

CHAPTER 18

INCOME TAXES

CHAPTER TOPICS CROSS REFERENCED WITH *CICA HANDBOOK*, PART I (IFRS) AND PART II (ASPE)

Corporate Income Taxes

IAS 12

Section 3465

LEARNING OBJECTIVES

1. Understand the importance of income taxes from a business perspective.
2. Explain the difference between accounting income and taxable income, and calculate taxable income and current income taxes.
3. Explain what a taxable temporary difference is, determine its amount, and calculate deferred liabilities.
4. Explain what a deductible temporary difference is, determine its amount, and calculate deferred tax assets.
5. Prepare analyses of deferred tax balances and record deferred tax expense.
6. Explain the effect of multiple tax rates and tax rate changes on income tax accounts, and calculate current and deferred tax amounts when there is a change in substantively enacted tax rates.
7. Account for a tax loss carryback.
8. Account for a tax loss carryforward, including any note disclosures.

9. Explain why the Deferred Income Tax asset is reassessed at the statement of financial position date, and account for the deferred tax asset with and without a valuation allowance account.
10. Identify and apply the presentation and disclosure requirements for income tax assets and liabilities, and apply intraperiod tax allocation.
11. Identify the major differences between ASPE and IFRS for income taxes.
12. Apply the temporary difference approach (future income taxes method) of accounting for income taxes in a comprehensive situation (Appendix 18A).

CHAPTER REVIEW

Introduction

1. Chapter 18 addresses the issues related to accounting for income taxes. Taxable income is computed in accordance with prescribed tax regulations and rules, whereas accounting income is measured in accordance with GAAP (IFRS or ASPE) guidelines. *CICA Handbook*, Part II (ASPE), Section 3465 is based on an asset/liability approach (deferred/future income taxes approach) to the recognition and measurement of accounting elements consistent with the approach taken in Part II (ASPE), Section 1000. This approach differs from the revenue/expense (income statement) view that was the basis of its predecessor. ASPE permits use of the taxes payable method as well, however the deferred income taxes method is permitted. IFRS requires use of the balance sheet liability method and is very similar to the future income taxes approach under ASPE, but uses the term “deferred income tax” rather than the “future income tax” term used under ASPE.

Accounting income, taxable income, tax payable, and current income tax expense

1. Due to the fact that tax regulations and generally accepted accounting principles differ in many ways, taxable income and accounting income frequently differ. The following represent examples of events that can result in such differences: (a) amortization computed on a straight-line basis for financial reporting purposes and on an accelerated basis for tax purposes, (b) income recognized on the accrual basis for financial reporting purposes and on the instalment or cash basis for tax purposes, and (c) warranty costs recognized in the same period as the sale for matching purposes for the financial statements and recognized as the warranty work is performed for tax purposes.
2. Once taxable income (or taxable profit as it is referred to under IFRS) is calculated, tax payable can be calculated by multiplying taxable income times the current year's rate. Tax payable is equal to current income tax expense.

Reversing and Permanent Differences

1. Differences between taxable income and accounting income can be categorized as either (a) a **reversing difference** or (b) a **permanent difference**. Reversing differences are those where the accounting treatment and the tax treatment are the same, but the timing of when they are included in accounting income and taxable income differs. Reversing differences usually result in a **temporary difference** between the tax basis and the carrying amount of an asset or liability on the statement of financial position. The temporary difference is an accumulated difference to date, i.e., a statement of financial position concept, whereas a reversing difference relates to the change in a temporary difference in the period, and is, therefore, more of an income concept.
2. The items discussed in paragraph 1 above can result in differences between amounts reported for book purposes and those reported for tax purposes. A **temporary difference** is the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable amounts (increase in taxable income) or deductible amounts (decrease in taxable income) in future years when the reported amount of the asset is recovered or when the reported amount of the liability is settled. When the carrying amount of an asset or liability differs from the tax basis, resulting in a temporary difference, the future tax effects on taxable income must be reported in the current financial statements.
3. Temporary differences arise when the tax basis of an asset or liability and its reported amount in the financial statements differ. The difference will reverse and result in taxable or deductible amounts in future years as the asset is recovered or the liability is settled at its reported amount. The following example is presented to demonstrate the deferred tax liability concept. Assume that Bobbie Company earns \$50,000 of net operating income before depreciation for each of five consecutive years. The company depreciates its fixed assets using the straight-line method for accounting purposes and the accelerated method for tax purposes over this five-year period. The following schedule shows taxable income, income tax payable, accounting income, and current and deferred income tax expense for the five-year period assuming a 40% tax rate.

