the effective tax rate to the U.S. statutory federal tax rate, shown in both percentage and dollar terms;
b. Identification of individual reconciling items if they are equal to or greater than 5 percent of the statutory tax amount;
c. Disaggregation of income taxes paid by federal, state, and foreign jurisdictions; and
d. Disclosure of income or loss from continuing operations before income taxes and income tax expense (or benefit) from continuing operations, by jurisdiction.

Although these changes do not affect deferred tax calculations, they require improved data tracking, greater documentation, and clearer explanation of how taxes are reported and analyzed in financial statements.

V. Summary

In wrapping things up, while the calculation of deferred tax assets and liabilities is rather mechanical, there is a lot of knowledge and judgment that supports the process. Identifying all temporary differences, as well as permanent ones, can be a daunting task. Coordination with your tax specialists is necessary.

Next, understanding the strategy for realizing deferred tax assets is also important. As we saw, some assets will be realized through either a look forward or look back feature, making the determination of the appropriate rate to use calculating the deferred tax asset challenging.

Lastly, in order to realize the tax benefit of future reductions in taxable income, the entity must forecast that it will have such taxable income in the future. While nothing is guaranteed, the entity should have a process in place to estimate future taxable income. If such income is not expected, then the entity should record a valuation allowance against the deferred tax asset. We will talk about this process next.

VI. Applying the learning

For the following fact pattern, determine the rate that the entity should use to calculate its deferred taxes for each temporary difference.

Facts

It is currently Year 3. The entity has two temporary differences, consisting of net operating loss carryforwards and the reversal of temporary differences related to accelerated deprecation that it records for tax purposes.

The enacted tax rate for the taxing jurisdiction is 20 percent, as it has been for the past 10 years. However, a recently passed law will reduce the enacted rate to 15 percent in Year 4.

VII. Applying the learning – Solution

For both temporary differences, the entity would use the enacted tax rate in the year in which taxable income will be impacted. With regard to the reversal of the temporary differences related to accelerated depreciation taken for tax purposes, this difference will reverse in years beyond Year 3. Accordingly, the 15 percent tax rate should be used.

As for the net operating losses, the analysis is a bit more complex. Depending on the taxing jurisdiction, the benefit of the operating loss carryforward could be used to reduce future taxable income or to obtain a refund on taxes previously paid in the prior years. The entity would need to assess past taxes paid as well as its forecasted taxable income to determine if the asset will be applied on a going forward or on a look-back basis. If the entity estimates sufficient taxable income, the tax benefit could be applied on a going forward basis, with the deferred tax asset recorded at the enacted rate starting in Year 4 of 15 percent. However, if the tax benefit will be obtained by applying the loss to previously paid taxes, the deferred tax asset would be recorded based on the enacted tax rate in Year 2 and earlier, or 20 percent.

Valuation Allowances

Valuation Allowances

Learning objectives

After completing this chapter, you should be able to:

- Recall information needed to evaluate the need for a valuation allowance;
- Recall that a valuation allowance is required when it is more likely than not that a DTA will not be realized;
- Recall that “realization” refers to incremental benefit achieved by reduction in future taxes;
- Recall the guidance for recording the effects of a change in valuation allowances; and
- Identify the interplay between VA and intraperiod allocations.

I. Executive summary

As with all assets, an entity must assess the recovery of a deferred tax asset in order to record its benefit in its financial statements. Deferred tax assets will be recovered if the entity forecasts future taxable income or, in some instances, if it can obtain a refund for previously paid taxes. An entity will need to perform some projections in order to support this assumption. Additionally, this analysis must be performed at the level of each tax paying jurisdiction. For example, an entity may be profitable on a consolidated basis but may have certain tax paying subsidiaries that are not profitable, nor do they expect to be in the foreseeable future. The recovery of any deferred asset related to that subsidiary must be assessed based on forecasted future taxable income at the level of the subsidiary and not at a consolidated level.

If it is more likely than not that the deferred tax asset will not be recovered, the entity would record a valuation allowance against the asset. To accurately determine the need for a valuation allowance, the entity will need to understand how the tax benefit can be applied against taxable income (via a look back and/or a look forward approach) and will also need to be able to forecast its future taxable income.

To accomplish these tasks, several of the entity’s departments will need to work closely together. First, as we have been seeing, the financial reporting and tax departments will need to continue to work closely. Additionally, these groups will need to coordinate with the planning or forecasting group in order to obtain an estimate of future earnings. Such budgets are almost always prepared on a GAAP basis, so these three groups will need to work together to convert the forecast to an assessment of estimated pre-tax earnings. This is the figure that the entity needs to assess its need for a valuation allowance.

Let us get into a deeper discussion on the assessment of the need for valuation allowances.

II. Valuation allowances – The basics

The threshold for recognizing a valuation allowance is whether it is more likely than not that the entity will not be able to realize the benefit of the deferred tax asset. This corresponds to a probability of greater than 50 percent. Realization means that the entity will be able to achieve the incremental benefit of the deferred tax asset through a reduction in future taxes payable or an increase in future taxes refundable. In this assessment, the underlying deductible differences and carryforwards are the last items to enter into the determination of future taxable income.

The assessment of the need for a valuation allowance is a balanced one, where the entity should assess both positive and negative evidence of its ability to realize the benefits of the deferred tax asset. The greater the quantity of negative evidence that exists, the greater amount of positive evidence that is necessary to counter the negative evidence. The assessment is inherently subjective, but Topic 740 also provides some guidance to assist with the assessment.

Additionally, the "more likely than not" threshold is a lower threshold than that used to assess for impairment for other assets. This may result in differing results when applying impairment tests for deferred tax assets and other assets such as fixed assets, intangibles, and accounts receivable. It is not uncommon for an entity to record a valuation allowance while at the same time, not record an impairment charge against other assets.

A. Negative evidence

Let us review some of the negative evidence that may exist which would cast doubt on an entity's ability to realize the benefit of deferred tax assets.

1. Cumulative losses in prior years

While past results are no guarantee of future results, Topic 740 more or less states that they are when assessing the need for a valuation allowance. ASC 740-10-30-23 indicates that a cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome when assessing the need for a valuation allowance.

While such a position is not surprising, the question arises as to what metric should an entity use to determine if it has cumulative losses? Generally, an entity should start with its pre-tax earnings, adjusted for such items as permanent differences between book and tax income. An entity will need to use judgment with regard to adjustments to this amount for such items as discontinued operations and non-recurring items, as these items may be indicative of other similar items in the future. Additionally, the entity should be careful about including the results of a profitable discontinued operation in this analysis, especially if the entity would otherwise have had a cumulative loss without including such an item.

The next question is how far back to go with this analysis. Topic 740 talks about cumulative losses; this implies that the entity should go back greater than one year. There is no prescribed time period in Topic 740 though it is reasonable that the lookback period should be long enough to take into account certain one-time events that have either positively or negatively impacted earnings. A period of at least three years appears to be reasonable. Additionally, the entity should consider its forecasts over the next few years as these also could support a conclusion of cumulative losses.

2. Other negative evidence

While cumulative losses are persuasive, an entity should still look for other negative evidence that would support the need for a valuation allowance.

If the entity has a history of operating loss or tax credit carryforwards expiring unused, this would give further evidence against such tax benefits being realized in the future. Similarly, brief carryback or carryforward periods in jurisdictions where results are traditionally cyclical or where a single year's reversal of the deductible difference will be larger than the typical level of taxable income would be other negative evidence of the entity's ability to realize their benefits.

Lastly, currently profitable operations are also not a guarantee that a valuation allowance will not be necessary. For example, losses expected in early future years of a presently profitable entity also constitute such negative evidence. The longer the period of time necessary to recognize the benefits, the greater the risk to the benefits ever being realized. Also, an entity should consider the impact of current unsettled circumstances which, if settled unfavorably, would adversely impact future earnings on an ongoing basis. Examples of this would be litigation, patents and other intellectual property issues, loss of key employees or members of management, or significant change in market conditions.

B. Positive evidence

Negative evidence should be weighed against positive evidence of the ability to realize the deferred tax asset in the future. In this evaluation, if multiple pieces of negative evidence exist, there should be multiple examples of positive evidence to offset it in order to support the need for no valuation allowance. ASC 740-10-30-22 lists the following examples of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence supporting the need for one:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures.
b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset.
c. A strong earnings history exclusive of the loss that created the future deductible amount, coupled with evidence indicating the loss is not indicative of a continuing condition.

The first and third item above both essentially point to the existence of future taxable income from operations as supporting the ability to realize the deferred tax asset. Skepticism is necessary when evaluating these assertions as very often the reason for the deferred tax asset in the first place is the existence of a large loss on a tax basis. An entity's expected profitability based on its current cost structure and expected backlog is much stronger evidence than its profitability relying on the success of a major future cost restructuring initiative or winning a new contract or customer. Essentially the entity just needs to execute its current business plan in order to generate future taxable income. The probability of that occurring is much higher than that of a future cost reduction or revenue increase resulting in the necessary future taxable income in order to realize the deferred tax asset. That said, an entity can utilize the expected benefits of future restructuring activities in its forecast of expected taxable earnings. However, it should be weighted less strongly when being assessed against negative evidence.

The last bullet reflects the often one-off nature of large losses that frequently drive the creation of deferred tax assets at many traditionally profitable entities. Entities may go through occasional unusual or infrequent transactions like restructurings, product liability loss, loss on sale of an asset or business, or another transaction that generates a large loss for tax purposes. While these types of transactions do occur occasionally at most entities, they are hopefully generally infrequent events, with the same type of event not occurring on a recurring basis. If that is the case, the entity can reasonably expect such events to not occur frequently enough or in such magnitude to offset its expected generation of future taxable income.

Essentially the second bullet is saying that, given current valuations, there is sufficient expected taxable income from the excess of this valuation of net assets over their tax basis that realization of that net asset value would support recovery of the deferred tax asset. Again, skepticism must be used when assessing this evidence as you would need to evaluate the plans to realize this excess value in the context of the entity's overall business strategy.

