

**PRESENT LAW AND BACKGROUND RELATING
TO THE INTERACTION OF FEDERAL INCOME TAX RULES
AND FINANCIAL ACCOUNTING RULES**

Scheduled for a Public Hearing
Before the
COMMITTEE ON WAYS AND MEANS
on February 8, 2012

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing for February 8, 2012, on the interaction of tax and financial accounting on tax reform. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides an overview of earnings per share computations and the financial accounting rules for deferred taxes and uncertain tax positions. The document also provides examples of financial accounting for income taxes. The examples include: comparisons of accelerated depreciation, expensing, or tax credits to encourage capital investment; permanent differences between financial statement income and taxable income; income tax rate reductions as compared to special deductions to arrive at measured taxable income; and earnings of foreign subsidiaries where there is an assertion made that the earnings are permanently reinvested as compared to when there is not such an assertion made. The document concludes with a discussion of incentives related to the financial accounting for income taxes.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to the Interaction of Federal Income Tax Rules and Financial Accounting Rules* (JCX-13-12), February 7, 2012. This document can be found on our website at www.jct.gov.

I. OVERVIEW OF FINANCIAL ACCOUNTING RULES

The Financial Accounting Standards Board (“FASB”) establishes and interprets the financial accounting standards that govern U.S. Generally Accepted Accounting Principles (“GAAP”) and are used by publicly traded companies in compiling their annual reports filed with the Securities and Exchange Commission (“SEC”). Companies that are not publicly traded often provide financial statements prepared in accordance with GAAP to investors and creditors.

The primary purpose of financial reporting is to provide information about a company to investors and creditors. By contrast, corporations calculate their taxable income in accordance with the Internal Revenue Code.² The primary purpose of tax accounting is to measure annual income for the purpose of levying the Federal income tax. The tax laws also have been used as instruments of social and fiscal policy.

A. Earnings Per Share

Earnings per share (“EPS”) is a widely followed performance measure. The objective of EPS computations is to measure the performance of an entity over the relevant accounting reporting period (typically reported quarterly and annually).³

Basic EPS is calculated as:

$$\frac{\text{Income Available to Common Shareholders}^4}{\text{Weighted-Average}^5 \text{ Number of Common Shares Outstanding}}$$

Events that increase the number of outstanding shares (the denominator of the EPS calculation) result in diluted EPS. Such events include the conversion of convertible securities, exercise of options or warrants, or issuance of additional shares; any of these events spread the corporate earnings amongst a greater number of common shares.

Under GAAP, companies are required to report basic EPS and are often also required to report diluted EPS. Diluted EPS measures the performance of an entity over the reporting period, while also giving recognition to all potentially dilutive common shares that are

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

³ Accounting Standards Codification (“ASC”) 260: *Earnings Per Share*.

⁴ Income available to common shareholders is computed by deducting dividends declared on preferred stock from net income.

⁵ Shares issued during the period and shares reacquired during the period are weighted for the portion of the period that they were outstanding.

outstanding during the period. The calculation of diluted EPS requires a series of assumptions to be made about potentially dilutive securities being converted into common stock.⁶

⁶ See ASC 260. Given the prevalence of potentially dilutive securities, much of the complexity in the GAAP rules for EPS computations relates to this issue.

B. Financial Accounting for Income Taxes

Temporary and permanent differences

The Code generally requires that a corporation's taxable year and overall method of accounting conform to those used for financial record keeping purposes.⁷ However, many specific differences are permitted (and, in some cases, required) between financial accounting and tax accounting.

Many differences between financial statement and tax reporting (hereinafter referred to as "book-tax differences") are caused by the timing of income or expense recognition under the two systems. Timing differences are often referred to as "temporary" differences because, over time, the total income and expense recognized as measured in undiscounted nominal dollars for these items is the same under the two systems. For example, expenses are generally accrued under GAAP if they are probable and their amount can be reasonably estimated. In contrast, expenses generally are not deductible for tax purposes until all events have occurred which determine the fact of liability and the amount of the liability can be determined with reasonable accuracy.⁸ These general principles often result in the recognition of accrued expenses in earlier years for financial statement purposes than for tax purposes; however, eventually the same amount of expenses will be reported under both systems.⁹

The treatment of capital costs is a prominent temporary difference; accelerated depreciation and expensing for small businesses generally result in deductions for capital costs being reflected in taxable income earlier than in financial statement income.¹⁰ Other examples include bad debts, an estimate of which must be accrued for financial statement purposes while no tax deduction generally is taken until an account is actually written off,¹¹ and nonqualified deferred compensation expenses, which are accrued as the employee earns the income for

⁷ Secs. 441 and 446.

⁸ Sec. 461(h).

⁹ If a GAAP estimate ultimately proves incorrect, the company will generally adjust its books when the correct amount is determined. For example, corporations often accrue a contingency reserve for ongoing legal disputes. Any ultimate payment under a judgment or settlement generally is not deductible until paid, at which time the book accrual is adjusted ("trued up") to reflect the actual amount of the payment.

¹⁰ The straight-line method of depreciation is often used for financial accounting purposes, although other methods are permitted.

¹¹ In general, section 166 allows a tax deduction for wholly worthless debts in the year such debts become wholly worthless and partially worthless debts in the year in which such debts become partially worthless, but only to the extent that the partially worthless debts have been charged off before the end of that taxable year. However, many companies wait until an account is completely written off (i.e., removed from receivables and any corresponding reserve account) before taking the tax deduction. Also see section 582 for special rules for worthless securities held by banks.

financial statement purposes but generally are not deductible for tax purposes until included in the gross income of the employee (i.e., when paid by the employer).¹²

In addition to the temporary differences caused by the timing of income and expense recognition, some book-tax differences are caused by the inclusion of an item of income or expense for one system but not the other. These are referred to as “permanent differences.” Permanent differences include, for example, the exclusion from income of interest on tax-exempt bonds and the disallowance of tax deductions for a portion of meals and entertainment expenses, fines and penalties, and compensation in excess of tax deductible limits, each of which is taken into account as income or expense in determining financial accounting income but not taxable income.

Deferred tax assets and liabilities

Under GAAP, income tax expense generally is recognized when the income to which it relates is recognized, regardless of when the income is actually taxed.¹³ Permanent differences affect the net income and EPS reported on the financial statements. In contrast, temporary items, while they may temporarily increase (or decrease) a company’s cash flow, do not affect net income or EPS.

For example, consider a corporation which has \$600 of gross income but incurs a \$100 fine during the year.¹⁴ Net pretax financial statement income is, therefore, \$500. Because the fine is not deductible for tax purposes, taxable income is \$600 and the corporation will owe \$210 in Federal income tax.¹⁵ The \$100 book-tax difference related to the nondeductible fine is permanent, so its effect (an additional \$35 in tax expense) is reflected in the financial statements in the period in which the permanent item (i.e., the nondeductible fine) occurs. For the year, the corporation reports \$210 of tax expense and net income after taxes of \$290.¹⁶ In contrast, if the \$100 book-tax difference is a temporary item which causes taxable income to be \$600, a corporation which has \$500 of pretax financial statement income reports only \$175 of tax

¹² Sec. 404(a)(5). However, amounts paid within 2.5 months of the year in which the amounts were earned by the employee generally are deductible when accrued for financial statement purposes. See Treas. Reg. sec. 1.404(b)-1T.

¹³ See ASC 740: *Accounting for Income Taxes*.

¹⁴ The examples in this document assume a Federal income tax rate of 35 percent on all corporate taxable income. In addition, all other taxes, including foreign and State income taxes, are ignored.

¹⁵ \$600 taxable income taxed at the 35 percent statutory tax rate results in \$210 tax.

¹⁶ \$500 pretax financial statement income, reduced by \$210 tax expense, results in \$290 net income after taxes.

expense and net income after taxes of \$325,¹⁷ regardless of the fact that the corporation owes \$210 in Federal income tax in the current year.

When a temporary difference arises, a company typically records both a current tax expense and a deferred tax expense. The current and deferred portions are added together to arrive at total income tax expense, which affects current net income and current EPS. Current tax expense represents an estimate of taxes payable on the tax return for the current year, while deferred tax expense is comprised of estimated future tax effects attributable to temporary differences and carryforwards.¹⁸ In the example of accounting for a \$100 temporary difference above, the corporation reports current taxes of \$210 (\$600 in taxable income at the 35-percent statutory tax rate) and a deferred tax benefit of \$35 (\$100 temporary difference at the 35-percent statutory tax rate) to arrive at total income tax expense of \$175.

