DECIPHERING THE NEW ACCOUNTING FOR INCOME TAX RULES

BY JOHN P. KLINGLER AND JAMES B. SAVAGE

Lybrand Gold Medal, 1987-88.

The recently issued Statement of Financial Accounting Standards 96 is difficult to apply and even more difficult to explain. Although certain provisions of FAS 96 are similar to the requirements of Accounting Principles Board Opinion 11, it is probably best to forget just about everything you know about income tax accounting.

Burk Uzzle

Recycling is an increasingly important source of Alcoa's aluminum supply. Authors Klingler and Savage are Alcoa accountants.

UNDERSTANDING FAS 96

The following are a number of specific concepts that need to be understood before a company can make an informed decision about when and how to adopt the new statement.

Temporary vs. timing difference identification. How does the new statement's concept of "temporary differences" relate to the familiar timing differences and permanent differences concepts?

Timing differences were defined by APB 11 as "differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income." A key point is that timing differences originate in one accounting period by affecting either taxable income or financial income and then reverse or "turn around" in another. Probably the most common example of a timing difference is depreciation that is recorded using a certain period and method for book purposes and a different period and method for tax purposes.

Permanent differences, on the other hand, are defined by APB 11 as "differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods." Thus, a permanent difference, such as percentage depletion and tax-free interest income, does not reverse or turn around.

FASB introduced the concept of temporary difference in FAS 96 and defined it as essentially the difference between the tax basis of an asset or liability and its book basis.

Because an underlying assumption inherent in the preparation of financial statements is that all assets will be recovered and all liabilities will be settled, most existing differences in the book and tax basis of an asset or liability will become taxable income or an income tax deduction in some future period. This future taxable income or income tax deduction forms the basis for the recognition of deferred taxes under FAS 96.

Here is an example of what a company will need to do to identify temporary differences under the new rules. The book and tax balance sheet of a hypothetical company has the following items: cash; property, plant and equipment; accounts payable; and a warranty reserve (Table 1). All items with book/tax basis differences need to be analyzed to see how each difference will affect future taxable income.

The tax basis of the company's property, plant and equipment is $120,000 lower than its book basis because the company has taken accelerated tax depreciation deductions. The recovery of the $500,000 net book value of the company's property, plant and equipment will result in the recognition of $120,000 of taxable income in future tax returns— either by continued use of the property or by its sale. The $120,000 is a temporary difference.

In addition, the company has established a $50,000 warranty reserve for future claims against its products. This reserve has a zero tax basis because warranties are deductible only when the claims are actually paid. The future payment of the liability will result in a $50,000 tax deduction in the year or years of the payment. Therefore, this item is also a temporary difference.

This example shows that most differences between the book and tax basis of the assets and liabilities of a company will relate to items that previously were considered to be timing differences under APB 11. Therefore, it is easy to assume that temporary differences under FAS 96 are simply a new way of saying timing differences. This is true to a considerable extent because basically all timing differences represent temporary differences. Under APB 11, however, a timing difference did not become a timing difference until it affected either taxable income or pretax book income. Although they are few, there are some differences between the book and tax basis of assets and liabilities that arise without affecting either book income or tax income.

One such example would be a reduction in the tax basis of depreciable assets because of tax credits, such as the investment tax credit. Another example is one that could have arisen if tax reform had allowed for the increase in the tax basis of assets because of indexing for inflation. Both of the above items are considered to be temporary differences under FAS 96 because the ultimate recovery of the asset for financial reporting purposes would have been different than the remaining tax basis and would, therefore, have resulted in future taxable income or future tax deductions. While the present instances of such differences between temporary and timing differences are not common, it is helpful to understand this distinction when trying to comprehend the underlying logic of other concepts in FAS 96.

Companies should make sure that adequate records have been kept of the tax bases of the company's assets and liabilities. If the records are deficient, a considerable amount of work may need to be done to ensure that sufficient information exists to comply with the new accounting provisions.

Recognition of Deferred Tax Liabilities and Assets. How should the deferred taxes related to these differences be measured and recognized? According to FAS 96, "A liability or asset shall be recognized for the deferred tax consequences of all temporary differences, that is, the amount of taxes payable or refundable in future years as a result of the deferred tax consequences (as measured by the provisions of enacted tax laws) of events recognized in financial statements in the current or preceding years."