C. Additional points

Assessing the need for valuation allowances is inherently subjective and requires both a strong grasp of the entity's past performance as well as its expected future performance, on both a book and tax basis. Clearly greater weight should be placed on anticipated events that have already happened in the past or on events that represent business as normal operations as opposed to those resulting from a significant restructuring of business operations or ownership and capitalization structure. For example, future profitability may depend on the occurrence of an initial public offering (IPO) that will result in the replacement of high yield debt with equity. Given the uncertainty surrounding IPOs, an entity should generally wait for the event to occur before including the benefits of such an event in its assessment.

Similarly, an entity can include the impact of events that occur after year end but before the issuance of its financial statements in its assessment of the recoverability of deferred tax assets. For example, the entity may enter into a transaction or announce plans for a restructuring early in the year subsequent to that of the financial statements that would support the recovery of the deferred tax asset. An entity should consider the impact of such a plan in its assessment.

Also, the analysis of recoverability must be detailed enough to support recovery of the deferred tax asset at the type of income level, if applicable. For example, if the deferred tax asset relates to the carryforward of capital losses, then the assessment of future taxable income should be performed at the capital gains level, not just overall pre-tax income. It is the generation of future capital gains income that will support recovery of the capital loss carryforward, not overall taxable income. Accordingly, the entity's assessment should contain an analysis of potential future capital gains, as well as an assessment of the entity's ability to execute a strategy that would lead to it realizing such gains.

While an entity's assessment of the need for a valuation allowance may change based on changes in facts and circumstances, there should be clear and explainable reasons for a change in this assessment. It should be able to identify the new information that came to light that led to the change in the assessment as well as be able to support why this information led it to the conclusion which it did. Further, it should be able to support why such information was either not relevant or not available to it at the prior reporting periods. For SEC registrants, the topic of valuation allowances continues to draw scrutiny from the SEC, given its subjective nature and the ability of registrants to manipulate earnings through the generation or release of a valuation allowance. As with all accounting estimates, good documentation of the process supporting the amount recorded on the financial statements is essential.

III. Sources of taxable income

Ultimately, the recovery of a deferred tax asset is dependent on an entity generating future taxable income. The income must be of the appropriate nature (ordinary or capital) and must be generated within the time period for carryforwards or carrybacks as allowed by applicable tax law.

ASC 740-10-30-18 identifies four sources of taxable income that may be available for the entity to realize the deferred tax asset.

The following are listed based on most to least objective:

a. Taxable income in prior carryback years if carryback is permitted under the applicable tax law.
b. Future reversals of existing taxable temporary differences.
c. Tax-planning strategies.
d. Future taxable income exclusive of reversing temporary differences and carryforward.

The first two do not require any future events to occur in order for the deferred tax asset to be realized, while the third represents actions that are under the control of management. Only the fourth source requires estimates and judgments about future events and, as such, is the most subjective.

A. Taxable income in prior carryback years

If sufficient income of the proper source exists in the carryback period, and the applicable tax law allows carrybacks, then this source is the most objective source of income against which to apply the deferred tax asset. However, if such income is not sufficient, then an entity will need to consider other sources of taxable income. Additionally, this source of income should only be considered if the carryback will actually be exercised.

Under the Tax Cuts and Jobs Act, and as made permanent by the One Big Beautiful Bill Act (OBBBA), Net Operating Losses (NOLs) generated after 2017 may no longer be carried back (with limited exceptions) but can be carried forward indefinitely. However, the use of these carryforwards is limited to 80 percent of taxable income in any given year, which must be factored into scheduling for valuation allowance assessments.

B. Future reversals of existing taxable temporary differences

As we saw, deferred tax liabilities exist when the reversal of temporary differences will result in future taxable income. An entity can consider these reversals into future taxable income in its assessment of its recovery of its deferred tax assets. However, the mere existence of such differences does not automatically make them a source of taxable income for purposes of supporting the recognition of a deferred tax asset. It is generally necessary to schedule these reversals out over a relevant time period to determine if such reversals will actually serve as a source of future taxable income. The level of detail of such scheduling will vary based on the nature of the temporary differences but, at a minimum, their reversal should match with the ability to use the operating loss carryforwards in the carryforward period.

In this simplified example, assume the taxable temporary differences reverse as follows and the entity has three years remaining to use $25,000 of operating loss carryforwards:

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Reversing temporary difference	$5,000	$7,500	$3,000	$10,000	$22,000	$47,500
Utilization of NOL	$5,000	$7,500	$3,000	$0	$0	$15,500

While there are sufficient reversing temporary differences to support recognition of the $25,000 net operating loss carryforward, this scheduling exercise determined that, due to the expiration of the net operating loss carryforwards, only $15,500 of them can be realized using this source of future taxable income. Accordingly, the entity would need to look to other sources in order to realize the remainder of the carryforward.

Similarly, assumptions used elsewhere in the determination of deferred taxes should be consistently applied when assessing the need for a valuation allowance. For example, an entity may expect to remit undistributed foreign earnings on which deferred taxes have been provided. In assessing this approach, you should consider whether it is feasible for the entity to actually remit the cash in the carryforward period. If such remittances are not a normal business practice, you should consider whether this strategy is more akin to a tax planning strategy, which we will discuss next, as opposed to the more objective reversal of an existing temporary difference. Lastly, such a consideration would not be appropriate if the entity considered such earnings as permanently reinvested and thereby did not provide for deferred taxes on such amounts.

C. Tax planning strategies

Per Topic 740, tax planning strategies serve two functions. First, it may provide assurance of realization of a deferred tax asset in a situation where otherwise a valuation allowance would be established. Second, a tax planning strategy may reduce the complexity of applying Topic 740. With regard to its first purpose, the entity is required to consider prudent and feasible tax planning strategies in its assessment of the need for a valuation allowance. However, this raises the question of how much effort an entity should undertake to identify such strategies. The FASB staff states that management should make a reasonable effort, with its obligation being the same as its obligations to apply other standards. However, that being said, if there is sufficient evidence of future taxable income from one of the other sources of taxable income to eliminate the need for a valuation allowance, then a search for such strategies is not necessary.

So, the answer to the question is that it depends. The entity must make some effort, but the strategy must be both prudent and feasible.

Per ASC 740-10-30-19, a tax planning strategy is a tax planning action that meets the following criteria:

a. It must be prudent and feasible; and
b. It must be a strategy that the entity ordinarily would not take but would take to prevent an operating loss or to prevent a tax credit from expiring unutilized and would result in a deferred tax asset.

The entity must have the ability to implement the strategy and expects to do so. If implementing the strategy is not in the best interests of the entity, then it is not prudent. If management cannot execute the strategy, then it is not feasible. Similarly, tax planning strategies that the entity currently takes to shift, delay, or accelerate income for tax purposes would not meet the second criteria but would be considered in an entity's forecast of future taxable income, or the fourth criteria.

There are many such strategies that an entity may employ and generally consist of generating additional taxable income. Here are some examples:

a. Accelerating repatriation of foreign earnings for which deferred taxes have been provided. However, the feasibility of this strategy would need to be assessed against the amount of cash available for transfer.
b. Sale of appreciated assets – Such assets would have to be non-integral to the business and there would need to be some evidence of the appreciation of the asset. Also, the after-sale impact of selling the asset would need to be considered in estimates of future taxable income. For example, the interest income on the sale of appreciated debt securities would need to be adjusted out of any projections of future taxable income.

Also, if appreciated real estate is sold, rental income related to the property should be adjusted out as well.

c. The sale of appreciated available-for-sale or trading securities would constitute a valid tax strategy; however, sale of held to maturity securities would not. This is because selling such securities would be inconsistent with the assumption that they are to be held until maturity. Additionally, the income generated, generally capital gains, would need to be of the same classification as that driving the deferred tax asset.
d. Sales-leaseback transaction – If the asset to be sold has a higher book that tax basis, a sales-leaseback transaction will generate additional taxable income by accelerating the reversal of access depreciation taken for tax purposes over that for book. Ideally, the asset to be sold has appreciated. If not, the loss generated on the sale would need to be considered in determining the value associated with this tax strategy.
e. LIFO reserves – An entity may have a taxable temporary difference for LIFO inventories where the book carrying amount exceeds the tax carrying amount. It may employ strategies that accelerate the reversal of this temporary difference. The tax advantage generated by using LIFO is essentially a permanent deferral of tax, with greater expense being recorded in the income statement than with other inventory valuation methods, thus resulting in less taxable income. However, it may be economically feasible to trigger a LIFO reserve release in order to keep a credit or loss carryforward from expiring unused. An entity would trigger the release of the reserve by either changing its accounting for inventory for taxes, which requires IRS permission, or by triggering the partial release of the LIFO reserve by taking action that results in a reduction of LIFO inventories that liquidates an inventory layer. If employing this strategy, an entity should ensure that it is prudent to do so, with the benefit of liquidating the reserve exceeding the long-term benefit of being on LIFO.
f. Shifting from a tax-exempt to taxable investment portfolio – As long as the investments are not held-to-maturity investments, such a shift would constitute a valid tax strategy. However, the entity should review the risk profile of its new investment portfolio to ensure that it is consistent with its risk profile and cash flow needs in order to determine that shift is prudent.
g. Electing out of installment sales provisions for tax purposes, thereby accelerating taxable income.
h. Funding a tax-deductible liability before the expected payment date, in order to generate a tax loss that would be used for carrybacks.
i. Filing a consolidated or combined return.

The benefit of the tax planning strategy would be recorded net of any costs incurred to implement such a strategy, such as professional fees. Essentially, the costs impact the amount of the recorded valuation allowance, if applicable. Additionally, the benefit of the strategy can be incorporated into future earnings projections.