When evaluated in isolation, each temporary difference generally results in either (1) taxable income being greater than financial reporting income currently, but taxable income being less than financial reporting income when the temporary difference reverses in the future, or (2) taxable income being less than financial reporting income currently, but taxable income being greater than financial reporting income when the temporary difference reverses in the future. Given this future reversal, financial reporting rules generally require the taxpayer to establish a deferred tax expense/(benefit) that completely offsets the current tax (benefit)/expense attributable to the temporary differences and carryforwards. Deferred tax expense is recorded as a liability on the company's balance sheet to reflect the amount of tax which will become payable in the future. Deferred tax benefit is recorded as an asset on the company's balance sheet to reflect the expected amount of tax which will be used to offset other taxes (or refunded) in the future. As discussed in more detail below, the net amount of the deferred tax expense and benefit is referred to as either a deferred tax asset, if it is a net benefit, or a deferred tax liability, if it is a net expense.

The distinction between temporary and permanent differences is reflected in the corporation's GAAP effective tax rate, which is a term financial accountants use to refer to the company's total tax expense (per financial statements) divided by pretax financial statement income. A corporation which has only temporary differences and no permanent differences generally has an effective tax rate in each year that is close to the statutory income tax rate, assuming its income is high enough. However, because permanent differences change the total amount of tax to be paid over time, they also cause a company's effective tax rate to differ from the statutory income tax rate. In the example above involving the permanent difference for a

¹⁷ \$500 pretax financial statement income multiplied by the 35 percent statutory tax rate results in \$175 tax reported on the financial statements. \$500 pretax financial statement income less \$175 income tax equals \$325 after-tax net income.

¹⁸ ASC 740-10-10-1.

nondeductible fine, the company's GAAP effective tax rate for the year is 42 percent, rather than the statutory 35 percent tax rate.¹⁹

¹⁹ However, this would not be the case for corporations with taxable income less than \$10 million and not subject to the maximum 35 percent statutory tax rate as a routine matter.

C. Financial Accounting for Uncertain Tax Positions

In June 2006, the FASB released its interpretation of accounting for uncertainty in income taxes, FASB Interpretation No. 48 (“FIN 48”). This Interpretation is intended to provide standards for recording tax benefits, eliminate flexibility in determining tax reserves, and provide clearer, more consistent, and more comparable reporting and disclosure of tax reserves in companies’ financial statements than had previously existed. In general, FIN 48 is mandatory for all companies subject to income taxes that are required to prepare financial statements in accordance with GAAP, including not-for-profit entities subject to income taxes. Adoption of FIN 48 is required for public companies for fiscal years beginning after December 15, 2006.²⁰

FIN 48 sets forth a two-step process for companies to use in evaluating their tax positions.²¹ The first step, recognition, requires a company to determine whether it is more likely than not that a tax position will be sustained, including resolution of any related appeals or litigation process, were the position to be scrutinized by the taxing authorities (e.g., the Internal Revenue Service (“IRS”). A more-likely-than-not position means that in the judgment of the company’s management, there is a greater-than-50-percent likelihood that the position will be sustained based on the specific facts and circumstances of the company. In determining whether the position satisfies the more-likely-than-not standard, a company must assume that the IRS (or other taxing authority for State, local, or foreign tax assessments) reviews the issue and is provided all relevant information.

If the company determines that its tax position does not satisfy the more-likely-than-not standard, the company is not permitted to recognize any financial statement benefit associated with such tax position.²² Conversely, when a company establishes that its position meets (or exceeds) the more-likely-than-not recognition standard, it must measure the amount of benefit to be included in its financial statements. This second step, measurement, requires a company to determine the amount, if any, of the tax benefit related to its tax positions that is more than likely to be realized upon ultimate settlement. Measurement takes into account the probabilities of various outcomes and the associated tax benefit that would be sustained at each level of probability based on all available facts as of the reporting date. In determining the amount to be recognized, companies consider alternative resolutions such as negotiated settlements and litigation.

²⁰ Delayed adoption of FIN 48 was available for private companies and exempt organizations. For private companies, adoption is required for fiscal years beginning after December 15, 2008. For exempt organizations, adoption is required for fiscal years ending after September 15, 2009. See FASB Staff Position (“FSP”) FIN 48-3 and Accounting Standards Update (“ASU”) 2009-06, respectively.

²¹ The term “tax position” includes: a decision not to file a tax return; an allocation or shift of income between tax years or jurisdictions; the characterization of income; a decision to exclude an item of income or expense from a tax return; a decision to classify a transaction, entity, or other position in a tax return as nontaxable (e.g., nontaxable spin-off); or a tax position acquired or otherwise assumed in a business combination.

²² Subsequent events may occur that result in a taxpayer changing their initial more-likely-than-not determination. In such instances, paragraphs 11 and 12 of FIN 48 dictate that a company may recognize (or derecognize) tax position benefits as of the date the recognition and measurement standards are revised.

Since FIN 48 was released, greater emphasis has been placed on companies' financial statement reporting for uncertain tax positions. The IRS even revised its policy of restraint²³ with respect to uncertain tax positions and began, with the 2010 tax return filing season, to require certain taxpayers to disclose uncertain tax positions on their Federal income tax returns. Corporations with total assets equal to or exceeding \$100 million were required to file Schedule UTP, detailing their uncertain tax positions, and include this schedule as part of their tax return filings starting in 2010. The total asset threshold is reduced to \$50 million in 2012 and \$10 million starting with 2014. Thus, by 2014, most corporations will be required to complete Schedule UTP as part of their annual Federal income tax filing.

²³ Announcement 2010-76, 2010-41 I.R.B. 432.

II. EXAMPLES OF FINANCIAL ACCOUNTING FOR INCOME TAXES

This section contains examples of financial accounting for income taxes.²⁴ These examples are simplified for illustrative purposes and do not take into account many complex factors that may be involved in typical transactions of this nature.²⁵ The examples assume that a 35-percent corporate tax rate applies to all income and ignore all other taxes, such as State or foreign income taxes.

First is an example of the different effects on a company's financial statements of accelerated depreciation of capital costs compared to expensing or tax credits. Next are two examples of permanent differences: tax-exempt income as compared to taxable interest income, and bonuses provided to employees in the form of stock options compensation as compared to cash payments. Following is an example of the effect of a tax rate reduction as compared to a special deduction. Last is an example of the financial accounting treatment of income taxes associated with undistributed earnings of foreign subsidiaries.

A. Accelerated Depreciation, Expensing, or Tax Credits

Overview

Cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property. The Federal income tax law permits this recoupment through the allowance of deductions for depreciation or amortization, or expensing (current year deduction of the cost of property). In lieu of (or in addition to) cost recovery, tax credits may be given to incentivize investment in capital assets.

A formulaic system of depreciation can serve to provide a tax incentive for capital investment to the extent the depreciation deductions are faster than the economic or financial statement depreciation of the property. For example, temporary rules providing for additional first-year depreciation (also known as bonus depreciation) were enacted several times in recent legislation with the purpose of providing economic stimulus during times of economic downturn.²⁶

Expensing, or allowing a deduction for the cost of business property in the year it is placed in service, provides a tax benefit of a greater present value than depreciation, including accelerated depreciation, because the full cost of the property is recovered in the first year rather than in subsequent years. Expensing the full cost of the property is economically equivalent to

²⁴ Many of the examples in this section draw from Christopher H. Hanna, Mark R. Martin, Michael J. Donohue, E. Daniel Leightman, and Cym H. Lowell, *Corporate Income Tax Accounting*, 2011 Edition, Thomson Reuters/Warren, Gorham & Lamont, 2010.

²⁵ These examples also ignore the concept of materiality for financial statement purposes relating to the importance or significance of an amount or a transaction.

²⁶ H.R. Rep. No. 108-94, page 23.

exempting from tax the so-called “normal” return on investment, assuming tax rates remain the same.