This requirement can be summarized in four steps:

- Estimate the particular future years in which temporary differences will result in taxable or deductible amounts.
- Determine the *net* taxable or deductible amounts in each future year.
- Carry back or carry forward (as permitted or required by law) net deductible amounts occurring in particular years to offset

TABLE 1 / IDENTIFICATION OF TEMPORARY DIFFERENCES

	Book Basis	Tax Basis	Diff.
Assets			
Cash	$ 10,000	$ 10,000	$ -0-
Property, Plant and Equipment	500,000	380,000	120,000
Total Assets	$510,000	$390,000	$120,000
Liabilities			
Accounts Payable	$ 20,000	$ 20,000	$ -0-
Warranty Reserve	50,000	-0-	50,000
Total Liabilities	$ 70,000	$ 20,000	$ 50,000

Temporary Differences:

Property, Plant and Equipment: $120,000 of taxable income will result through future recovery of $500,000 book basis of property because the tax basis is only $380,000.

Warranty Reserve: $50,000 tax deduction will result when warranty is exercised and paid.

TABLE 2 / DEPRECIATION TEMPORARY DIFFERENCE

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Book Depreciation	$100,000	$100,000	$100,000	$100,000	$100,000	$500,000
Tax Depreciation	120,000	100,000	70,000	50,000	40,000	380,000
Temporary Difference	$ (20,000)	$ -0-	$ 30,000	$ 50,000	$ 60,000	$120,000

net taxable amounts that are scheduled to occur in prior or subsequent years.

- Compute the tax effect on the resulting amounts at the currently enacted rate that will be applicable to each future period.

In essence, it is necessary to prepare mini-tax returns for each future year with the only elements of the returns being temporary differences. Let's see how this process works.

Estimate Reversal of Temporary Differences. We first estimate the particular future years temporary differences will result in taxable or deductible amounts. The $120,000 difference in the book and tax basis of the property, plant and equipment relates to the accelerated tax depreciation deductions of current and prior years. This difference in the future book and tax depreciation amounts is shown in Table 2.

The excess of tax over book depreciation generates an additional $20,000 temporary difference in Year 1. There is no difference in Year 2. However, beginning in Year 3, the difference begins to "turn around." In Year 3, $30,000 of excess book depreciation is generated; in Year 4, $50,000 is generated; and in Year 5, $60,000.

Next, we need to consider the warranty issue. Remember that we have set aside $50,000 in a warranty reserve that will not be deductible for tax purposes until the warranty claim is paid. Let's assume that we are able to estimate that the warranties will be paid at $10,000 a year for the next five years.

Determine Net Taxable or Deductible Amounts. The next step in the computation of deferred tax liabilities or assets is to determine the net taxable or deductible amount in each future year (Table 3). In Years 1 and 2, we have net deductible amounts of $30,000 and $10,000 respectively, and in Years 3, 4, and 5. We have taxable income of $20,000, $40,000, and $50,000, respectively.

Consider this a key point of FAS 96. The measurement of a deferred tax liability or asset shall assume that the only taxable or deductible amounts in future years are the result of temporary differences at the end of the current year. That means that what we see in Table 3 is *it*! These are the "mini-tax returns" we referred to before.

We are specifically prohibited from assuming that future net deductible amounts, such as we see in Years 1 and 2, will be able to be offset against profits that we expect to generate in future years. This provision may severely restrict the recognition of deferred tax assets.

Carry Back or Carry Forward to Offset. Now that we have determined the net taxable and deductible amount in each future year, we are permitted to carry back or carry forward (as permitted or required by law) net deductible amounts occurring in particular years to offset taxable amounts that are scheduled to occur in prior or subsequent years.

In Years 1 and 2, our company generated $30,000 and $10,000, respectively, of net deductible amounts in each year (Table 3). Assuming that no carrybacks are available, these net deductible amounts must then be carried forward to future years, according to current tax law provisions.

As a result, the $30,000 net deductible amount in Year 1 can be carried forward and offset the $20,000 of net taxable income generated in Year 3 and $10,000 generated in Year 4. Also, the $10,000 net deductible amount in Year 2 can be carried forward to Year 4 and partially offset the net taxable income generated in that year. Therefore, after our carry back/carry forward exercise, we end up

TABLE 3 / CALCULATION OF DEFERRED TAXES

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Ordinary Income						
Depreciation	$(20,000)	$ -0-	$ 30,000	$ 50,000	$ 60,000	$120,000
Warranty Reserve	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(50,000)
	(30,000)	(10,000)	20,000	40,000	50,000	70,000
Year 1 Deduction Carried Forward	30,000		(20,000)	(10,000)		-0-
Year 2 Deduction Carried Forward		10,000		(10,000)		-0-
	$ -0-	$ -0-	$ -0-	$ 20,000	$ 50,000	$ 70,000
Tax rate	34%	34%	34%	34%	34%	34%
Deferred Tax Liability	$ -0-	$ -0-	$ -0-	$ 6,800	$ 17,000	$ 23,800

with $20,000 net taxable income in Year 4 and $50,000 net taxable income in Year 5.