<u>Year</u>	<u>Taxable Income</u>	<u>Income Tax Payable</u>	<u>Accounting Income</u>	<u>Current Tax Expense</u>	<u>Future Tax Expense</u>
1	\$ 40,000	\$16,000	\$ 44,000	\$16,000	\$ 1,600
2	42,000	16,800	44,000	16,800	800
3	42,000	17,600	44,000	17,600	-
4	46,000	18,400	44,000	18,400	(800)
5	<u>48,000</u>	<u>19,200</u>	<u>44,000</u>	<u>19,200</u>	<u>(1,600)</u>
Totals	<u>\$220,000</u>	<u>\$88,000</u>	<u>\$220,000</u>	<u>\$88,000</u>	<u>-0-</u>

- Temporary differences originate in one or more periods and reverse or "turn around" in one or more subsequent periods. For example, when a company records a product warranty liability, an expense is recognized for accounting purposes but not for tax purposes. In the year this happens, this is an originating difference that results in a temporary difference on the statement of financial position. In future years when the company makes good on its product warranty, tax deductible amounts result, which reverse the effect of the originating difference.
- Two concepts related to temporary differences are **originating differences** and **reversing differences**. An originating difference is the initial temporary difference between the carrying amount and tax basis of an asset or liability regardless of whether the tax basis of the asset or liability exceeds or is exceeded by the carrying amount of the asset or liability. A reversing difference, on the other hand, occurs when a previously recognized temporary difference is eliminated in whole or in part and the tax effect is removed from the future tax account. In the depreciation example presented in paragraph 5 above, the originating differences were \$4,000 and \$2,000 in year 1 and year 2, respectively, resulting in a deferred tax liability of \$1,600 in year 1 and an additional \$800 in year 2. The reversing differences were \$2,000 and \$4,000 in year 4 and year 5, respectively, which drew down on the previously accumulated deferred tax liability by \$800 in year 4 and \$1,600 in year 5.

6. **Permanent differences** are caused by items that (a) enter into the calculation of accounting income but *never* into the calculation of taxable income, or (b) items that enter into taxable income but *never* into accounting income. Since permanent differences affect only the period in which they occur, **they do not give rise to future taxable or deductible amounts**. As a result, there are no future tax consequences to be recognized. Examples of permanent differences include most dividends received from taxable Canadian corporations, proceeds from life insurance on key executives, and compensation expense associated with certain employee stock options.

Deferred Tax Liability

1. A **deferred tax liability** is the amount of future tax consequence attributable to the temporary differences that will result in net taxable amounts (taxable amounts less deductible amounts) in future years. The liability is the amount of taxes payable on these net taxable amounts in future years based on existing provisions of the tax law (or substantively enacted provisions).
2. The following example is presented to demonstrate the deferred tax liability concept. Assume that Bobbie Company earns \$50,000 of net operating income before depreciation for each of five consecutive years. The company depreciates its fixed assets using the straight-line method for accounting purposes and the accelerated method for tax purposes over this five-year period. The following schedule shows taxable income, income tax payable, accounting income, and current and deferred income tax expense for the five-year period assuming a 40% tax rate.

	<u>Taxable</u>	Income	Accounting	Current	Future
<u>Year</u>	<u>Income</u>	<u>Tax</u>	<u>Income</u>	<u>Tax</u>	<u>Tax</u>
		<u>Payable</u>		<u>Expense</u>	<u>Expense</u>
1	\$ 40,000	\$16,000	\$ 44,000	\$16,000	\$ 1,600
2	42,000	16,800	44,000	16,800	800
3	42,000	17,600	44,000	17,600	-
4	46,000	18,400	44,000	18,400	(800)
5	<u>48,000</u>	<u>19,200</u>	<u>44,000</u>	<u>19,200</u>	<u>(1,600)</u>
Totals	<u>\$220,000</u>	<u>\$88,000</u>	<u>\$220,000</u>	<u>\$88,000</u>	<u>-0-</u>

3. At the end of year one, the entry to recognize the current tax expense and the tax payable liability is:

Current Income Tax Expense	16,000	
Income Tax Payable		16,000

At the end of year one, the entry to record the future tax effects of the \$4,000 temporary difference that now exists between the carrying amount and tax basis of the fixed assets is:

Deferred Tax Expense	1,600	
Deferred Tax Liability		1,600

Each year (two through five) the entries are made, debiting current income tax expense for **the amount of income tax currently payable**. The deferred tax liability account will increase in year two, because the difference between the tax basis and the carrying amount of the capital assets has increased (by \$2,000). Deferred tax expense of \$800 is recognized as this difference increases. The balance of the deferred tax liability account remains unchanged in year three, as the amount of the temporary difference between the tax basis and carrying amount of the fixed asset does not change. In year four, the deferred tax liability is reduced by \$800, and a deferred tax benefit (future tax income under IFRS) is recognized on the income statement. In year five, the deferred tax liability account is further reduced by \$1,600, with a corresponding deferred tax benefit on the income statement. At the end of year five, a zero balance remains in the deferred tax liability account. At this point, the carrying amount and tax basis of the fixed assets are the same.

4. Deferred tax liabilities meet the definitions of a liability because (a) they result from past transactions, (b) a present obligation exists, and (c) future outflows of resources will result when payment of the tax comes due.
5. For example, assume Angle Corporation has a taxable temporary difference of \$5,000,000 at the end of its initial year of operations. Its tax rate is 45%, which means a deferred tax liability ($\$5,000,000 \times .45$) is recorded. Assuming taxes payable are \$2,000,000, the required journal entry is:

Current Income Tax Expense.....	2,000,000	
Income Tax Payable		2,000,000
Deferred Tax Expense	2,250,000	
Deferred Tax Liability.....		2,250,000

Deferred Tax Asset

1. Due to the fact that deductible amounts can arise in the future as a result of temporary differences at the end of the current year, the deferred tax consequences of these deductible amounts should be recognized as a **deferred tax asset**. A deferred tax asset is the amount of taxes (calculated in accordance with the provisions of the tax law) that will be refundable in future years as a result of these deductible amounts.
2. A key issue in accounting for income taxes is whether a deferred tax asset should be recognized in the financial records. However, because deferred tax assets meet the definition of an asset, they should be given accounting recognition. The three main conditions for an item to be reported as an asset are (a) it will contribute to future net cash flows; (b) access to the benefits are controlled by the entity; and (c) it results from a past transaction or event. These conditions are met by the deferred tax asset.
3. Under ASPE, future income assets should be recognized **only to the extent that it is more likely than not** that the future tax asset will be realized. Under IFRS, a deferred tax asset (future tax asset under ASPE) is permitted to be recognized only to the extent that it is **probable** that it will be realized in the future. A valuation account is not used under IFRS but is under ASPE.
4. A deferred tax asset is recognized for all deductible temporary differences. However, deferred tax assets should be reduced if, based on available evidence, it is probable that some portion or all of the deferred tax asset will not be realized. When it is judged more likely than not (“probable” under IFRS) that some portion or all of the deferred tax asset will not be realized, and only that portion expected to be realized should be given accounting recognition. Probable is defined as a level of likelihood of at least slightly more than 50%. For example, assume that Angie Company has a deductible temporary difference of \$2,500,000 at the end of its initial year of operations. Its tax rate is 45%. After further consideration, it is considered more likely than not that the tax benefits associated with \$700,000 of this deductible temporary difference will never be realized. The entries to record income taxes, assuming taxes of \$2,000,000 as currently payable are shown below.

Current Income Tax Expense	2,000,000	
Income Tax Payable		2,000,000
Future Tax Asset ($\$2,500,000 - \$700,000$) \times .45	810,000	
Future Tax Benefit		810,000

5. The formula to compute income tax expense (benefit) is as follows:

Income Tax Payable or Refund	+/-	Change in Deferred Income Taxes	=	Total Income Tax Expense or Benefit	
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In the income statement or in the notes to the financial statements, the significant components of income tax expense attributable to continuing operations should be disclosed.

Future Tax Rates

1. When recording deferred income taxes, consideration must be given to the tax rate in effect when the temporary differences reverse. Normally, the current tax rate is used to calculate deferred income taxes. However, **future tax rates** should be used when such rates have been **enacted** or **substantively enacted** into law. Substantively enacted means that the legislation or regulation has been drafted in an appropriate form and tabled in Parliament or presented in council. When an unexpected change in the tax rate has been enacted into law, its effect on deferred income tax accounts on the statement of financial position should be recorded immediately with the effects reported as a component of deferred tax expense in the year of the change in rate.