A tax credit can also serve as a form of cost recovery or may permit recovery of an amount different from the cost of the property. Prior to 1986, an investment tax credit was allowed for up to 10 percent of a taxpayer’s investment in certain tangible depreciable property (generally not including buildings or their structural components). The taxpayer could not reduce its tax liability by more than the sum of a specified dollar amount plus a percentage of the tax liability in excess of that amount, though a carryover was provided for unused credits. The investment tax credit was repealed as part of the Tax Reform Act of 1986.²⁷ However, the Code currently provides tax credits for investments in specified types of property, including the rehabilitation credit, the low-income housing credit, and credits for energy-related property.²⁸

Comparison of cost recovery methods

The examples provided in Tables 1-4 below illustrate the economic and tax effects of several possible methods of cost recovery:

1. straight-line depreciation, a method in which a taxpayer’s depreciation deduction for a given asset is the same each year;
2. accelerated depreciation, under which a taxpayer’s depreciation allowance for an asset is greatest in the first year in which the asset is used and declines over time (using the 200-percent declining balance method);
3. expensing, in which a taxpayer is permitted to deduct the entire cost of an asset in the year in which the taxpayer places the asset in service; and
4. use of a tax credit to provide cost recovery or recovery of amounts different from the cost of the asset.²⁹

Each example assumes the following facts. A taxpayer buys a machine for \$10,000. The machine is used for five years,³⁰ generates \$3,000 net cash flow annually, and has no salvage value. The taxpayer’s tax rate is 35 percent. The discount rate is six percent. The taxpayer is

²⁷ Pub. L. No. 99-514, sec. 211.

²⁸ Secs. 47 (rehabilitation credit), 42 (low-income housing credit) and, e.g., 45 (credit for electricity produced from renewable sources) and 48C (advanced energy project credit).

²⁹ These examples provide a comparison of the cash flow and tax effects of the different methods of cost recovery. Other issues such as the relative complexity of each method, record-keeping and administrability aspects of each method, and the use of methods in combination with each other also would have to be taken into account in selecting among cost recovery methods.

³⁰ For the sake of simplicity, each example treats the property as if it were placed in service on the first day of the taxable year. However, under present tax law, the date the property was placed in service would be determined under the applicable placed in service convention.

assumed to derive other taxable income so that any net decrease in income tax liability (shown in each table as a negative number) attributable to the machine can be used to offset the taxpayer's tax liability from its other income sources. The present value ("PV") figures in the tables are derived by assuming that nominal dollars are paid (in the case of taxes) or received (in the case of cash flow) at the end of each year and by discounting these nominal dollars back to when the machine was purchased, the beginning of year one. Thus, nominal year-one dollars paid or received are discounted one year in deriving the present value of those dollars, nominal year-two dollars are discounted two years, and so forth.

Table 1.—Straight Line Depreciation

	(1) Unrecovered Cost	(2) Dollars Received	(3) Cost Recovery	(4) Taxable Income	(5) 35% Tax, (4) x .35	(6) PV of Tax Liability	(7) After-Tax Cash Flow (2) - (5)	(8) PV of After-Tax Cash Flow (7)
Year 1	\$10,000	\$3,000	\$2,000	\$1,000	\$350	\$330	\$2,650	\$2,500
Year 2	8,000	3,000	2,000	1,000	350	311	2,650	2,358
Year 3	6,000	3,000	2,000	1,000	350	294	2,650	2,225
Year 4	4,000	3,000	2,000	1,000	350	277	2,650	2,099
Year 5	2,000	3,000	2,000	1,000	350	262	2,650	1,980
End/total	\$0	\$15,000	\$10,000	\$5,000	\$1,750	\$1,474	\$13,250	\$11,162

Table 2.—Accelerated Depreciation

	(1) Unrecovered Cost	(2) Dollars Received	(3) Cost Recovery	(4) Taxable Income	(5) 35% Tax, (4) x .35	(6) PV of Tax Liability	(7) After-Tax Cash Flow (2) - (5)	(8) PV of After-Tax Cash Flow (7)
Year 1	\$10,000	\$3,000	\$4,000	-\$1,000	-\$350	-\$330	\$3,350	\$3,160
Year 2	6,000	3,000	2,400	600	210	187	2,790	2,483
Year 3	3,600	3,000	1,440	1,560	546	458	2,454	2,060
Year 4	2,160	3,000	1,080	1,920	672	532	2,328	1,844
Year 5	1,080	3,000	1,080	1,920	672	502	2,328	1,740
End/total	\$0	\$15,000	\$10,000	\$5,000	\$1,750	\$1,349	\$13,250	\$11,287

Table 3.—Expensing

	(1) Unrecovered Cost	(2) Dollars Received	(3) Cost Recovery	(4) Taxable Income	(5) 35% Tax, (4) x .35	(6) PV of Tax Liability	(7) After-Tax Cash Flow (2) - (5)	(8) PV of After-Tax Cash Flow (7)
Year 1	\$10,000	\$3,000	\$10,000	-\$7,000	-\$2,450	-\$2,311	\$5,450	\$5,142
Year 2	0	3,000	0	3,000	1,050	934	1,950	1,735
Year 3	0	3,000	0	3,000	1,050	882	1,950	1,637
Year 4	0	3,000	0	3,000	1,050	832	1,950	1,545
Year 5	0	3,000	0	3,000	1,050	785	1,950	1,457
End/total	\$0	\$15,000	\$10,000	\$5,000	\$1,750	\$1,122	\$13,250	\$11,516

Economic and tax results

Several observations can be made about the examples in Tables 1-3. First, in each example, by the end of year five, the last year in which the machine is used, the taxpayer has recovered the entire cost of the machine, \$10,000. Second, measured in nominal or total combined annual dollars, the total amount of cash flow (\$15,000), income after cost recovery (\$5,000), and tax paid (\$1,750) is the same under each of the three methods of cost recovery. Third, the amount of the taxpayer's total eventual tax liability expressed in present value terms at the outset of the taxpayer's investment – the number in column (6) of each example – varies significantly among the three examples. The present value of after-tax cash flows – the number in column (8) of each example – likewise varies among the examples. The initial present value of all future tax liabilities attributable to the income generated by the machine is greatest under straight-line depreciation, somewhat less under accelerated depreciation, and least under expensing. The present value of after-tax cash flows is the smallest under straight-line depreciation, greater under accelerated depreciation, and greater again under expensing.

The reason for these relationships is that expensing accelerates cost recovery relative to accelerated and straight-line depreciation, and accelerated depreciation yields more up-front cost recovery than does straight-line. Faster cost recovery defers the taxpayer's tax liability. For a fixed income stream, deferral of the tax increases the return to investment. In the end, the entire cost of the machine is recovered under all three methods, but front-loading of depreciation deductions and the concomitant lessening of the taxpayer's tax liability in the early years increase the present value of cash flows.

Tax credits as an incentive for capital investment

Table 4 shows the effects of a five-percent income tax credit under the assumptions used in Tables 1 through 3: A machine with a five-year life is purchased for \$10,000, the machine generates annual cash flow (net of expenses) of \$3,000, and the discount rate is six percent. As is shown in Table 4, the five-percent investment credit generates a \$500 tax savings (five-percent of \$10,000) in year one and requires the taxpayer to reduce its basis in the machine by \$500 in that year (from \$10,000 to \$9,500). Table 4 assumes the taxpayer then is required to use straight-line depreciation in recovering its remaining cost.

Table 4.—Investment Tax Credit

	(1) Unrecovered Cost	(2) Dollars Received	(3) Cost Recovery	(4) Taxable Income	(5) 35% Tax, (4) x .35	(6) PV of Tax Liability	(7) After-Tax Cash Flow (2) - (5)	(8) PV of After-Tax Cash Flow (7)
Year 1	\$9,500*	\$3,000	\$1,900	\$1,100	-\$115**	-\$108	\$3,115	\$2,939
Year 2	7,600	3,000	1,900	1,100	385	343	2,615	2,327
Year 3	5,700	3,000	1,900	1,100	385	323	2,615	2,196
Year 4	3,800	3,000	1,900	1,100	385	305	2,615	2,071
Year 5	1,900	3,000	1,900	1,100	385	288	2,615	1,954
End/total	\$0	\$15,000	\$9,500***	\$5,500	\$1,425	\$1,151	\$13,575	\$11,487

* After initial basis reduction for five-percent investment credit equaling \$500.