However, it is important to differentiate between a tax-planning strategy and simply projecting future taxable income. As mentioned above, the benefit of enacting a tax-planning strategy, net of its expense to implement it, would be included in future earnings projections. However, if the action does not meet the definition of a tax-planning strategy, generally because it is a strategy that the entity would ordinarily take, the benefit of the action would not be included in the estimate of future taxable income until the action is actually taken. This difference could impact the amount of the credit or carryforward that is realizable and thereby the amount of any necessary valuation allowance.

So, what types of strategies do not constitute tax-planning strategies? If the strategy does not result in incremental cash savings, even if it does result in a financial statement benefit, it is not a tax-planning strategy. Similarly, an anticipated business acquisition would not be considered a tax-planning strategy, as its execution would not be under the control of the entity. Other actions that may not be considered as tax-planning strategies include the following:

a. Selling assets that are valuable to the ongoing operations of the entity;
b. Funding deferred compensation before the expected payment date as such an activity merely triggers taxable income for its recipient;
c. Change in the entity's tax filing status; this would be considered a discrete event; and
d. Moving income from a nontax jurisdiction to a taxable one solely to realize net operating loss carryforwards.

Other strategies, such as disposing of an unprofitable subsidiary or cost reduction initiatives could be considered tax-planning strategies, based on the facts and circumstances.

Here are several last points. While we stated that deferred tax accounts should not be discounted, the time value of money should nonetheless be considered when determining whether a tax planning strategy is prudent. Additionally, the feasibility of the strategy should be evaluated at the consolidated group level, as an evaluation at the subsidiary level may not be able to incorporate all benefits and costs of implementing the strategy. Lastly, tax planning strategies which assume transactions that impact the timing of deductions and taxable income should be applied consistently across all entities and jurisdictions, unless the applicable tax code allows for different elections.

Applicability of this strategy for post 2017 NOLs is also no longer valid support for use of the DTA generated from unused NOLs due to their indefinite carryforward period.

D. Future taxable income, exclusive of reversing temporary differences and carryforwards

As most entities forecast pre-tax GAAP income as opposed to taxable income, it is much easier to use a forecasted GAAP amount that is adjusted for permanent differences. Ultimately, pre-tax book and taxable income will eventually equal over time, making the difference less relevant.

An entity should look at all available information when reviewing this forecast, including forecasts, budgets, industry trends, as well as assess potential changes to the business. Generally, most recent results would be most indicative of future results. Additionally, the entity should make sure to adjust forecasts in order to obtain "core" or recurring earnings and factor out one-off items like gains on sales that would distort an earnings trend.

Lastly, an entity should make an attempt to forecast temporary differences in the projection time period that arise from future operations. While difficult to do this, an entity may be able to forecast the temporary differences that will arise from depreciation deductions that will occur in the forecast period. Note that this is a different exercise considering the impact of temporary differences that have already occurred at the date of the projection. However, caution must be used when doing this process so as not to simply substitute one future reversal with another, which does nothing else than simply push out the reversal of the temporary difference. Such an activity does not create future taxable income for those differences to be applied against. Detailed scheduling that shows future taxable income, as adjusted as need be, and carryforwards may be necessary to support the recovery of the deferred tax assets, especially if the entity has recent tax losses or a large amount of carryforwards in relation to overall taxable income.

Generally, an entity can assume, unless information to the contrary exists, that if it has cumulative profits in recent years, then that trend will continue into the future. Additionally, the forecast of future taxable income must be in years that support the realization of the future tax benefits. To ensure this, scheduling of such income against the future tax benefits may be required. Lastly, an entity should utilize the projected benefits of earnings from acquisition synergies and built-in growth rates with caution, as these may prove to be overly optimistic. When an entity uses a range of forecasts, based on a low, most likely an upper, stretch goal, it may make sense to take a weighted average probability assessment that incorporates all such outputs into the forecast model.

As a general rule, the forecasts used to support recognition of deferred tax assets should be consistent with those used in other analyses, such as those used in impairment testing. However, as per ASC 740-10-30-23, the evidence should be weighted based to the extent that it can be objectively verified. Accordingly, forecasts used to support recovery of goodwill or fixed assets, while appropriate for their intended purpose, may differ if the entity has a history of recent losses. As those losses would be objectively verifiable, they would serve as better evidence to support recovery of the deferred tax asset. As you can see, this is a very subjective exercise. Strong documentation of key assumptions and rationales for supporting inclusion or exclusion of items of forecasted earnings should be developed. Plus, assumptions in the forecast should be consistent with others used in the determination of income tax expense, such as expectations around repatriation of foreign earnings.

IV. Changes in valuation allowances

Valuation allowances reduce the amount of the deferred tax asset recorded in the financial statements. As the change in deferred tax assets is a component of total income tax expense, a change in the amount of the valuation allowance recorded impacts income in the year of the change. ASC 740-10-45-20 provides the guidance for accounting for changes in valuation allowances. This guidance groups changes in valuation allowances into four groups. They are:

a. Effects of a change in judgment on the beginning of the year valuation allowance balance;
b. Effects of changes due to adjustments made in the measurement period for tax benefits recognized as part of a business acquisition;
c. Effects related to initial recognition of tax benefits related to certain transactions impacting shareholders' equity, which are changed to equity; and
d. Other changes not covered above.

As a result of applying the allocation guidance of Topic 740, most changes to the valuation allowance fall into the first bucket above and are charged to current operations. However, if changes in the assessment of the need for a valuation allowance result from income or loss recognized as not from current operations, an entity should assess whether a portion of the reversal should be allocated against discontinued earnings, using the intraperiod allocation rules which we will discuss later in the course.

Further, a change in the valuation allowance related to a deferred tax asset recognized as part of a business acquisition due to changes in the facts and circumstances during the measurement period would be charged to goodwill. If the change does not relate to a measurement period adjustment, the impact would be subject to the intraperiod allocation rules discussed above and most likely being included as a component of current earnings.

Although ASU 2023-09 does not change the recognition or measurement of deferred tax assets or valuation allowances, it significantly expands disclosure requirements. Entities will need to disaggregate valuation allowance changes by jurisdiction and disclose key drivers for recognition or release.

V. Summary

Accounting for valuation allowances can be very complex and is inherently subjective. While it may be very difficult to overcome the negative evidence supporting the non-recovery of the future tax benefits, entities can support their recognition through a variety of manners.

With Topic 740's focus on objectively verifiable evidence, recent past performance is a strong indicator for both realization as well as a need for a valuation allowance. Early years of forecasts are also better predictors of future taxable income than those in out years, as well as those that rely on a significant change or improvement in operations to support recoverability.

As with all subjective analyses, it is important to adequately document the assumptions used to arrive at your final decision, as well as document any variations from existing business plans or projections that were incorporated into forecasts used to support the recovery of deferred tax assets.

VI. Applying the learning

Given the following fact patterns, discuss the need for a valuation allowance against potential deferred tax assets related to net operating loss carryforwards for each of these three entities:

Year Ended	Pre-tax Income or Loss		
	Company A	**Company B**	**Company C**
December 31, Year 0	($1,500,000)	($1,200,000)	$1,100,000
December 31, Year 1	($900,000)*	($400,000)*	($900,000)*
December 31, Year 2	($1,200,000)	$250,000	($500,000)
3-year cumulative (loss) income as of Year 2	($3,600,000)	(1,350,000)	($300,000)
December 31, Year 3 projected	($900,000)	$400,000	($700,000)
* Includes non-recurring charge due to settlement of product liability suit of $600,000.			

VII. Applying the learning – Solution

Company A – Even with adding back the non-recurring charge in Year 1, Company A would have three consecutive years of losses, which is negative evidence that is difficult to overcome. Additionally, the entity is projecting a current year loss. Taken as a whole, it would be difficult to assert that Company A has sufficient, objectively verifiable evidence to support recognition of the deferred tax asset. It would most likely record a valuation allowance for the full amount of the deferred tax asset.

Company B – After adjusting Company B's earnings history for the non-recurring item, it has earned income in two of the past three years, on a "core" or recurring basis and is also projecting to earn income in the current year. While its cumulative net earnings history shows a loss, Company B is showing a positive trend in earnings. It would appear that a valuation allowance may not be necessary for Company B. However, Company B should consider scheduling out its future pre-tax income to see if it is sufficient to allow for the recovery of the full amount of the net operating loss carryforward.

Company C – While Company C does not have a three-year trend of losses, it does have a two-year trend, even with the add-back of the non-recurring item in Year 1. Additionally, Company C is projecting a current year pre-tax loss. Accordingly, it is demonstrating a negative trend in earnings, making the recording of a valuation allowance likely.

Intraperiod Allocations

Intraperiod Allocations

Learning objectives

After completing this chapter, you should be able to:

- Recall rules for allocating the total tax expense for the year among various financial statement components; and
- Identify the intricacies in applying the accounting model for intraperiod allocations.

I. Executive summary

Intraperiod allocations refer to the process of allocating total income tax expense or benefit for the year among the various financial statement components. These components include the following:

a. Income from continuing operations;
b. Income from discontinued operations;
c. Other comprehensive income; and
d. Items recorded directly to equity.

While ultimately this process is an allocation exercise, the results of this allocation are important. Analysts, bankers, and many internal metrics rely on results from continuing operations as the performance metrics against which performance is graded. Additionally, entities are using such non-GAAP measures as EBITDA and adjusted GAAP earnings to communicate the results of their operations. In order to consistently develop these reporting metrics, as well as to ensure that an entity is following SEC rules with regard to non-GAAP metrics, as appropriate, an entity requires a methodology to allocate the tax effects of certain transactions to the various constituent parts.

As multiple types of transactions generate taxable income or expense, both of a current and deferred nature, it is necessary to be able to allocate, in a rational, systematic way, the tax impact of each of these transactions to the related pre-tax impact. Ultimately, this is what the intraperiod allocation process does.

In this section, we will go over the basics of these intraperiod allocation rules.

II. Intraperiod allocations – The basics

The intraperiod allocation process is a combination of specific identification and allocation in order to distribute income tax expense into its constituent parts. While we will discuss the discreet identification of income tax expense related to certain transactions later in this chapter, we will discuss the general allocation approach first.

