Corporate Income Taxes

GAAP treatment

- GAAP is not IRS
  - Income tax expense on the income statement (GAAP) includes several permanent and temporary differences with what is required by the IRS
    - Income tax expense is composed of:
      - Current tax expense (taxes payable to government)
      - Deferred tax expense (increase (CR) to deferred tax liability)
  - GAAP is full accrual accounting (revenues when earned and expenses when incurred)
  - IRS is a modified cash basis (income is when cash comes in, deductions are when cash goes out)
  - Congress shapes tax provisions to achieve political, social and economic objectives
    - Excluding certain revenues from taxation
    - Limiting deductibility of certain expenses
    - Permit the deduction of other expenses above costs
  - Examples of financial vs. taxable differences
    - Interest on state and municipal obligations
    - Proceeds on life insurance
    - Fines and expenses from law violations
  - Permanent differences will never reconcile

Deferred taxes

- Taxes that will be paid in future periods
- A liability means that taxes will be higher in the future depends on past transactions, present obligation and future sacrifice
- An asset means taxes will be lower in the future
  - Arise from deductible temporary difference
  - Tax asset must be reduced by a valuation allowance if it is more likely than not that some portion will not be realized
  - Evaluated at the end of the accounting period
  - Deferred tax consequences are attributable to taxable temporary differences
    - Temporary differences arise under the following conditions
      - When assets are recovered in future years (taxable)
    - When liabilities are settled in future years (deductible)
    - Examples of revenues and gains
      - Sales (accrual vs. installment cash)
      - Contracts (% completion vs. portion of gross profit deferred)
      - Investments (equity financial vs. cost (tax))
      - Gain on involuntary conversion of asset
    - Examples of expenses and losses
      - Product warranty liability
      - Estimated liability discontinued operations
      - Litigation accruals
      - Bad debt expense (allowance for financials)

Carry-backs and Carry-forwards

- When a company has a net operating loss (when tax-deductible expenses exceed taxable revenues)
  - Carry-back loss for 2 years (earlier year first)
    - File an amended return
      - Income Tax Refund Receivable (current asset)
  - Carry-forward remaining loss for 20 years
    - Future tax savings
    - Issue: should deferred tax asset have different requirements:
      - Deductible temporary differences
      - Operating loss carry-forwards
      - “Benefit due” is a contra-income tax expense
    - A valuation allowance is used if it is likely that the loss will not be realized (thereby not resulting in tax savings)

Balance Sheet Presentation

- Recognize a current or non-current asset or liability that is based on the expected reversal date of temporary differences