** Including \$500 investment credit.

*** Not including \$500 initial basis reduction required under the investment tax credit rules.

Major differences between tax and financial accounting cost recovery

Differences between financial statement and tax cost recovery arise due to the use of the salvage value in computing the depreciable base for financial statement purposes, the difference in methodologies (e.g., use of the straight-line method for financial statement purposes as opposed to accelerated recovery methods for tax purposes), and the inability to depreciate or amortize certain costs (e.g., goodwill) for financial statement purposes or (e.g., removal costs) for tax purposes. In addition, for financial reporting purposes, if the value of a tangible or intangible asset becomes impaired, the impairment loss is recognized in the current period. In contrast, for tax purposes, impairment losses generally are not recognized until the asset is disposed or abandoned.

Table 5 reflects the financial accounting results where the straight-line method of depreciation is used for both financial statement and taxable income, and the salvage value is assumed to be zero, using the same facts as those employed in Table 1, above. Because the cost recovery method and recovery period are identical, financial statement income and taxable income are equal in each year. The company's cash tax expense is equal to its financial statement tax expense, which (in the absence of permanent differences) is 35 percent of financial statement income.

Table 5.—Example Using Straight-Line Depreciation for Both Financial Statement and Tax

	(1) Book Income	(2) Taxable Income	(3) Book-Tax Difference (2)-(1)	(4) Deferred Tax Expense (3) x .35	(5) Current (Cash) Tax Expense (2) x .35	(6) Total Tax Expense (4)+(5) or 1 x .35	(7) Book Reported Average Tax Rate
Year 1	\$1,000	\$1,000	\$0	\$0	\$350	\$350	35%
Year 2	1,000	1,000	0	0	350	350	35%
Year 3	1,000	1,000	0	0	350	350	35%
Year 4	1,000	1,000	0	0	350	350	35%
Year 5	1,000	1,000	0	0	350	350	35%
Totals	\$5,000	\$5,000	\$0	\$0	\$1,750	\$1,750	35%

Table 6 below reflects the financial accounting results if accelerated depreciation is permitted for tax purposes while straight-line depreciation is used for financial accounting. While the pattern of income differs, the cumulative taxable income over the five-year period is equal to cumulative financial statement income. Because the capital costs are recovered earlier under accelerated depreciation, taxable income is less than financial statement income in the early years and greater than financial statement income in the later years.

On an annual basis, the temporary differences are accounted for by accruing deferred tax expense. For example, in year one, financial statement income exceeds taxable income by

\$2,000 – Table 6, column (3). That difference represents the excess of tax depreciation deductions of \$4,000 – Table 2, column (2) – over financial statement depreciation expense of \$2,000 – Table 1, column (2) – in year one. Because this difference will exactly offset over the life of the asset, it is also offset for financial accounting purposes when calculating income tax expense. This offset is accomplished by accruing a deferred tax expense equal to 35 percent of the difference between financial statement and tax income of \$2,000, or \$700 – the number in column (4). Following across the row, the \$1,000 taxable loss produces a current tax benefit (negative expense) of \$350 – the number in column (5). Netting the deferred tax expense of \$700 against the current tax benefit of \$350, the total tax expense on the financial statements in year one is \$350 – the number in column (6), or 35 percent of book income – the number in column (7).

**Table 6.—Example Using Straight-Line Depreciation for Financial Statement;
Accelerated Depreciation for Tax**

	(1) Book Income	(2) Taxable Income	(3) Book-Tax Difference (2)-(1)	(4) Deferred Tax Expense (3) x .35	(5) Current (Cash) Tax Expense (2) x .35	(6) Total Tax Expense (4)+(5) or (1) x .35	(7) Book Reported Average Tax Rate
Year 1	\$1,000	-\$1,000	\$2,000	\$700	-\$350	\$350	35%
Year 2	1,000	600	400	140	210	350	35%
Year 3	1,000	1,560	-560	-196	546	350	35%
Year 4	1,000	1,920	-920	-322	672	350	35%
Year 5	1,000	1,920	-920	-322	672	350	35%
Totals	\$5,000	\$5,000	\$0	\$0	\$1,750	\$1,750	35%

While the net present value of cash flows under the accelerated depreciation method is higher than under the straight-line method (see Tables 1 and 2, column (8)), the tax expense and average tax rates reported on the financial statements are identical under the two methods, in each year and on a cumulative basis. Similarly, use of expensing for tax purposes and straight-line depreciation for financial reporting purposes produces a higher net present value of cash flows – Table 3, column (8), but no difference in the tax expense and average tax rates reported on the financial statements.

Investment tax credit

In contrast to the straight-line depreciation, accelerated depreciation, and expensing methods of cost recovery, an investment tax credit generally reduces the total cash taxes paid over the life of an asset as well as the total tax expense and average tax rate reported on the financial statements.

Table 7 below reflects the financial accounting results of a five-percent investment tax credit, using the same facts as Table 4 above.³¹ Unlike the examples of temporary book-tax differences in Tables 5 and 6, the \$500 investment tax credit in year one is a permanent reduction in the company's tax expense and thus is treated as a permanent difference.

During year one, financial statement depreciation exceeds tax depreciation by \$100. That difference represents the excess of financial statement depreciation expense of \$2,000 – Table 1, column (2) – over tax depreciation deductions of \$1,900 – Table 4, column (3) – in year one. The tax basis of the capital asset is reduced by \$500 under the investment tax credit rules. Thus, the financial statement basis of the asset exceeds the tax basis of the asset by \$400 at the end of year one – the number in column (4). To reflect the future financial statement depreciation expense in excess of tax deductions, a \$140 deferred tax expense (35 percent of the basis difference) is accrued in year one – the number in column (5). When netted against the cash tax benefit of \$115 – the number in column (6), total tax expense for year one is only \$25 – the number in column (7), or 2.5 percent of year one financial statement income – the number in column (8). The average tax rate is reduced because the tax expense has been permanently reduced by the investment tax credit.

Over the life of the asset, as the temporary difference from year one reverses and the company experiences no further permanent differences, the average tax rate returns to 35-percent of financial statement income each year. However, on a cumulative basis, because the total tax expense has been reduced, the average tax rate over the life of the asset, for financial statement purposes, is reduced as well.

³¹ See discussion of Table 4, above, for calculation of taxable income and current (cash) tax expense figures in Table 7.

**Table 7.—Example Using Straight-Line Depreciation for Book;
Five-Percent Investment Tax Credit for Tax**

	(1) Book Income	(2) Taxable Income	(3) ITC Basis Adjustment	(4) Book Tax Difference (2)-(1)+(3)	(5) Deferred Tax Expense (4) x .35	(6) Current (Cash) Tax Expense [(2) x .35] +(3)	(7) Total Tax Expense	(8) Book Reported Average Tax Rate
Year 1	\$1,000	\$1,100	-\$500	-\$400	\$140	-\$115	\$25	2.5%
Year 2	1,000	1,100	0	100	-35	385	350	35.0%
Year 3	1,000	1,100	0	100	-35	385	350	35.0%
Year 4	1,000	1,100	0	100	-35	385	350	35.0%
Year 5	1,000	1,100	0	100	-35	385	350	35.0%
Totals	\$5,000	\$5,500	-\$500	\$0	\$0	\$1,425	\$1,425	28.5%

B. Tax-Exempt Interest Income as Compared to Taxable Interest Income

The Federal income tax laws include a number of provisions under which an item of income or gain is not taxable. An example is interest on State and local bonds.³² While this interest income is excluded from gross income for tax purposes, it is included in pretax financial statement income. In this instance, pretax financial statement income is greater than taxable income in the amount of the interest income, and a permanent difference results.

Consider the example in Table 8, where a company has pretax financial statement income of \$200,000, of which \$20,000 is interest income. If the \$20,000 of interest income arises from tax-exempt State and local bonds, income tax expense is a different amount than if the \$20,000 of interest income arises from taxable corporate bonds.³³

Table 8.—Example of Interest Income

	<u>Tax-exempt state and local bonds</u>	<u>Taxable corporate bonds</u>
Pretax financial statement income..... a	200,000	200,000
Permanent differences:		
Tax-exempt interest income..... b	<u>(20,000)</u>	
Taxable income..... c=a+b	180,000	200,000
Statutory income tax rate..... d	35.0%	35.0%
Current income tax expense..... e=d*c	63,000	70,000
Deferred income tax expense..... f	<u>none</u>	<u>none</u>
Total income tax expense..... g=e+f	63,000	70,000
GAAP effective tax rate..... h=g/a	31.5%	35.0%

If the interest income arises from tax-exempt State and local bonds, the company subtracts the \$20,000 (line b of Table 8) of interest income from the \$200,000 pretax financial statement income (line a). This results in taxable income of \$180,000 (line c), and current income tax expense of \$63,000 (\$180,000 multiplied by 35 percent). As the book-tax difference related to interest income is a permanent item, there is no deferred income tax expense related to this item (line f). The GAAP effective tax rate of 31.5 percent (line h, total income tax expense

³² Sec. 103(a).