This method consists of using the “with-and-without” approach to allocate income tax expense and can be applied by following three steps:

- **Step 1** – Compute total tax benefit or expense for the period that is recognized in the financial statements.
- **Step 2** – Compute the tax effect of pre-tax income or loss from continuing operations, without consideration of the current-year pre-tax income from other financial statement components as well as those other items of income tax expense which Topic 740 requires to be allocated to continuing operations.

- **Step 3** – Allocate to the other financial statement components, in accordance with the guidance, the portion of the total tax that remains after allocation of tax to continuing operations.

We have basically discussed Step 1 in our course discussion to date. Topic 740 lists several specific adjustments to be made to the total tax expense or benefit related to the effects of business combinations, amounts recorded to equity, and amounts related to certain quasi-reorganizations. As these are specialized situations, we will not discuss these further in this course.

Step 2 requires the computation of income tax expense or benefit from continuing operations. This is done before considering the tax effects of current year income from all other financial statement components. For example, if results from discontinued operations resulted in a loss, this loss would be excluded from the computation in Step 2.

The application of Step 2 can yield interesting results. Assume that an entity has a net operating loss carryforward available to it at the beginning of the year due to tax losses at one of its operating units. Due to size of these losses, the entity has established a 100 percent valuation allowance against this deferred tax asset. In the current year, the entity has total pre-tax income of $0, split between pre-tax earnings from continuing operations of $5,000 and a pre-tax loss from discontinued operations of $5,000.

Step 2 requires computation of income tax expense or benefit before consideration of the current year pre-tax income from other financial statement components, such as discontinued operations. In this instance, the entity would apply the NOL carryforward available from the prior year against the pre-tax income from current operations in the current year, as the entity would exclude the pre-tax income or loss from other financial statement components, such as discontinued operations. As the continuing operations have pre-tax income against which to apply the NOL, the entity would do so. Application of this NOL against current year pre-tax income from continuing operations would reduce the tax expense from continuing operations in the current year.

In addition to the application of Step 2 above, Topic 740 requires certain elements of income tax expense to be allocated to income tax expense/benefit from continuing operations. These are as follows:

a. Tax effects of change in tax laws and rates;
b. Tax effects of changes in tax status;
c. Effect of a changed assessment about the realizability of deferred tax assets that existed at the beginning of the year because of a change in expectation of taxable income in future years;
d. Tax deductible dividends paid to shareholders; and
e. Tax effect of change in assertion related to unremitted earnings of foreign subsidiaries.

A. Changes in valuation allowances

Per the third bullet above, changes in a valuation allowance would be allocated to tax expense or benefit from continuing operations; however, there are some nuances. This classification as a component of tax expense/benefit from continuing operations is due to a change in the likelihood of realization due to income in future years.

When income in the current year allows for the release of the valuation allowance, the tax benefit should be allocated to the current year component of income that allows for its recognition. Lastly, when the tax benefit of a loss in the current year is recognized, it is allocated to the component of income that generated the loss, irrespective of its source.

For example, assume an entity has a valuation allowance against a deferred tax asset related to a NOL carryforward at the beginning of the year. As a result of the sale of a non-profitable subsidiary, the entity expects taxable income in future years against which to apply the NOL. As a result, the entity releases its valuation allowance against this deferred tax asset. As the release is due to projected taxable income in future years, the benefit of the release would be recorded as part of tax expense/benefit from continuing operations.

Now, assume that the NOL relates to a tax jurisdiction where the discontinued operation operates. The entity has established a valuation allowance related to NOLs just for this entity. However, in the current period, the discontinued operation generates pre-tax income that allows for the release of the valuation allowance. As this release was due to current year income, the benefit would be allocated to the source of the income. In this case, as the source was income from discontinued operations, the benefit of the release would be allocated to the tax benefit/expense from discontinued operations.

Step 3 of the approach requires the entity to allocate to the other financial statement components, in accordance with the guidance, the portion of the total tax that remains after allocation of tax to continuing operations. If there is only one item of income other than continuing operations, all remaining tax expense or benefit after the application of Step 2 is allocated to it.

However, if there are two or more items other than continuing operations, the remaining income tax expense or benefit should be allocated based on the respective income tax effect of each item. This approach requires the calculation of the discreet income tax effect of each specific item that is not included in earnings from continuing operations. This would be accomplished using a with and without approach, whereby income tax expense or benefit is measured both with the discreet item included and with it excluded. The difference in these amounts is the amount originally allocated to the other financial statement component. Note that in performing these calculations, the sum of the original amounts allocated to other financial statement components may not equal the balance to be allocated after completion of Step 2 of the approach. Any such differences would be allocated based on the original allocation percentages of the components. This reinforces the principle that the component of pre-tax income that enables recognition of a deferred tax benefit determines the allocation target, even when the source of the original valuation allowance spans multiple jurisdictions or operations.

B. Dealing with items included in other comprehensive income

As we have been discussing calculating income tax expense, our general assumption is that all of the items generating temporary differences are included in GAAP pre-tax earnings. However, certain items may be components of other comprehensive income (OCI). Generally, the tax effects of items included in OCI are also recorded in OCI. Some of these items include:

a. Foreign currency translation gains or losses;
b. Unrealized gains or losses on available for sale securities (to be impacted by ASU No. 2016-01);
c. Net unrecognized gains or losses and prior service cost related to pension and other postretirement benefits; and
d. Deferred gains or losses on derivatives classified as cash flow hedges.

For purpose of allocating income taxes, each component of OCI should be considered a separate financial statement component. Additionally, due to the allocation rules of Topic 740, certain changes to the current and deferred tax effects of items included in OCI will not result in a corresponding change to OCI. For example, the entire impact of a change in tax rates or laws would be included in tax expense/benefit from continuing operations, even for items originally included in OCI. Accordingly, OCI may contain deferred tax accounts that will never reverse out, with the tax effect in OCI not equal to the deferred tax asset or liability for such item on the balance sheet. Ultimately, this “lodged” tax effect in OCI should be cleared as the underlying item which generated it is included in book income. However, with regard to such items as a cumulative translation adjustment or unrealized pension or post-retirement plan gains or losses, this may take a long period of time to occur, such as when the foreign subsidiary is disposed of or the pension or post-retirement plan is terminated.

C. Discontinued operations

Accounting guidance for disclosure of the results of operations of discontinued operations changed with the effective date of ASU No. 2014-08 in 2015. Under ASC 205, as updated for this ASU, when operations that meet the definition of discontinued operations are disposed of or classified as held for sale, prior year’s results are segregated between continuing and discontinued operations. An entity will need to follow the guidance in Topic 740 to split income tax expense for the appropriate periods. In these restated financial statements, there may be other items to which income taxes were allocated. So as to not restate the amounts already allocated to such items, in such instances, the amount of tax allocated to the discontinued operations would be the difference between the tax originally allocated to the discontinued operations and the tax allocated to the restated continuing operations. This approach may result in a different allocation than what would have occurred if the entity used the intraperiod allocation rules. However, it is easier to apply and results in amounts presented in prior year financial statements not needing to be restated.

III. Summary

Intraperiod allocations can be very complex. In this chapter, we covered more or less the basic approach to performing such allocations. However, the basic three-step approach we discussed can be consistently applied to the more complex situations requiring intraperiod allocations.

Complicating the situation is the challenge of applying the “with-and-without” approach in order to determine the isolated effect on both current and deferred income tax on each financial statement component. However, with the prescribed rules-based approach, Topic 740 provides a thorough road map to guide you through the process.

IV. Applying the learning

Given the following fact pattern, determine the amount of income tax expense or benefit that should be allocated between pre-tax earnings from continuing operations and discontinued operations.

The entity has pre-tax loss, prepared on a tax basis, for the current year of $750,000, split as follows:

Continuing operations	$ 750,000
Discontinued operations	($ 1,500,000)
Total	($ 750,000)

During the year, the entity announced its intention to sell one of its two operating divisions, which, given the magnitude of its operations, constitutes a major strategic shift in its business.

Further, during the year, one of the entity's taxing jurisdictions changed its tax rate from 25 percent to 20 percent. The impact of this change was to reduce the entity's net deferred tax liability by $40,000.

At the beginning of the year, the entity had a 100 percent valuation allowance against a deferred tax asset of $100,000 related to net operating loss carryforwards of $500,000 which were generated in one of the tax jurisdictions where both the continuing operations and discontinued operations operate. However, due to the plans to sell the unprofitable operations which the entity classifies as discontinued, the entity expects enough taxable income in future years to realize the benefit of the NOLs. Accordingly, the entity released 100 percent of valuation allowance in the current year.

Assume that other than the impact of the change in tax rates, there was no change in deferred tax amounts.

V. Applying the learning – Solution

In applying the three-step process, the entity would calculate first calculate its total income tax provision as follows:

Pre-tax income/(expense)	($750,000)
Tax rate	20%
Income tax benefit, current portion	150,000
Impact of change in tax rates	40,000
Release of valuation allowance	100,000
Total tax benefit	$290,000

In Step 2 of the process, the entity would calculate the tax effect on pre-tax income from continuing operations, as follows:

Pre-tax income from continuing operations	$750,000
Tax rate	20%
Income tax expense from continuing operations	($150,000)
Release of valuation allowance	100,000[(1)]
Impact of change in tax rate	40,000[(2)]
Income tax expense allocated to continuing operations	($10,000)

(1) As the release of the valuation allowance against the deferred tax asset was due to forecasted future taxable income from the continuing operations, the impact of the release would be included in income tax expense/benefit from continuing operations.

(2) The impact of a change in tax rates or tax law would be included in income tax expense/benefit from continuing operations.

After allocations, income tax expense/benefit would be allocated as follows:

Income tax expense from continuing operations	($10,000)
Income tax benefit from discontinued operations	$300,000[(3)]
Total income tax (expense)/benefit	$290,000

(3) As the discontinued operations are the only other financial statement component against which to allocate income taxes, the balance of income tax expense/benefit which is not allocated to continuing operations is allocated to discontinued operations.

