FA Module 12: Accounting for income taxes (overview 4th edition)

(The attached PDF file has better formatting.)

(Readings from the fourth 4th edition of the Robinson text.)

This course covers accounting for taxes on financial statements, not tax accounting. Taxes are specific to the country and are computed by the firm based on the countries where it operates; nothing in the textbook or the discussion forum explains tax accounting. Instead, the final exam problems give the tax liabilities and refunds, the current tax assets and liabilities, and the deferred tax assets and liabilities, and derive the tax expense on the income statement. Other problems on taxes may give the income statement entries and the cash flows and derive the balance sheet items, or give the income statement and balance sheet entries and derive the cash flows.

The articulation principles are the same as for other entries but with an additional layer of complexity. For accounts payable, the accountant deals with the accrued amount and the paid amount. For incurred taxes, the accountant deals with the accrued amount based on tax accounting, the accrued amount based on financial accounting, and the paid amount.

For example, suppose an insurer is computing the value of its stock holdings. The market value of the stocks currently held ignores the tax liability on stocks sold in the past year. If the insurer bought stocks for 100 in January and sold them for 300 in December, its assets have not increased by 200. It has not yet paid the tax on the capital gain, so it has a tax liability of 200 × the capital gains tax rate.

One might think that if the insurer bought stocks for 100 in January and the stocks' market value increased to 300 in December, its assets have increased by 200, since it has not sold the stocks and has no tax liability. But this is wrong: if it does sell the stocks, it will incur a tax liability of 200 × the capital gains tax rate. On its financial statements (not on its tax statements), the insurer shows a *deferred* tax liability of 200 × the capital gains tax rate. It has not yet paid the tax on the capital gain, so it has a tax liability of 200 × the capital gains tax rate.

Selling stocks for their market value does not affect the insurer's equity. Before the tax is paid, the deferred tax liability becomes a tax liability; when the tax is paid, the tax liability is offset by a decrease in cash.

The same reasoning applies to depreciation schedules. Suppose an insurer uses double declining balance for financial accounting and straight line depreciation for tax accounting. After one year, the long-term asset has a lower value for financial accounting than for tax accounting. The insurer has incurred more tax in the first year than it should have (given its financial statements), so it has a deferred tax asset. This deferred tax asset is different from an expected tax return from overpayment of taxes, which is based on tax accounting. The deferred tax asset assumes the tax payments were correct (based on tax accounting), but they differ from the taxes implied by the financial statements.

Deferred tax assets and liabilities are confusing, so taxes are covered in two modules. This module covers the basic principles; the next module covers deferred tax assets and liabilities for various scenarios.

Reading: chapter 9

- § 2 differences between accounting profit and taxable income
- § 3 determining the tax base of assets and liabilities
- § 4 temporary and permanent differences between taxable and accounting profit, *excluding*
  - sub-section 4.4 (temporary differences at initial recognition of assets and liabilities)
  - sub-section 4.5 (business combinations and deferred taxes)
  - sub-section 4.6 (investments in subsidiaries, branches, associates, and interests in joint ventures)

Example 1, "Reston Partners," illustrates the basic concepts.

Pre-tax income differs from taxable income by permanent or temporary differences:

- permanent tax differences:
  - some income is taxed at lower rates than ordinary income
    - example: many insurers hold tax exempt municipal bonds in the U.S.
  - some expenses are not tax deductible
    - example: lobbying expenses and entertainment expenses may be deductible only in part (if at all)
- temporary (timing) differences:
  - some revenue or expenses allocated to one period by financial accounting may be allocated to other periods by tax accounting
    - example: depreciation schedules may differ for tax accounting and financial accounting
  - some revenue or expenses may be carried forward or back to other tax years
    - example: firms with outstanding losses may offset income of future years

Be sure you understand how the deferred tax liability is computed. As the textbook says: "that because the different treatment of depreciation is a temporary difference, the income tax on the income statement is 30 percent of the accounting profit, although only a part is income tax payable, and the rest is a deferred tax liability." (The 30% is the assumed tax rate; the final exam problem will specify the tax rate.) Both the deferred tax liability and the income tax payable are included in the tax expense, as the textbook says: "On the income statement, the company's income tax expense will be the sum of change in the deferred tax liability and the income tax payable."

Distinguish the carrying value of an asset or liability on the financial statements from the tax basis on the tax return. Outstanding insurance claims and policy reserves may use one discount rate for financial statements and another discount rate for tax returns. Example 2, "Determining the Tax Base of an Asset," illustrates the concepts. The final exam problems use depreciation schedules and unrealized capital gains and losses to test this subject.

Example 3, "Determining the Tax Base of a Liability," is particularly relevant to insurers. Policyholder reserves are the largest liability for insurers, and the statutory, GAAP, IFRS, and tax bases differ widely. Deferred tax assets and liabilities are large parts of insurers' GAAP and IFRS equity.

Memorize the matrix in Exhibit 1, "Treatment of Temporary Differences." Spend ten minutes explaining the reasoning to yourself: one principle with four scenarios. On the exam, you get flustered with the reasoning, so it helps to memorize the matrix.

Example 4, "Taxable and Deductible Temporary Differences," shows how deferred tax assets and liabilities result from tax basis differences. The four lines at the bottom of this example are illustrations; tax accounting differs by country.