³³ In practice, the tax-exempt bonds are likely to have a lower yield than taxable bonds of similar quality, which would factor into a corporation's investing decision.

of \$63,000 divided by pretax financial statement income of \$200,000) is lower than the 35-percent statutory income tax rate because the interest income was excluded from taxable income.

In contrast, if the interest income arises from taxable corporate bonds, taxable income is \$200,000 (line c of Table 8), and current (and total) income tax expense is \$70,000 (line e), a difference of \$7,000 (equal to \$20,000 of interest income multiplied by the 35-percent tax rate), as compared to the case where the interest relates to State and local bonds. The GAAP effective tax rate is equal to the 35 percent statutory tax rate (line h).

C. Stock Options Compared to Cash Bonuses

Under the current financial accounting and tax rules, the form in which incentive compensation is given to an employee can have disparate financial statement and tax results. Bonuses paid in cash to an employee generally result in identical treatment for financial statement and tax purposes. That is, the deduction for amounts paid to an employee usually is taken in the same period as when those amounts are accrued for financial statement purposes.³⁴ Stock options, in contrast, can result in different financial accounting and tax treatment.³⁵ A stock option expense generally is recorded on the financial statements in the amount of the estimated fair value of the stock option over the period of time that the stock option vests, while the exercise of the stock option by an employee does not affect the company's net income.³⁶ Conversely, for tax purposes, there is no immediate tax consequence when an option is granted or vests.³⁷ When the employee exercises the option and receives vested stock, the employee recognizes ordinary income in the amount of the fair market value of the stock received minus any amount paid for the stock or the option.³⁸ The company (i.e., the employer) is allowed a deduction for an amount equal to the amount included in income of the employee.³⁹ Thus, the company's tax deduction amount is generally equal to the fair market value of the stock on the date exercised less the exercise price paid by the employee.

³⁴ However, section 404 provides instances where the tax deduction may be taken subsequent to the financial statement deduction (e.g., deferred compensation). These situations will result in temporary, not permanent, differences in income tax expense.

³⁵ The financial accounting rules in this area are quite complex and require all the relevant facts and circumstances to be taken into account. The financial accounting rules for stock based compensation changed with the issuance of FASB Statement No. 123(R) (revised 2004), *Share-Based Payment*, codified as part of ASC 718: *Compensation - Stock Compensation*. FASB Statement No. 123(R) was intended to provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost related to share-based payment transactions be recognized in financial statements. Public entities are required to apply Statement 123(R) as of the first interim or annual reporting period that began after June 15, 2005. Nonpublic entities are required to apply the statement as of the beginning of the first annual reporting period after December 15, 2005.

³⁶ However, EPS may be affected if the number of common shares outstanding increases as a result of the exercise of the stock options.

³⁷ This discussion assumes that the employee stock option is a nonstatutory ("nonqualified") stock option and does not have a readily ascertainable fair market value. A stock option that is not actively traded on an established market has a readily ascertainable fair market value only if the requirements under Treas. Reg. sec. 1.83-7(b) are met. For financial accounting purposes, the company is required to estimate the fair market value of the stock option (even if for tax purposes there is no readily ascertainable fair market value) based on acceptable option-pricing models. See Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006, pp. 34-39, for a discussion of the tax and financial accounting rules applicable to compensatory stock options.

³⁸ Sec. 83(a). If the stock is not vested when received, the employee recognizes ordinary income when the stock vests in the amount of the fair market value of the stock at that time minus any amount paid for the stock or option.

³⁹ Sec. 83(h).

In Table 9, consider a simple example of a company with pretax financial statement income of \$200,000 (before considering stock options or a cash bonus) for both years shown below. In one scenario, a stock option that is treated as a nonqualified stock option for tax purposes is granted to an employee in the first year. The fair market value of the stock on the date the stock option is granted is \$4,000. The stock option, which vests immediately upon grant, allows the employee to purchase the stock for an exercise price of \$4,000. Under GAAP, the company estimates the value of the stock option granted to the employee to be \$1,000 on the grant date. In the second year, when the fair market value of the stock is \$14,000 the employee exercises the option and receives vested stock. The employee recognizes taxable income in the second year of \$10,000, equal to the fair market value of the stock on the exercise date, \$14,000, less the amount the employee paid for the stock, \$4,000. In the other scenario, the company does not issue a stock option in the first year, but instead compensates the employee with a cash bonus of \$10,000 in the second year.

**Table 9.—Example of Stock Option Compared to Cash
Bonus**

	<u>Stock Option</u>	<u>Cash Bonus</u>
<u>Year 1:</u>		
Income before bonus..... a	200,000	200,000
Stock option fair market value at grant date..... b	<u>(1,000)</u>	<u>none</u>
Pretax financial statement income..... c=a+b	199,000	200,000
Temporary Difference		
Stock option at grant date..... d=-b	<u>1,000</u>	<u>none</u>
Taxable income..... e=c+d	200,000	200,000
Statutory income tax rate..... f	35.0%	35.0%
Current income tax expense..... g=e*f	70,000	70,000
Deferred income tax benefit..... h=b*f	<u>(350)</u>	<u>none</u>
Total income tax expense..... i=g+h	69,650	70,000
GAAP effective tax rate..... j=i/d	35.0%	35.0%
<u>Year 2:</u>		
Income before bonus..... k	200,000	200,000
Cash bonus..... l	<u>none</u>	<u>(10,000)</u>
Pretax financial statement income..... m=k+l	200,000	190,000
Temporary Difference		
Reverse temp. diff. from grant of stock options..... n	<u>(1,000)</u>	<u>none</u>
Taxable income..... o=m+n	199,000	190,000
Statutory income tax rate..... p	35.0%	35.0%
Current income tax expense..... q=o*p	69,650	66,500
Deferred income tax expense..... r=-h	<u>350</u>	<u>none</u>
Total income tax expense..... s=q+r	70,000	66,500
GAAP effective tax rate..... t=s/m	35.0%	35.0%
Adjustment to additional paid-in-capital for excess tax benefit		
Financial statement expense for stock option..... u=-b	1,000	
Tax deduction for stock option..... v	10,000	
Difference..... w=u-v	<u>(9,000)</u>	
Statutory income tax rate..... x	35.0%	
Current income tax benefit..... y=w*x	(3,150)	none
Total income taxes due on tax returns: Yr 1&2..... z=i+s+y	136,500	136,500
Total pretax financial statement income: Yr 1&2.... v=c+o	399,000	390,000

The first column in Table 9 provides the treatment for stock options. In year one, the company records an expense on its financial statements equal to the estimated fair market value of the stock option that it granted (and vested), \$1,000 (line b). After subtracting the stock option expense, the company has pretax financial statement income of \$199,000 (line c). The grant of the stock option does not result in a tax deduction, so the company reverses the \$1,000 stock option expense recorded for financial accounting purposes to arrive at \$200,000 of taxable income (line e). The company records current income tax expense of \$70,000 (line g, \$200,000 taxable income multiplied by the 35-percent statutory tax rate). The \$1,000 book-tax difference is treated as a temporary difference and the company records a deferred tax benefit of \$350 (line h, \$1,000 temporary difference multiplied by the 35-percent statutory tax rate). The GAAP effective tax rate is 35 percent (line j, \$69,650 total income tax expense divided by \$199,000 pretax financial statement income).