Financial Statement Presentation and Disclosure of Income Taxes

Financial Statement Presentation and Disclosure of Income Taxes

Learning objectives

After completing this chapter, you should be able to:

- Identify presentation requirements for balance sheet and income statement components of accounting for income taxes;
- Identify required disclosures for uncertain tax positions; and
- Identify footnote disclosures for income taxes and other topics related to taxes.

I. Overview

Once calculated, the income tax accounts must be properly presented in the financial statements. This includes both the accounts in the income statement as well as those on the balance sheet related to taxes currently receivable or payable as well as the deferred tax amounts.

From an income statement perspective, both the current and deferred portion of income tax expense/benefit should be shown in the financial statements, allocated between continuing operations and any other appropriate financial statement component, such as discontinued operations. This allocation is performed using the intraperiod allocation rules which we previously discussed.

As for the balance sheet, in addition to current taxes payable or receivable, deferred taxes must be presented using various netting rules contained within Topic 740.

From a disclosure perspective, it is not surprising that given the scrutiny over income taxes, there are a variety of required disclosures. The goal is to tell the reader information about future taxable events as well as let them know the actual or effective rate at which the entity actually pays income taxes, based on its book income.

Lastly, as we have seen, there are a variety of assumptions that an entity makes when determining its deferred tax balances, such as realizability of deferred tax assets and the likely outcome of any uncertain tax positions which the entity has taken. As with any key assumptions that drive amounts recorded, or not recorded, in the financial statements, it is important to tell the reader about them and the impact of changes in these assignments.

So, there is a lot to cover with regard to presentation and disclosure issues related to Topic 740. Let us get into our discussion.

II. Balance sheet presentation

As a reminder, deferred tax assets represent future reductions in the payment of income taxes while deferred tax liabilities represent future tax payments of income taxes. They are separately classified on balance sheet from income taxes payable or receivable, which represent the amount owed or receivable based on the current year's income tax return.

A. Classification of deferred taxes

To determine the presentation of deferred taxes, reporting entities should net all current deferred tax assets and liabilities within a single tax jurisdiction and present them as a single amount, current deferred tax assets or liabilities. A similar exercise is performed for non-current deferred tax balances by jurisdiction, resulting in a single non-current deferred tax asset or liability, for each tax-paying entity, by jurisdiction.

Then the net current and non-current deferred tax asset or liability, by tax-paying entity and by jurisdiction, are further netted to obtain a single non-current deferred tax asset or liability by tax-paying entity and tax jurisdiction. Any valuation allowance is netted against this amount. For financial statement presentation purposes, the net non-current deferred tax assets and liabilities are separately aggregated to arrive at the amounts presented on the financial statements. Note that these two amounts are not further netted in order to arrive at just one non-current deferred tax asset or liability amount.

Here is an example that applies this guidance. Assume no valuation allowance and each entity is located in a different tax jurisdiction.

The following table details the calculation of deferred taxes for different entities.

	Entity A		Entity B	Entity C		Entity D
Current deferred tax assets	$ 30		$ 150	$ 90		$ 120
Noncurrent deferred tax assets	40		125	25		60
Total deferred tax assets	$ 70		$ 275	$ 115		$ 180
Current deferred tax liabilities	$ (40)		$ (75)	$ (25)		$ (45)
Noncurrent deferred tax liabilities	(140)		(60)	(80)		(200)
Total deferred tax liabilities	$ (180)		$ (135)	$ (105)		$ (245)

As an intermediate step the entity could classify its deferred tax balances as follows:

	Entity A		Entity B	Entity C		Entity D	Consolidated
Current deferred tax assets	$ -		$ 75	$ 65		$ 75	$ 215
Noncurrent deferred tax assets			65				65
Current deferred tax liabilities	(10)		-	-		-	(10)
Noncurrent deferred tax liabilities	(100)		-	(55)		(140)	(295)

However, whether it takes the above intermediate step or just combines all deferred tax amounts in one step, its presentation of deferred taxes would be the following:

	Entity A		Entity B	Entity C		Entity D	Consolidated
Noncurrent deferred tax assets	$ -		$ 140	$ 10		$ -	$ 150
Noncurrent deferred tax liabilities	(110)		-	-		(65)	(175)

III. Income statement presentation

The total income tax amount for an entity consists of two parts. First, the current portion is the amount of the total tax payable or receivable from the taxing jurisdiction; this is taken directly from the tax return.

The second component of income tax expense or benefit is the change between the beginning and end of the year deferred tax account balances that are found on the balance sheet. However, as we saw when we were discussing intraperiod allocations, there are a few exceptions to this general rule. For example, certain changes to deferred taxes are recorded through OCI, such as balances related to pensions or available for sale investments (before the effective date of ASU No. 2016-01).

Further, an entity makes an election as to how it will classify interest and penalties due to taxing authorities. Interest can be classified as either a component of income tax expense or interest expense, while penalties can be classified as either income tax expense or another classification. Entities must disclose the policy, and the amount of interest and penalties included in the income statement.

Lastly, professional fees incurred as part of tax compliance or planning activities would not be included in income tax expense but rather as part of selling, general, and administrative expense (SG&A).

IV. Financial statement disclosures

Given that a large amount of activity is summarized in two income statement accounts and, under ASU No. 2015-17, two balance sheet accounts, it is not surprising that the required disclosures related to income taxes are extensive, both for the balance sheet and income statement amounts. Let us start with the balance sheet disclosures.

A. Balance sheet disclosures

Entities are required to disclose the following in the notes to their financial statements with regard to balance sheet tax accounts for each period presented in the financial statements:

a. Gross deferred tax assets and liabilities.
b. Valuation allowance and its net change. In addition to these quantitative disclosures, entities should consider adding qualitative evidence concerning the positive and negative evidence it considered in arriving at these amounts.
c. The tax effect of each type of temporary difference and carryforward that gives rise to deferred tax assets and liabilities. Public entities are required to provide this information in a quantitative format while a private company can provide the information in a qualitative format.
d. The amounts and expiration dates of loss and tax credit carryforwards.
e. Temporary differences for which a deferred tax liability has not been recognized. An example of this would be if an entity did not provide a deferred tax liability on the earnings of foreign subsidiaries due to its intent to permanently reinvest those earnings in the subsidiary. This disclosure should include the following:
    (i) A description of the temporary difference and the reasons which could make them taxable in the future;
    (ii) Their cumulative amount; and
    (iii) The amount of any unrecognized deferred tax liability.
f. Other required disclosures, as applicable, include the following:
    (i) Nature and effect of any significant matters affecting the comparability of the information presented;
    (ii) Any portion of the valuation allowance for which subsequently recognized tax benefits will be credited directly to contributed capital; and

(iii) The amount of income tax expense or benefit allocated to each component of OCI.

B. Income statement disclosures

An entity is required to disclose the amount of income tax expense or benefit allocated to continuing operations, as well as that allocated to other components, in accordance with the intraperiod allocation provisions. Often, this disclosure, at least for continuing and discontinued operations, is on the face of the financial statements.

Entities are also required to reconcile income tax expense attributable to continuing operations to the statutory Federal income tax rate applied to book pre-tax income from continuing operations. For public companies, this reconciliation can be in a dollar or percentage format while, for private companies, the rate reconciliation can be of a qualitative nature only.

The following are common items included in the rate reconciliation:

a. Changes in the valuation allowance;
b. Use of permanent differences or tax credits in determination of taxes payable or deferred taxes;
c. Impact of changes in tax rates;
d. Unremitted foreign earnings that are deemed permanently reinvested;
e. Impact of tax holidays;
f. Change in unrecognized tax benefits from uncertain tax positions;
g. Stock-based compensation shortfalls (windfalls will also be included with the effective date of ASU No. 2016-09); and
h. Goodwill impairment or tax amortization.

Often the rate reconciliation is seen as a report card on the entity's ability to manage its tax liability. Many of the reconciling items can be seen as arising as the result of effective tax planning strategies.

Additionally, entities are required to disclose the significant components of income tax expense. These components should consist of the following:

a. Current income tax expense or benefit;
b. Deferred tax expense or benefit;
c. Investment tax credits;
d. Government grants;
e. Benefits of operating loss carryforwards;
f. Tax expense from the direct allocation of certain tax benefits directly to contributed capital;
g. Adjustments to deferred taxes due to enacted changes in tax rates or laws; and
h. Changes in valuation allowance from the beginning of the year due to changes in assumptions about the realization of deferred tax assets.

Topic 740 also requires other disclosures with regard to uncertain tax positions. We will discuss the accounting for such positions, including required disclosures, later in the course. Additionally, extensive disclosures are required with regard to stock-based compensation, including amounts related to taxes on such transactions. We will also discuss this topic later in the course.

Generally, these disclosures are required for all entities, whether they be public or private, unless otherwise noted above. However, there are several other items of disclosure relief for non-public entities. They are not required to disclose the following:

a. Tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the reporting date;
b. Tax holidays granted by foreign jurisdictions; or
c. Net difference between the tax bases and the reported amount of assets and liabilities when they are structured as nontaxable entities.

Further, only SEC registrants are required to make the following disclosures, under the SEC S-X rules:

a. In the rate reconciliation, individual reconciling items that are more than 5 percent of the amount computed by multiplying the pre-tax income by the statutory tax rate;
b. The source of income/loss before taxes as either foreign or domestic;
c. For each major component of income tax expense, the amounts applicable to U.S. Federal tax, foreign income taxes, or other income taxes; and
d. Tax holidays granted.

In December 2023, the FASB issued ASU 2023-09, which enhances income tax disclosures under ASC 740. Beginning in 2025, for public business entities, companies must disclose:

a. Reconciliation of the effective tax rate using both percentages and dollar amounts;
b. Separate reconciling items 5 percent or more of the statutory tax amount; and
c. Disaggregated information on income taxes paid by jurisdiction (federal, state, and foreign).

These changes increase transparency but do not alter measurement or recognition guidance under ASC 740.