Accounting for Income Tax Loss Carryover Benefits

1. A **net operating loss** occurs for tax purposes in a year when the tax-deductible expenses exceed taxable revenues. Under certain circumstances, the tax laws permit taxpayers to use the losses of one year to offset the profits of other years by allowing them to **carry back** or **carry forward** losses incurred. Under these rules, a company pays no income taxes for a year in which it incurs a net operating loss, and it may recover taxes paid in a previous year or reduce taxes that would otherwise be payable in a future year. That is, there may be a benefit associated with incurring a tax loss.
2. A company may carry a loss back three years and receive refunds for income taxes paid in those years. Any loss remaining after the three-year carryback may be carried forward up to 20 years (for losses occurring in 2005 and after) to offset future taxable income.

3. When a company carries a tax loss back, the tax loss gives rise to a refund that is both measurable and currently realizable; therefore, the associated tax benefit is recognized in the income statement of the year of the loss. When a company carries a tax loss forward, a deferred tax asset should be established for the benefits of future tax savings to the extent they are more likely than not to be realized. The benefit, once again, is recognized in the year of the loss. If, in the year of the loss, it is considered more likely than not that the benefits of the tax loss will **not** be realized, the benefit is **not** recognized; instead, the existence of the available tax losses is reported in a note to the financial statements. If the company does benefit from these losses in a future year, the benefit of the loss is recognized as a reduction of tax expense in that future year.

Subsequent Review of Deferred Tax Asset Account

1. Each year, all available evidence must be examined to determine whether the entity is expected to benefit from the Deferred Tax Asset recognized. In addition, future deductible amounts not previously given accounting recognition as a Deferred Tax Asset must be considered to determine whether the entity is now in a position to benefit from them in the future. Previously recognized amounts must be written off if it is determined that they are not likely to be realized in the future.

Reporting and Disclosure

Statement of Financial Position Presentation

1. Deferred/future income taxes are reported on the statement of financial position as assets and liabilities. Under ASPE an individual future tax liability or asset is classified as current or non-current based on the classification of the related asset or liability for financial reporting purposes. A future tax asset or liability is considered to be related to an asset or liability if reduction of the asset or liability will cause the temporary difference to reverse or turn around. A future tax liability or asset that is not related to an asset or liability for financial reporting purposes should be classified according to the expected reversal date of the temporary difference. The balance in the future income tax account should be analyzed into its components and classified on the statement of financial position into two categories: one for the net current amount and one for the noncurrent, or long-term, component. Under IFRS, all deferred income tax asset and liability accounts are classified as non-current.

Income Statement Presentation

1. Income tax expense (or benefit) should be allocated to continuing operations, discontinued operations, and other comprehensive income, with adjustments flowing through retained earnings, accumulated other comprehensive income, and share capital as appropriate. This approach is known as **intraperiod tax allocation**. In addition, the significant components of income tax expense attributable to continuing operations should be disclosed. Both the current and deferred income tax expense must be presented.

Disclosure Requirements

Taxes Payable Method

1. A company reporting under ASPE can choose the taxes payable method to report income taxes. With this simplified method, income tax expense is equal to the current tax expense/benefit, though additional disclosure and reconciliation related to tax issues concerning discontinued operations, the amount of reserves to be included in each of the next five years, and the amount of unused income tax credits and losses carried forward is still required.

Deferred/Future Income Taxes Method

1. ASPE: If a company reporting under ASPE chooses the deferred/future income taxes accounting policy, limited disclosure is required, including disclosure when income is not taxed because it is taxable directly to its owners.
2. IFRS: A company reporting under IFRS using the deferred income taxes accounting policy will be required to provide much more extensive disclosure including information that explains changes in most tax-related accounts, the reasons for temporary differences, and a breakdown of major components of deferred income tax expense for the period.
3. The extensive disclosures related to current and deferred income taxes aid in assessing quality of earnings and better predictions of future cash flows.

Outstanding issues with the asset-liability method

1. While there is general agreement on the appropriateness of the asset-liability method, criticism and debate regarding this method include:
 - a. Failure to discount future tax accounts.
 - b. The basis for current and noncurrent classifications.
 - c. The degree of certainty that should exist before recognizing any future benefits associated with tax losses.

IFRS/ASPE Comparison

1. The United States, Canada and the international community all use a statement of financial position or asset-liability approach; therefore, for purposes of this course, there are few differences other than some differences in terminology. ASPE also allows the taxes payable method for its simplicity. Refer to Illustration 18-45 in the text to see a comparison of this terminology differences, as well as differences in recognition, presentation, and disclosure.