In year two, the exercise of the stock option by the employee has no effect on pretax financial statement income. However, the company is allowed to deduct \$10,000 on its tax return, an amount equal to the amount the employee recognizes in gross income (\$14,000 fair market value of the stock on the exercise date less the \$4,000 exercise price). The \$9,000 excess of the tax deduction of \$10,000 over the financial statement expense of \$1,000 has the same broad effect that a permanent difference has on the financial statements. However, under the GAAP rules,⁴⁰ the income tax associated with the excess tax deduction for stock options over the amount of stock option expense recorded in the financial statements (the “excess tax benefit”) is credited as additional paid-in-capital, and does not affect the amount of income tax expense recorded on the financial statements (and thus net income) or the GAAP effective tax rate. In year two, the company reverses the \$1,000 temporary difference recorded in the prior year (line n) and computes taxable income (not accounting for the excess tax benefit) of \$199,000. The current income tax expense is \$69,650 (line q). The company records deferred income tax expense of \$350 (line r) to reverse the temporary item that was recorded in year one. Total income tax expense reported on the financial statements is \$70,000 (line s) and the GAAP effective tax rate is 35 percent (line t, \$70,000 total income tax expense divided by \$200,000 pretax financial statement income). The company includes the excess tax benefit, \$3,150 (line y, the \$9,000 tax deduction in excess of financial statement expense multiplied by the 35-percent statutory tax rate) as an adjustment to additional paid-in-capital. The company also reduces the tax due on its current year tax return by the same amount.

The second column in Table 9 provides the treatment for cash bonuses. In year one, taxable income of \$200,000 (line e) is equal to pretax financial statement income of \$200,000 (line c). Current and total income tax expense are \$70,000 (line g, line i), and the effective tax rate is 35 percent (line j). In year two, the cash bonus of \$10,000 is subtracted from pretax financial statement income. As this cash bonus is also deducted for tax purposes, no book-tax difference results, and pretax financial statement income of \$190,000 (line m) is equal to taxable income of \$190,000 (line o). Current income tax expense is \$66,500 (line q, equal to taxable income of \$190,000 multiplied by the statutory tax rate of 35 percent). As deferred tax is zero

⁴⁰ ASC 718-740-35-3.

(line r), total income tax expense is \$66,500 and the GAAP effective tax rate is 35 percent (line t, \$66,500 total income tax expense divided by \$190,000 pretax financial statement income).

While, in both scenarios, the employee receives compensation in the second year with a value of \$10,000 and includes \$10,000 in his or her taxable income, the form of the compensation has a disparate effect on the company's financial statements. Although the total income taxes due on the tax returns for year one and year two combined is \$136,500 (line u) regardless of whether the company compensates employees with stock options or cash bonuses, the pretax financial statement income is different. If stock options are used, total pretax financial statement income for year one and year two is \$399,000, as compared to only \$390,000 if a cash bonus is paid (line v). This is because, for financial accounting purposes, only the fair market value of the option at the time the option is granted, \$1,000, is treated as an expense, while the \$10,000 cash bonus is recorded as an expense, a difference of \$9,000.

D. Special Deduction as Compared to Income Tax Rate Reduction

To give preferential treatment to certain types or classes of income, either an income tax rate reduction⁴¹ or a special deduction could be provided under the tax law (among other choices).⁴² Lowering a tax rate has the effect of prospectively reducing a company's annual tax burden, but it also affects the amount of any deferred tax balance recorded on the financial statements.⁴³ In the year a tax rate reduction is enacted, a company with a deferred tax liability recognizes income on its financial statements to reflect the change in amount of the deferred tax liability. Conversely, a company with a deferred tax asset recognizes an expense on its financial statements to reflect the change in amount of the deferred tax asset. While a special deduction also prospectively reduces a company's annual tax burden, it does not affect the amount of the deferred tax balance recorded on the financial statements.⁴⁴

Table 10 provides a simplified example of the accounting treatment of a special deduction in comparison to a tax rate reduction. Assume that in year one a tax rule is enacted that provides, in effect, a reduced income tax rate of 31.85 percent on manufacturing income. The tax rule is effective immediately and all the company's income qualifies as manufacturing income. Further assume that the company has an opening cumulative timing difference of \$100,000, resulting in a deferred tax liability of \$35,000 (line c). Pretax financial statement income is \$200,000 for both year one and year two. The first column illustrates the financial statement effect of a special deduction (nine percent of qualified income), while the second column illustrates the effect of an income tax rate reduction. Although the current taxes due to the government are identical in either case, this example shows that the company's net income (and EPS) is different.

If a special deduction is enacted, the value of the company's deferred tax liability is not affected (line g). The effect of the special rate on the temporary item is not recorded immediately in the financial statements and is instead recorded at the time the temporary item is reversed. In contrast, if a tax rate reduction is enacted, the deferred tax liability of \$35,000 (line c, \$100,000 multiplied by the 35-percent statutory income tax rate) becomes worth only \$31,850 (line f, \$100,000 multiplied by the 31.85-percent reduced income tax rate). The company recognizes a current income tax benefit of \$3,150 (line g, \$35,000 minus \$31,850) to reflect the decrease in the amount of the liability.

⁴¹ Under present law, there are no reduced rates for corporate taxpayers. Individual taxpayers, however, have reduced rates for their capital gains under section 1(h).

⁴² Section 199 is a deduction related to manufacturing income that was designed to have an effect equal to a rate reduction for manufacturing income.

⁴³ ASC 740-10-35-4.

⁴⁴ ASC 740-10-25-37. Further, ASC 740-10-55-29 provides that the qualified production activities deduction in section 199 should be accounted for as a special deduction.

Table 10.—Example of Special Deduction as Compared to Tax Rate Reduction

	<u>Special deduction</u>	<u>Tax rate reduction</u>
Opening cumulative timing difference.....a	(100,000)	(100,000)
Old statutory rate.....b	35.00%	35.00%
Deferred income tax liability.....c=a*b	(35,000)	(35,000)
Rate reduction of 3.15 percent.....d=a		(100,000)
New statutory rate.....e		31.85%
New deferred income tax liability.....f=d*e	unchanged	(31,850)
Income tax benefit.....g=c-f	none	(3,150)
<u>Year 1:</u>		
Pretax financial statement income.....h	200,000	200,000
Permanent differences:		
Special deduction.....i=h*.09	(18,000)	none
Taxable income.....j=i+h	182,000	200,000
Statutory income tax rate.....k	35.0%	31.85%
Current income tax expense.....l=j*k	63,700	63,700
Deferred income tax benefit.....m=g	none	(3,150)
Total income tax expense.....n=l+m	63,700	60,550
GAAP effective tax rate.....o=n/h	31.85%	30.28%
<u>Year 2:</u>		
Pretax financial statement income.....p	200,000	200,000
Timing differences:		
Reverse deferred tax liability.....q=-a	100,000	100,000
Permanent differences:		
Special deduction.....r=(p+q)*.09	(27,000)	none
Taxable income.....s=p+q+r	273,000	300,000
Statutory income tax rate.....t	35.00%	31.85%
Current income tax expense.....u=s*t	95,550	95,550
Deferred income tax benefit.....v=c, f	(35,000)	(31,850)
Total income tax expense.....w=u+v	60,550	63,700
GAAP effective tax rate.....x=w/p	30.28%	31.85%
Total tax expense: combined.....y=n+w	124,250	124,250

In both years, the amount of current income tax is identical whether there is a special deduction or a tax rate reduction. In the first column, in year one, \$200,000 in pretax financial

statement income (line h), less the nine percent special deduction of \$18,000 (line i), results in taxable income of \$182,000 (line j). Taxable income of \$182,000, multiplied by the 35-percent statutory rate results in \$63,700 of current income tax expense (line l). Alternatively, in the second column \$200,000 in taxable income (line j) multiplied by a reduced rate of 31.85 percent results in \$63,700 of current income tax expense (line l), the same amount as if a reduced rate were enacted. Similarly, in year two, the current income tax expense is the same, \$95,550 (line u), regardless of whether a reduced rate or special deduction is in place.

The difference in the financial accounting treatment arises in the accounting for deferred tax items. In the year the tax rate reduction is enacted, in the second column a deferred income tax benefit of \$3,150 (line m) is recorded, and total income tax expense is \$60,550 (line n, \$63,700 current income tax expense less \$3,150 deferred tax benefit). The GAAP effective tax rate is lower for a rate reduction, 30.3 percent (line o), as compared to a special deduction, 31.9 percent (line o). In the second year, the total income tax expense and effective tax rate are lower for the special deduction, \$60,550, 30.3 percent, as compared to the reduced rate, \$63,700, 31.9 percent. This is due to the reversal of the deferred tax liability (which was reduced in the first year in the reduced tax rate example).