In light of the One Big Beautiful Bill Act (OBBBA), enacted in July 2025, entities should also assess how the permanency of various TCJA provisions (such as the Section 199A deduction and expanded Section 179 expensing) affects their effective tax rate reconciliations. While these provisions may not require separate line-item disclosure under ASC 740, their impact – particularly if material – should be reflected within permanent differences or statutory reconciling items. Additionally, if a company holds qualified small business stock acquired after July 4, 2025, the revised Section 1202 exclusion rules may impact long-term gain projections and could warrant discussion in disclosures where relevant.

V. Example of income tax disclosures

The following are sample disclosures of some of the required disclosures related to income taxes. The entities selected provide examples of the significantly different outcomes that may occur based on the operations of the entity. For instance, Microsoft derives a significant portion of its revenue from outside of the U.S. and it has a relatively small, fixed asset base. On the other hand, AT&T has primarily domestic operations and has a significant fixed asset base.

A. Microsoft FY 2024 financial statement disclosures

1. Components of income and income tax expense

The following disclosure details the sources of Microsoft's income before taxes by geography as well as the breakdown of its income tax expense both by component and jurisdiction. As we will see when we look at Microsoft's rate reconciliation, foreign earnings are generally taxed at a lower rate than their U.S.-based earnings, contributing to a lower effective tax rate.

The components of the provision for income taxes were as follows:

(In millions)			
Year Ended June 30,	**2024**	**2023**	**2022**
Current Taxes			
U.S. federal	**$ 12,165**	$ 14,009	$ 8,329
U.S. state and local	**2,366**	2,322	1,679
Foreign	**9,858**	6,678	6,672
Current taxes	**$ 24,389**	$ 23,009	$ 16,680
Deferred Taxes			
U.S. federal	**$ (4,791)**	$ (6,146)	$ (4,815)
U.S. state and local	**(379)**	(477)	(1,062)
Foreign	**432**	564	175
Deferred taxes	**$ (4,738)**	$ (6,059)	$ (5,702)
Provision for income taxes	**$ 19,651**	$ 16,950	$ 10,978

U.S. and foreign components of income before income taxes were as follows:

(In millions)			
Year Ended June 30,	**2024**	**2023**	**2022**
U.S.	**$ 62,886**	$ 52,917	$ 47,837
Foreign	**44,901**	36,394	35,879
Income before income taxes	**$ 107,787**	$ 89,311	$ 83,716

2. Rate reconciliation

In Microsoft's rate reconciliation, we see that their effective tax rate of 18.2 percent is lower than their U.S. Federal statutory rate of 21.0 percent. This is due to several reasons:

a. Lower tax rate on foreign earnings than on U.S.-based earnings;
b. The foreign-derived intangible income (FDII) deduction, which provides a favorable U.S. tax rate on income from exports of goods and services, thereby encouraging the use of U.S.-based intellectual property; and
c. Excess tax benefit over that recorded at the statutory rate from the exercise or vesting of share-based awards. Essentially, the actual deduction taken exceeded the expected tax benefit recorded when the expense for share-based payments recorded under ASC 718 was originally recorded.

Effective Tax Rate

The items accounting for the difference between income taxes computed at the U.S. federal statutory rate and our effective rate were as follows:

Year Ended June 30,	2024	2023	2022
Federal statutory rate	**21.0%**	21.0%	21.0%
Effect of:			
Foreign earnings taxed at lower rates	**(1.4)%**	(1.8)%	(1.3)%
Impact of intangible property transfers	**0%**	0%	(3.9)%
Foreign-derived intangible income deduction	**(1.1)%**	(1.3)%	(1.1)%
State income taxes, net of federal benefit	**1.5%**	1.6%	1.4%
Research and development credit	**(1.1)%**	(1.1)%	(0.9)%
Excess tax benefits relating to stock-based compensation	**(1.1)%**	(0.7)%	(1.9)%
Interest, net	**1.1%**	0.8%	0.5%
Other reconciling items, net	**(0.7)%**	0.5%	(0.7)%
Effective rate	**18.2%**	19.0%	13.1%

3. Components of its deferred tax assets and liabilities

Unlike many capital-intensive businesses, Microsoft reports a net deferred tax asset position. The largest component of its deferred tax asset relates to the amortization of intangible assets that is recognized for financial reporting purposes but not yet deductible for tax purposes, deferred (unearned) revenue that has been taxed but not yet recognized in the financial statements, and various accruals, reserves, and other expenses recorded for book purposes that have not yet been deducted for tax purposes.

On the liability side, Microsoft's deferred tax liabilities primarily reflect the tax effects of unrealized gains on equity and debt investments, as well as deferred taxes related to GILTI, suggesting that Microsoft does not assert permanent reinvestment of certain foreign earnings.

In addition, the company recognizes both a deferred tax asset and a liability related to leases, which are largely offset. These arise under ASC 842, which creates temporary differences between the right-of-use asset and lease liability for book and tax purposes.

The components of the deferred income tax assets and liabilities were as follows:

(In millions)

June 30,		**2024**		**2023**
Deferred Income Tax Assets				
Stock-based compensation expense	**$**	**765**	$	681
Accruals, reserves, and other expenses		**4,381**		3,131
Loss and credit carryforwards		**1,741**		1,441
Amortization		**4,159**		9,440
Leasing liabilities		**6,504**		5,041
Unearned revenue		**3,717**		3,296
Book/tax basis differences in investments and debt		**9**		373
Capitalized research and development		**11,442**		6,958
Other		**426**		489
Deferred income tax assets		**33,144**		30,850
Less valuation allowance		**(1,045)**		(939)
Deferred income tax assets, net of valuation allowance	**$**	**32,099**	$	29,911
Deferred Income Tax Liabilities				
Leasing assets	**$**	**(6,503)**	$	(4,680)
Depreciation		**(3,940)**		(2,674)
Deferred tax on foreign earnings		**(1,837)**		(2,738)
Other		**(167)**		(89)
Deferred income tax liabilities	**$**	**(12,447)**	$	(10,181)
Net deferred income tax assets	**$**	**19,652**	$	19,730
Reported As				
Other long-term assets	**$**	**22,270**	$	20,163
Long-term deferred income tax liabilities		**(2,618)**		(433)
Net deferred income tax assets	**$**	**19,652**	$	19,730

4. Other required disclosures

This table represents the roll-forward of Microsoft's uncertain tax positions.

(In millions)

Year Ended June 30,		**2024**		**2023**		**2022**
Beginning unrecognized tax benefits	**$**	**17,120**	$	15,593	$	14,550
Decreases related to settlements		**(76)**		(329)		(317)
Increases for tax positions related to the current year		**1,903**		1,051		1,145
Increases for tax positions related to prior years [(a)]		**4,289**		870		461
Decreases for tax positions related to prior years		**(464)**		(60)		(246)
Decreases due to lapsed statutes of limitations		**(12)**		(5)		0
Ending unrecognized tax benefits	**$**	**22,760**	$	17,120	$	15,593

(a) *Fiscal year 2024 includes unrecognized tax benefits of $3.4 billion related to the acquisition of Activision Blizzard.*

B. AT&T 2024 income tax disclosures

1. Significant components of deferred tax liabilities (assets)

As a capital-intensive company, AT&T's largest deferred tax liability is due to book-tax depreciation differences and licenses and other intangibles that are amortizable for tax purposes, reducing taxable income but otherwise not amortizable for book purposes. These are most likely indefinitely lived intangibles.

Significant components of our deferred tax liabilities (assets) are as follows at December 31:

		2024		2023
Depreciation and amortization	$	36,531	$	37,931
Licenses and nonamortizable intangibles		20,660		20,049
Lease right-of-use assets		5,103		5,100
Lease liabilities		(5,107)		(5,146)
Employee benefits		(3,017)		(2,970)
Deferred fulfillment costs		1,788		1,941
Equity in partnership		2,716		2,943
Net operating loss and other carryforwards		(5,619)		(6,484)
Other – net		1,466		563
Subtotal		54,521		53,927
Deferred tax assets valuation allowance		4,338		4,656
Net deferred tax liabilities	$	58,859	$	58,583
Noncurrent deferred tax liabilities	$	58,939	$	58,666
Less: Noncurrent deferred tax assets		(80)		(83)
Net deferred tax liabilities	$	58,859	$	58,583

2. Uncertain tax positions

A reconciliation of the change in our UTB balance from January 1 to December 31 for 2024 and 2023 is as follows:

		2024		2023
Depreciation and amortization	$	36,531	$	37,931
Licenses and nonamortizable intangibles		20,660		20,049
Lease right-of-use assets		5,103		5,100
Lease liabilities		(5,107)		(5,146)
Employee benefits		(3,017)		(2,970)
Deferred fulfillment costs		1,788		1,941
Equity in partnership		2,716		2,943
Net operating loss and other carryforwards		(5,619)		(6,484)
Other – net		1,466		563
Subtotal		54,521		53,927
Deferred tax assets valuation allowance		4,338		4,656
Net deferred tax liabilities	$	58,859	$	58,583
Noncurrent deferred tax liabilities	$	58,939	$	58,666
Less: Noncurrent deferred tax assets		(80)		(83)
Net deferred tax liabilities	$	58,859	$	58,583

3. The components of income tax (benefit) expense

Below is the breakout of AT&T's income tax provision, by component and jurisdiction. Lastly, given its operations, AT&T generates most of its pre-tax earnings from domestic operations.

	2024	2023	2022
Federal:			
Current	$ 2,769	$ 2,280	$ 579
Deferred	1,289	2,250	2,206
	4,058	4,530	2,785
State and local:			
Current	859	423	21
Deferred	(512)	(832)	912
	347	(409)	933
Foreign:			
Current	68	66	106
Deferred	(28)	38	(44)
	40	104	62
Total	$ 4,445	$ 4,225	$ 3,780

	2024	2023	2022
U.S. income (loss) before income taxes	$ 16,674	$ 20,506	$ (1,480)
Foreign income (loss) before income taxes	24	(658)	(1,614)
Total	$ 16,698	$ 19,848	$ (3,094)

4. Rate reconciliation

AT&T's rate reconciliation shows a small difference between the statutory federal rate of 21 percent and its effective tax rate of 26.6 percent. The increase is primarily driven by nondeductible goodwill impairments, as well as the impact of state income taxes and other permanent items.