Thus, in the above example, the financial accounting difference between the two scenarios is the timing of when the deferred tax liability affects the total tax expense and effective tax rate. For most companies that do not reverse their entire deferred tax balances by the end of the tax year following the tax year the rate change was enacted, the difference between the total tax expense and effective tax rate as compared to the special deduction counterpart will not reverse fully in the subsequent year and may reverse over the course of many years.

E. Undistributed Earnings of Foreign Subsidiaries

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred.⁴⁵ Under GAAP, a company generally is required to accrue deferred taxes on undistributed earnings of foreign subsidiaries. However, the GAAP rules provide an exception to the requirement to record deferred taxes on this income if sufficient evidence shows that the foreign subsidiary has invested, or an assertion is made by management that the company will invest, the undistributed earnings indefinitely abroad.⁴⁶ If such an assertion is made, the amount of undistributed foreign earnings is subtracted from pretax financial statement income and is treated as a permanent difference in the total income tax expense reported in the financial statements. No deferred tax expense is recorded for any residual tax that would be payable upon remittance of the earnings to the U.S. parent company. Thus, when a company's management asserts that the undistributed earnings of a foreign subsidiary are indefinitely invested abroad, its income tax expense is lower, and consequently its earnings and EPS are higher, than would occur if such an assertion is not made.⁴⁷

In Table 11, consider an example of a U.S. parent company where its only foreign investment is a 100-percent-owned foreign subsidiary. In this simple example, assume that there is no income tax in the foreign jurisdiction.⁴⁸ Pretax financial statement income consists of \$100,000 from the operations of the U.S. parent (line a) and \$50,000 from the operations of the foreign subsidiary (line b), for a total of \$150,000 pretax financial statement income (line c). The foreign subsidiary's earnings are not distributed to the U.S. parent during the year and is deferred for U.S. Federal income tax purposes. The first column illustrates the financial accounting if an assertion is made, and the second column illustrates the financial accounting if no assertion is made. In both columns, to arrive at taxable income of \$100,000 (line f), the company subtracts the foreign subsidiary's earnings of \$50,000 (line e) from the pretax financial statement income of \$150,000 (line c). In both columns, current income tax expense is equal \$35,000 (line h). While taxable income and current income tax expense are identical in both cases, the company's total income tax expense, earnings, and EPS for the period are different under GAAP because of the disparate treatment of the deferred income tax.

⁴⁵ See Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, pp. 43-53 for a discussion of the U.S. tax rules applicable to foreign activities of U.S. persons.

⁴⁶ See ASC 740-30-25 (known as Accounting Principles Board Opinion 23 ("APB 23") prior to the accounting standards codification). A parent entity must have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely.

⁴⁷ Assuming residual U.S. tax would be due after taking foreign tax credits into account.

⁴⁸ If there was foreign tax, a foreign tax credit would be available.

Table 11.—Example of Effect of Unrepatriated Earnings on Effective Tax Rates

	<u>Assertion</u>	<u>No Assertion</u>
Pretax financial statement income - United States. a	100,000	100,000
Pretax financial statement income - foreign..... b	<u>50,000</u>	<u>50,000</u>
Total pretax financial statement income..... c=a+b	150,000	150,000
Temporary differences:		
Subtract income deferred until repatriation..... d		(50,000)
Permanent differences:		
Subtract permanently reinvested earnings..... e	<u>(50,000)</u>	<u>N/A</u>
Taxable income..... f=c+d+e	100,000	100,000
Statutory income tax rate..... g	35%	35%
Current income tax expense..... h=f*g	35,000	35,000
Deferred income tax expense..... i	<u>none</u>	<u>17,500</u>
Total income tax expense..... j=h+i	35,000	52,500
GAAP effective tax rate..... k=j/c	23.3%	35.0%

If management makes an assertion, the \$50,000 income of the foreign subsidiary is treated as a permanent item and no deferred income tax is accrued for the residual U.S. tax that would become payable should the foreign affiliate remit its \$50,000 earnings to its U.S. parent company. Total income tax expense is equal to the current income tax expense of \$35,000 (line h, \$100,000 of taxable income multiplied by the 35-percent statutory income tax rate) plus zero deferred income tax, or \$35,000 (line i). The GAAP effective tax rate is 23.3 percent (line k, \$35,000 income tax expense divided by \$150,000 pretax financial statement income), which is lower than the statutory income tax rate of 35 percent.

In contrast, if management does not make such an assertion, the \$50,000 income of the foreign subsidiary is treated as a temporary item. Deferred income tax of \$17,500 is accrued for the residual U.S. tax that would become payable when the foreign affiliate remits its earnings to its U.S. parent company (line i, \$50,000 multiplied by the 35-percent statutory income tax rate). Total income tax expense is equal to current income tax expense of \$35,000 (line h) plus deferred income tax expense of \$17,500 (line i), or \$52,500 (line j). The GAAP effective tax rate is 35 percent (line k, \$52,500 income tax expense divided by \$150,000 pretax financial statement income), which is equal to the statutory income tax rate.

If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future, but residual U.S. income taxes were not previously recorded by the parent entity, the parent entity must record current income tax attributable to that remittance. This decreases earnings and EPS in the period in which the circumstances change. Alternatively, if it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes were previously recorded will not be remitted in

the foreseeable future, the parent entity records a current income tax benefit.⁴⁹ This increases earnings and EPS in the period in which the circumstances change.

One recent example of a change in circumstances for many companies occurred when section 965 was enacted in 2004,⁵⁰ providing a special one-time 85-percent dividends-received-deduction on the repatriation of certain foreign earnings. In effect, the provision allowed foreign earnings to be remitted at a 5.25-percent U.S. income tax rate. A decision to repatriate foreign earnings under this provision impacted companies' financial statements differently, depending on whether the company had previously made an assertion with respect to the foreign earnings.⁵¹

If a company had previously made an assertion with respect to earnings it decided to repatriate under the provision, income tax expense was required to be recorded for the residual U.S. income tax, albeit at the reduced rate. In contrast, if a company had not made an assertion and had already accrued a deferred tax expense with respect to its foreign earnings, an income tax benefit was required to be recorded for the difference between the statutory income tax rate and the 5.25-percent rate allowed under the provision (net of any foreign tax credits available).

Table 12 continues the example in Table 11 above. In the next year, section 965 is enacted and the company repatriates the \$50,000 in foreign earnings. Assume the company had pretax financial statement income of \$200,000 from the operations of the U.S. parent, and no foreign earnings. Regardless of whether an assertion had previously been made, the company adds \$50,000 in repatriated earnings (lines m and n) and subtracts the \$42,500 dividends-received-deduction (line o, \$50,000 multiplied by 85 percent) to arrive at taxable income of \$207,500 (line p). The company records current income tax expense of \$72,625 (line r, \$207,500 multiplied by 35 percent).

⁴⁹ ASC 740-30-25-19.

⁵⁰ The American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 422(a).

⁵¹ For an illustration of the effect of section 965 on Black & Decker's income tax expense, see Christopher H. Hanna, Mark R. Martin, Michael J. Donohue, E. Daniel Leightman, and Cym H. Lowell, *Corporate Income Tax Accounting*, 2011 Edition, Thomson Reuters/Warren, Gorham & Lamont, 2010, pp 5-15 to 5-17.

Table 12.—Effect of Repatriating Earnings with a Special Dividends-Received-Deduction on Effective Tax Rates

<u>Year 2:</u>	<u>Assertion</u>	<u>No Assertion</u>
Pretax financial statement income..... l	200,000	200,000
Timing differences:		
Include current repatriation..... m		50,000
Permanent differences:		
Include current repatriation..... n	50,000	
Dividend received deduction..... o=-50,000*.85	(42,500)	(42,500)
Taxable income..... p=l+m+n	207,500	207,500
Statutory income tax rate..... q	35.0%	35.00%
Current income tax expense..... r=p*q	72,625	72,625
Deferred income tax expense..... s=-i	none	(17,500)
Total income tax expense..... t=r+s	72,625	55,125
GAAP effective tax rate..... u=t/l	36.3%	27.6%

If the company had previously made the assertion with respect to the foreign earnings that were remitted during the year, the company does not reverse any deferred tax expense related to the earnings. In the first column, total income tax expense equals current income tax expense of \$72,625 plus deferred income tax expense of zero (line s), or \$72,625 (line t). The GAAP effective tax rate is 36.3 percent (line u, \$72,625 income tax expense divided by \$200,000 pretax financial statement income), which is higher than the statutory tax rate and reflects the income tax expense related to foreign earnings that were included in pretax financial income in a prior year.

In contrast, if the company had not previously made the assertion with respect to the foreign earnings that were remitted during the year and recorded a deferred tax expense, the company reverses the deferred tax expense related to the earnings. In the second column, total income tax expense equals current income tax expense of \$72,625 (line r) less a deferred tax benefit of \$17,500 (line s), or \$55,125 (line t). The GAAP effective tax rate is 27.6 percent (line u, \$55,125 income tax expense divided by \$200,000 pretax financial statement income), which is lower than the statutory rate and reflects the reversal of deferred income tax previously recorded at the statutory tax rate for the foreign earnings prior to the enactment of the special dividends-received-deduction.

III. DISCUSSION OF INCENTIVES

A. Incentives for Activities that Provide Discretion in Financial Statement and Tax Reporting

Differences between financial and tax accounting treatment give rise to deferred tax positions on corporate balance sheets that can alter incentives and influence behavior. In general, companies may respond to taxes by: 1) changing the timing of activity; 2) restructuring transactions or positions to qualify for more favorable tax treatment; or 3) changing their real economic behavior.⁵² For example, a company may make an investment this year rather than next year because of more generous cost recovery rules available to investments made in the current period, may characterize certain expenses as qualified research expenses to take advantage of the credit for increasing research activities, or may invest in renewable energy resources rather than nonrenewable sources because of the credit for renewable energy. The ability to respond along these dimensions suggests that the activities of companies may be influenced, in part, by the extent to which they give managers discretion over the timing or characterization of financial statement income or tax income. Such discretion can offer managers greater control and flexibility in their tax and financial statement reporting.⁵³

For example, deferring the U.S. tax liability on the earnings of foreign subsidiaries provides the parent company with potentially valuable discretion in financial statement reporting.⁵⁴ Companies may accrue Federal tax expense on foreign profits at the time the profits are recorded for financial statement purposes, or defer the expense until the profits are repatriated.⁵⁵ If the company accrues the tax expense in the year the profits are earned, it may later decide that those funds will not be repatriated after all. At that later time it may then reverse the tax expense and shift financial statement income from the prior period into the current period. Alternatively, the company may defer the tax until the profits are repatriated, resulting in higher earnings for financial statement purposes in the year the foreign profits are earned and lower earnings in the year of repatriation, relative to the first option.

⁵² Joel Slemrod, "Do Taxes Matter? Lessons from the 1980s," *American Economic Review Papers and Proceedings*, vol. 82, 1992, pp. 250-256.

⁵³ Douglas A. Shackelford, Joel Slemrod, and James M. Sallee, "Financial Reporting, Tax, and Real Decisions: A Unifying Framework," Working Paper, University of North Carolina, Chapel Hill, NC, May 1, 2009.

⁵⁴ However, because a company's auditor, in compliance with GAAP, is required to evaluate evidence compiled by management (as well as any other relevant evidence) regarding management's assertion at each balance sheet date, a history of frequent reversals may be considered negative evidence, thus hindering the auditor's approval of any future assertions made by management with respect to its audited financial statements. Moreover, such frequent reversals of management's assertions could invite scrutiny from the SEC because such reversals could be perceived as an attempt by management to manipulate its GAAP earnings through the income tax expense line item in its profit and loss statement. The result of such SEC scrutiny may be the issuance of an SEC comment letter, the required restatement of the company's financial statements, or other possible sanctions.

⁵⁵ Section II.E. of this document discusses repatriation of foreign earnings and the financial statement impact of repatriating earnings that had been asserted to be invested abroad indefinitely pursuant to ASC 740-30-25.

Some have argued that this discretion in financial reporting creates an incentive to locate activity in low-tax foreign jurisdictions.⁵⁶ Locating earnings from operations in jurisdictions with low foreign tax rates can create large amounts of residual Federal tax that can create greater opportunities for earnings management. A survey of tax executives suggests that avoiding financial accounting tax expense is as important as avoiding cash income taxes when corporations decide where to locate operations and whether to repatriate earnings.⁵⁷ However, companies may also locate operations abroad for business reasons, such as being closer to markets they serve.

⁵⁶ Shackelford *et al.* (2009), pp. 29-32. The authors also suggest other activities that may increase value because they provide tax or book discretion. These include investments in intangibles that can cross jurisdictions because transfer pricing rules may be most difficult to enforce in the context of multinational companies with high profit margins from hard-to-value intangibles. In addition, because credit sales provide discretion in recording bad debt reserves for financial statement purposes and write-offs for uncollectible debts for tax purposes, the authors anticipate that some companies advance credit at a lower cost than would otherwise be optimal.

⁵⁷ John R. Graham, Michelle Hanlon, and Terry Shevlin, "Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions," *Journal of Accounting Research*, vol. 49, March 2011, pp. 137-185.

B. Incentives Related to Tax Changes

Companies may also face different incentives with respect to proposed changes in the tax rules depending on whether they have net deferred tax assets or net deferred tax liabilities.⁵⁸ Net deferred tax assets typically arise when a company has net operating loss carryforwards or accrued but unpaid employee benefit obligations. Deferred tax liabilities commonly arise from tax depreciation deductions that are accelerated relative to depreciation deductions for financial accounting purposes. Companies might also face different incentives in the short run versus the long run.

A prospective change in the corporate income tax rate generally creates an incentive for companies to shift income into the period with the lower rate. Companies with deferred tax liabilities face an even stronger incentive to do so, as both current earnings and any reversals of those deferred tax liabilities will be taxed at a lower rate. However, companies with deferred tax assets face an incentive to accelerate income into the period with a higher corporate rate, or risk reducing the value of those deferred tax assets. Deferred tax assets lose value when tax rates decline because future taxes (and thus any future tax savings) are reduced.

Companies may be forced to book losses as a result of writing down the value of deferred tax assets.⁵⁹ As shareholders and potential investors would realize that such a reduction is attributable to a future lower tax rate on corporate earnings, one would not expect this to be a significant event. However, the reduction in the value of deferred tax assets could be severe enough to trigger technical insolvency. This may cause some companies to prefer a special deduction rather than a reduction in the corporate tax rate. For example, in 2004, a group of manufacturing companies argued for a tax benefit in the form of a new deduction rather than a corporate tax rate cut to avoid a detrimental effect on current year earnings, even though a rate reduction would have benefited the companies in the long run.⁶⁰

However, under different circumstances, companies may prefer a rate reduction to other forms of tax benefits. One author cites a recent survey of multinational corporations that suggests a majority of respondents prefer a lower corporate tax rate to other tax changes.⁶¹ In particular, the author compares expensing of new investment to a rate reduction. Expensing, a case of the most accelerated depreciation possible, creates deferred tax liabilities that may alter

⁵⁸ For a discussion of the incentives companies face in the context of a hypothetical corporate income tax rate reduction, see James M. Poterba, Nirupama S. Rao, and Jeri K. Seidman, "Deferred Tax Positions and Incentives for Corporate Behavior around Corporate Tax Changes," *National Tax Journal*, vol. 64, March 2011, pp. 27-58.

⁵⁹ For a report on the recent experience in Japan see Phred Dvorak and Kenneth Maxwell, "Japan's Taxing Question," *Wall Street Journal*, January 31, 2012.

⁶⁰ Christopher H. Hanna, "Corporate Tax Reform: Listening to Corporate America," *Journal of Corporation Law*, vol. 35, Winter 2010, pp. 283-325.

⁶¹ Tom Neubig, "Where's the Applause? Why Most Corporations Prefer a Lower Tax Rate," *Tax Notes*, vol. 111, April 24, 2006, pp. 483-486.

company preferences over future policy. Whether a particular company prefers one form of benefit to another depends on the company's specific facts and circumstances.

Different tax positions among companies may give rise to special transition rules to mitigate the effects of any tax changes. Recent corporate tax reforms in Ohio provide an example of transition relief. Ohio phased out its corporate income tax and replaced it with a commercial activities tax. Companies were encouraged to reverse any temporary timing differences during the phase-out period. Deferred tax assets related to research and development credits were retained in the new system. Provision was also made for companies with deferred tax assets related to net operating loss carryforwards.⁶²

⁶² Poterba *et al.*, 2011, pp. 53-54.