A reconciliation of income tax expense (benefit) on continuing operations and the amount computed by applying the statutory federal income tax rate of 21 percent to income from continuing operations before income taxes is as follows:

	2024	2023	2022
Taxes computed at federal statutory rate	$ 3,507	$ 4,168	$ (650)
Increases (decreases) in income taxes resulting from:			
State and local income taxes – net of federal income tax benefit	478	345	795
Tax on foreign investments	3	102	43
Noncontrolling interest	(274)	(259)	(308)
Permanent items and R&D credit	(174)	(207)	(121)
Audit resolutions	192	319	(642)
Divestitures	—	(75)	(481)
Goodwill impairment[1]	929	9	5,210
Other – net	(216)	(177)	(66)
Total	$ 4,445	$ 4,225	$ 3,780
Effective Tax Rate	26.6 %	21.3 %	(122.2) %

[1] Goodwill impairments are not deductible for tax purposes.

VI. Practice exercise and suggested solution

A. Practice exercise

Given the following fact pattern, determine the financial statement presentation of deferred taxes account balances under the current accounting guidance of ASC 740.

	Entity A		Entity B		Entity C
Current deferred tax assets	$ 45		$ 60		$ 20
Noncurrent deferred tax assets	$ 70		80		$ 50
Total deferred tax assets	$ 115		$ 140		70
Current deferred tax liabilities	$ (90)		$ (35)		-
Noncurrent deferred tax liabilities	(240)		(85)		$ (125)
Total deferred tax liabilities	$ (330)		$ (120)		$ (125)

B. Practice exercise – Suggested solution

Deferred taxes can only be netted by entity and by jurisdiction. As there are three entities within this jurisdiction, each will have a separate deferred tax balance.

The first step of the process is to put net amounts into one current and one deferred balance, by entity. This would be the result under current accounting guidance.

	Entity A		Entity B		Entity C
Current deferred tax assets	$ -		$ 25		$ 20
Noncurrent deferred tax assets			-		
Current deferred tax liabilities	$ (45)		-		-
Noncurrent deferred tax liabilities	$ (170)		$ (5)		$ (75)

Under ASU No. 2015-17, by entity and by taxpaying jurisdiction, all deferred tax amounts are netted into one non-current deferred tax asset or liability, as shown below.

	Entity A		Entity B	Entity C		Consolidated
Noncurrent deferred tax assets	$ -		$ 20	$ -		$ 20
Noncurrent deferred tax liabilities	$ (215)		$ -	$ (55)		$ (270)

Accounting for Uncertain Tax Positions

Accounting for Uncertain Tax Positions

Learning objectives

After completing this chapter, you should be able to:

- Recall the two-step model for entities to follow related to uncertain tax positions (UTPs) accounting;
- Identify the required disclosures related to UTPs; and
- Recall specific disclosures for public companies.

I. Executive summary

While the tax code is very rule oriented, there can nonetheless be great subjectivity in applying these rules to certain situations. As a result, entities need to deal with the effects of their uncertain tax positions (UTPs), which may take years to finally resolve with the IRS or other taxing authority. Often, they will take a position in their tax return which, because of this ambiguity, may not be upheld on final audit by the tax jurisdiction. However, given this uncertainty, they may not want to record the full benefit of this position in the financial statements. Accounting for this scenario is what we will cover in this chapter.

In 2006, the FASB issued guidance to address diversity in practice with regard to accounting for such tax positions. Before the issuance of FIN 48, later codified as part of Topic 740, entities tended to create a reserve for the possible adverse outcome of these tax positions. However, FIN 48 established consistency with regard to the accounting for these situations. This guidance established a two-step model for entities to measure and recognize uncertain tax positions. Further, the guidance also required certain disclosures which entities should make about their tax positions. While subsequently scaled back in 2009, these disclosures require entities to discuss tax years open to audit as well as information related to reasonably possible near-term changes in the total amount of unrecognized tax benefits.

We will review the basic model in the following section.

II. Uncertain tax positions – The basics

Accounting for uncertain tax positions (UTPs) is similar to accounting for other contingent liabilities. Here are the basics of the accounting model:

a. **Recognition threshold** – The tax benefit of a UTP should be recognized in the financial statements only if it is more-likely than not that the position is sustainable, based on the technical merits of the tax position. This generally means that the outcome is more than 50 percent.
b. **Measurement** – Often there is a range of potential outcomes with regard to UTPs. Only the portion of the position that exceeds the 50 percent threshold should be recognized.
c. **Change in judgment** – Changes in the assessment of outcome and measurement should occur only with the availability of new information and not result from a reassessment of existing facts.
d. **Interest and penalties** – The entity should accrue any interest and penalties that it would be subjected to under the tax law, beginning in the year in which it would be subject to the interest and penalty for taking the position in its tax return.
e. **Liabilities from UTPs** – Such liabilities would be classified as long-term unless payment is expected within 12 months of the date of the financial statements.

f. **Disclosures** – ASC 740-10-50 requires the following disclosures related to UTPs:
   (i) Accounting policy with regard to interest and penalties and the amount accrued.
   (ii) For public companies, a roll forward of all unrecognized tax benefits from the beginning to the end of the year.
   (iii) The amount of unrecognized UTPs that, if recognized, would impact the effective tax rate.
   (iv) A discussion of reasonably possible changes to the balance of UTPs that could occur within the 12 months following the reporting date.
   (v) A description of tax years that remain open to audit.

III. Identifying uncertain tax positions

Per the FASB Master Glossary, a tax position is a position in a previously filed tax return or one expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities.

The position can result in a permanent reduction of income taxes payable, a deferral of income taxes payable until a later year, or a change in the expected realizability of a deferred tax asset.

Examples include:

a. A decision not to file a tax return;
b. An allocation or shift of income between jurisdictions;
c. The characterization of income;
d. A decision to exclude taxable income in a return;
e. A decision to classify a transaction, entity, or other tax position in a tax return as tax exempt; and
f. An entity’s tax status.

The specific circumstances that can bring any of these situations about are numerous and generally very specific to the entity. Guidance on such transactions may be vague or may not even exist. Such positions may be numerous and present a challenge for an entity to identify all of them.

Once identified, the entity must assess the UTP to see if it should be recognized. The first step in this assessment is to recognize the appropriate unit of account. This is a matter of judgment based on the facts and circumstances, and one should consider how the entity prepares its tax returns as well as its approach with the relevant tax authority during an audit. The unit of account defines the level at which the tax position should be analyzed. Once established, the unit of account should be consistently applied, barring a change in facts and circumstances.

Once the unit of account has been established, the next decision is to determine whether the uncertain tax positions should be recognized. As we said previously, the appropriate threshold is “greater than 50 percent,” or “more likely than not,” that the benefit will be realized. When assessing this probability, the entity should assume that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.

The technical merits of the position derive from the sources of authorities in the tax law, such as the following:

a. IRC and other statutory provisions;
b. Interpretive regulations;
c. Revenue Rulings;
d. Tax treaties;
e. Court cases;
f. Congressional intent;
g. JCT "Blue Book";
h. IRS Publications;
i. Private Letter Rulings; and
j. Technical Advice Memoranda.

Also, each position must be assessed individually, without consideration of the possibility of offset or aggregation with other positions.

Lastly, the decision to recognize an UTP is different than that of whether an entity needs a valuation allowance. An UTP exists because of ambiguity in the application of the tax code while the need for a valuation allowance arises when there is a lack of future taxable income against which deferred tax assets may be applied. While both use the "more likely than not" threshold for recognition, each represents a different type of uncertainty and should be accounted for separately.

IV. Measuring the tax benefit to be recorded

Per ASC 740-10-30-7, an UTP meeting the more likely than not threshold should be initially and subsequently measured as the largest amount of the benefit that is greater than the 50 percent threshold. Accordingly, entities must develop a probability assessment of the likely outcome of their tax position. While this determination is pretty straightforward when there are only two possible outcomes, it becomes more complicated when there are more than two outcomes, requiring a more sophisticated assessment.

This approach, known as the cumulative probability approach, should be used when the range of outcome can be more than an "all or none." In applying this approach, the outcome that provides the greatest tax benefit should be assessed first. If the probability of that outcome exceeds 50 percent, no further analysis is necessary and that amount is recorded in the financial statements. However, if that outcome is less than 50 percent, the probability of the next most advantageous position should be assessed, with that amount being recorded if the cumulative probability exceeds 50 percent. This process goes on until the cumulative probability of an outcome exceeds 50 percent. The following is an example of what a cumulative probability table would look like:

Amount of "As Filed" Benefit Being Sustained	Individual Probability of Outcome	Cumulative Probability of Outcome
$250	25%	25%
$200	20%	45%
$150	**15%**	**60%**
$100	15%	75%
$50	15%	90%
$0	10%	100%

In the above scenario, the entity would record a benefit of $150, as this is the largest benefit that meets the most likely than not threshold.

The assessment of probability is by nature subjective. This assessment is based on the perceived weight of the tax law in the entity's favor, precedent, expectations about how the taxing authority will pursue the issue and the entity's willingness to defend the position in court, as opposed to accepting a negotiated outcome. All of these must be assessed under the assumption that the taxing authority has full knowledge of the uncertain tax position.

If the more likely than not threshold is not met in the period in which the tax position is taken, it should be recorded in the period, including interim periods for public companies, when any of the following is met:

a. The more likely than not threshold has been met by the reporting date;
b. The tax position is effectively settled through examination, negotiation, or litigation; or
c. The statute of limitations expires.

Again, a change in recognition or measurement should only be based on new information, not a reexamination of existing information that existed when the position was originally taken. However, an entity should assess the availability of such new information on an ongoing basis.

When recording an adjustment to a previously recorded UTP or recording it initially, the amount should be recorded as a discrete item in the period in which the change occurs.

A. Interest and penalties

Interest expense related to underpaid taxes on an UTP should begin to be recorded in the period in which interest would be due to the taxing authority based on the position taken.

With regard to penalties, per ASC 740-10-25-57, if the tax position does not meet the minimum statutory threshold to avoid payment of penalties, the entity should accrue an expense for the amount of the statutory penalty in the period in which it claims or expects to claim the position in the tax return.

B. Disclosures

With such sensitivity around income taxes, the adequacy of financial statement disclosures is a large concern for entities. Entities are concerned that such disclosures would serve as an aid to the tax authorities in their review of the financial statements. In response to these concerns, the FASB made certain concessions in the required disclosures for UTPs under Topic 740.

One of the concessions made by the FASB with regard to disclosure related to UTPs is that the following qualitative disclosures are only required if it is reasonably possible that the positions and events could change in the next 12 months. For such items, the following disclosures are required:

a. The nature of the uncertainty;
b. Nature of the events that could occur within the next 12 months to cause the change; and
c. Estimate of the range of the changes or a statement saying the range cannot be estimated.

All entities must also include a reconciliation of the beginning and ending balances of the unrecognized tax benefits from uncertain tax positions. Further, public entities must present a tabular reconciliation roll forward amounts of unrecognized tax benefits at the beginning and end of the year that includes the following:

a. Gross amount of increase and decreases in unrecognized tax benefits as a result of tax positions taken during the prior period;
b. The gross amount of increases and decreases in unrecognized tax benefits as a result of income tax positions taken in the current period;
c. The amount of the decrease in unrecognized tax benefits related to settlements with taxing authorities; and
d. Reductions to unrecognized tax benefits as a result of a lapse in the statute of limitations.

Entities should consider additional lines to the table if they help with explaining changes in the balance of UTPs.

C. Documentation

The amount of documentation which an entity needs to prepare to support its analysis will vary. Some issues that drive UTPs are fairly straight forward and do not require a significant level of documentation to support the position which the entity has taken. Others are very complicated, with the required level of documentation being more. For each material position, the entity should document its expected outcome, including probability assessments and likely outcomes.

Given the potentially large amounts of UTPs, and the various tax jurisdictions in which an entity operates and the number of issues, the development of such documentation should be considered as part of a process, rather than a discrete activity. It is best to start the documentation process as soon as the UTP is taken, with broader issues addressed in a standard memo which can be modified to address transaction specific or more complex issues.

V. Applying the learning

An entity has developed the following table of cumulative probability with regard to one of its uncertain tax positions. Based on the following, determine which amount should be recorded as the benefit of this UTP.

Amount of "As Filed" Benefit Being Sustained	Individual Probability of Outcome	Cumulative Probability of Outcome
$1,000	10%	
$800	15%	
$750	20%	
$400	25%	
$200	20%	
$0	10%	

VI. Applying the learning – Solution

The greatest amount where the probability of favorable outcome is more likely than not (greater than 50 percent) should be recorded as the benefit of the uncertain tax position. Given the above, the first step would be to complete the cumulative probability table, as follows:

Amount of "As Filed" Benefit Being Sustained	Individual Probability of Outcome	Cumulative Probability of Outcome
$1,000	10%	10%
$800	15%	25%
$750	20%	45%
$400	**25%**	**70%**
$200	20%	90%
$0	10%	100%

Per this analysis, the amount to be recorded is $400, as that is the largest amount for which the probability of positive outcome exceeds 50 percent.

Accounting for Income Taxes at Interim Periods

Accounting for Income Taxes at Interim Periods

Learning objectives

After completing this chapter, you should be able to:
- Recall the method for estimating the estimated annual effective tax rate (ETR);
- Identify the exceptions to using the ETR for interim reporting; and
- Recall additional unique challenges in developing interim accrual for income taxes.

I. Executive summary

Interim reporting issues are generally only a concern for public entities, which must prepare quarterly financial statements, which are filed with the SEC on Form 10-Q. However, there may also be circumstances where a private entity will need to prepare interim statements on a GAAP basis, which include income taxes.

Computing income taxes on an interim basis can be challenging, as estimates must be made about the full year's results. Additionally, as we saw previously, certain tax effects such as changes in UTPs are considered discrete items, with their effect on earnings recorded in the period in which the transaction occurs.

We will review the basic approach to calculating income taxes on an interim basis in this section.

II. Interim reporting – The basics

The general model for interim reporting is to report income tax expense or benefit related to ordinary income based on an estimated effective tax rate (ETR).

Topic 740 defines ordinary income as the income or loss from continuing operations before income taxes and excluding significant unusual or infrequently occurring items. Discontinued operations and the cumulative effect of changes in accounting principles are also excluded.

The tax or benefit is the total income tax expense or benefit, including the provision for income taxes both currently payable and deferred.

The following items would also be considered as discrete items in the calculation of interim income taxes:

a. Certain investment tax credits – exclude if amortized over asset life;
b. Leveraged leases;
c. After-tax equity pick-up of equity investment;
d. Change in measurement and/or recognition of an UTP; however, current year UTPs would be included in the ETR;
e. Interest and penalties on UTPs;
f. Impact of change in tax law or status;
g. Certain changes in realizability of DTAs;
h. Change in judgment concerning unremitted foreign earnings; and
i. Change in estimate of prior-year provision.

III. Estimating the annual ETR

To determine the income tax expense or benefit related to ordinary income, the entity must estimate its annual tax rate.

To do so, the entity must estimate its taxable income for the year, as this will be used to estimate taxes payable as well as deferred income taxes at each quarter. The entity must also estimate permanent differences, which are used to estimate the current provision and serve as the basis for the year-end estimate of permanent differences. These estimates are used to develop the estimate for deferred taxes.

The entity's ETR should represent the best estimate of the composite tax provision in relation to its best estimate of its worldwide pre-tax book income. This amount is then applied to the year to date (YTD) ordinary income calculated as per the above. The difference between the YTD interim tax provision and the YTD interim tax provision from the preceding interim quarter is the current period's interim income tax expense.

Note that in applying this above methodology, the interim income tax provision may vary significantly from that which would have been calculated if the provision was calculated separately based on that quarter's taxable income. Also, the entity can continue to change its estimate of full-year income from quarter to quarter, which would impact the estimate of the ETR. Accordingly, the ETR for any particular quarter may have no meaningful relationship to pre-tax income for that quarter or the current estimated annual ETR.

A. Determining tax effect of discrete items

The interim tax provision should encompass the tax on ordinary income as well as other items not included in ordinary income, such as those items subject to the intraperiod allocation rules as well as items for which the discrete effects of income taxes should be computed.

ASC 740-270-45 states that the intraperiod allocation rules should be used to allocate the interim provision to such items as discontinued operations, other comprehensive income, and items recorded directly to equity. When applying the "with and without" rules for intraperiod allocations, the allocation of tax expense or benefit for interim purposes should be performed using the estimated fiscal year income or expense for ordinary income or loss and year-to-date income and tax for the following:

a. Gain or loss on disposal of discontinued operations.
b. Another component of the financial statements.

The tax effect of items included in continuing operations would be considered first if more than one of the above items exist.

Lastly, as the need for a valuation allowance must be reassessed each quarter, a change in the valuation allowance needs to be included in the interim provision as well. The impact of the change will be recorded either as part of the ETR estimation or as a discrete item, depending on the facts of the change.

If the change in the valuation allowance is due to a change in judgment about the realizability of a related deferred tax asset due to changes in the projection of income expected to be available in future years, the impact of the change is reported in the period in which the change in estimate occurs, a discrete item.

However, the impact of a change in valuation allowance would be considered in the estimation of the ETR used for interim purposes (and thereby spread across the year) in the following situations:

a. The change in the valuation allowance related to deductible temporary differences and carryforwards that are expected to originate in ordinary income in the current year.
b. The change in the valuation allowance for beginning of the year deferred tax assets that results from a difference between the estimate of annual ordinary income for the current year and the estimate that was inherent in the beginning of the year valuation allowance.

Changes in valuation allowance for beginning of the year deferred tax assets that result from other than ordinary income (i.e., discontinued operations) should be included as a discrete item in the quarter's income tax provision.

IV. Interim disclosures

Disclosure requirements for income taxes are applicable for both interim financial statements as well as for those for the entire year. However, the interim disclosures are generally condensed and consist of fewer disclosures.

Interim financial information is intended to provide users with timely information about a reporting entity and is generally prepared based on the expectation that users will read the annual financial statements in conjunction with the interim financial statements. Accordingly, interim disclosures are not expected to repeat annual financial information but rather provide an update from the prior year-end.

With regard to income taxes, entities should disclose any significant changes in their estimate of the annual ETR from period-to-period. Additionally, unless apparent from the financial statements or the nature of the reporting entity's business, the reasons for significant variations in the customary relationship between income tax expense and pre-tax accounting income should be disclosed.

Also, if important developments occur during the year or if the tax amounts reported for the interim periods do not adequately reflect events that the entity expects to occur, the entity should consider disclosure of these matters.

Interim period disclosures related to income taxes often include:

a. Tax effects of significant unusual or infrequent items that are recorded separately or items that are reported net of their related tax effect;
b. Significant changes in estimates or provisions for income taxes (e.g., changes in the assessment of the need for a valuation allowance that occur during the period); and
c. Material changes to: (1) uncertain tax benefits, (2) amounts of uncertain tax benefits that if realized would affect the estimated annual effective tax rate, (3) total amounts of interest and penalties recognized in the balance sheet, (4) positions for which it is reasonably possible that the total amount of uncertain tax benefits will significantly increase or decrease within the next 12 months, and (5) the description of tax years that remain open by major tax jurisdiction.

Material changes in unrecognized tax benefits that occur during an interim period should be disclosed during the interim period. Lastly, remember that the entity should not delay disclosure of material changes until the end of the annual reporting period.