Compute the Tax Effect on Resulting Amounts. Now we can complete the deferred tax calculation. As the next step, apply the presently enacted tax rates for each of the respective years to the remaining net taxable amounts to arrive at the total deferred tax liability to be recorded. Using the presently legislated corporate tax rate of 34% for these future years, we arrive at a $23,800 total deferred tax liability to be recorded (Table 3).

Deferred tax expense for the year would simply be the difference between this amount and the deferred tax liability as of the beginning of the year. Total tax expense for the year would be this deferred tax expense amount plus the amount estimated to be currently payable on the company's tax return.

Aggregate vs. Detailed Scheduling. Why do we have to go through these calculations when we simply could have aggregated all of the temporary differences that we have identified and applied the 34% rate to arrive at our $23,800 deferred tax balance?

Realizing that this question would be asked, FASB has stated in FAS 96 that "a single calculation of the deferred tax consequences of the aggregate amount of temporary differences is sufficient provided that the result is not significantly different from the results that would have been obtained from separate calculations for each future year."

Because FASB has given us some leeway on this issue, we need to consider under what circumstances an aggregate calculation may not be materially different from detailed scheduling. If we stop and think about the provisions of FAS 96, it becomes clear that certain circumstances must exist in order for an aggregate calculation to be an acceptable surrogate for detailed scheduling:

- The enacted tax rates in effect for future periods should be the same from year to year. If they are not, then you may have some problems doing an aggregate calculation unless you are able to estimate the net taxable or deductible amounts arising in the years that the rates will change.
- The temporary differences you have identified should not include any large net deductible amounts that may not qualify for recognition as a tax benefit. As a side issue on this point, if FASB requires that the projected costs of postemployment medical benefits be expensed on a current basis, this will represent a temporary difference that will pose a real problem for many companies in meeting this requirement.
- The net taxable amounts in future years should be sufficient to use any operating loss carryforwards or tax credit carryforwards before expiration of the carryforward period.

SPECIAL PROBLEMS

Tax rate changes and financial statement presentation are two special problems most accountants will face.

Looking at the company's deferred tax liability balance in Table 4, let's assume that we are now in the middle of Year 4. In addition, let's assume that Congress decides to raise the corporate rate from 34% back up to 46%—retroactive to the beginning of Year 4. What does that do to our numbers?

As we can see from Table 4, the $23,800 deferred tax liability amount that we calculated would now be calculated at $32,200, or 46% of the $70,000 of temporary differences. Accordingly, an immediate adjustment of $8,400 is necessary to reflect the new deferred tax balance. The FASB has concluded that the adjustment to reflect the rate change should be recorded as of the *enactment date*. Accordingly, we would record an $8,400 deferred tax expense in Year 4 to reflect this change.

However, as we see in Table 5, if this rate change enacted in Year 4 were not effective until Year 5, the deferred tax balance would still be adjusted in Year 4, but only those temporary differences that affect taxable income in Year 5 and beyond would be tax-affected at the new rate. Note that the new deferred tax adjustment is $6,000 calculated using the different tax rate in Year 5.

Let's now review the new financial statement presentation. Under present rules, deferred tax liabilities and assets are classified as current and deferred, based upon

TABLE 4 / TAX RATE CHANGE EFFECTIVE RETROACTIVELY

	Year 4	Year 5	Total
Future taxable income	$20,000	$50,000	$70,000
Deferred tax @34%	$ 6,800	$17,000	$23,800
Deferred tax after rate change to 46%	$ 9,200	$23,000	$32,200
Adjustment	$ 2,400	$ 6,000	$ 8,400

TABLE 5 / TAX RATE CHANGE EFFECTIVE PROSPECTIVELY

	Year 4	Year 5	Total
Future taxable income	$20,000	$50,000	$70,000
Deferred tax @34%	$ 6,800	$17,000	$23,800
Deferred tax after rate changes			
– Year 4 @34%	$ 6,800		$ 6,800
– Year 5 @46%		23,000	23,000
Total	$ 6,800	$23,000	$29,800
Adjustment	$ -0-	$ 6,000	$ 6,000

whether they are associated with current or noncurrent assets or liabilities on the company's balance sheet. For example, deferred tax liabilities for the excess of tax over book depreciation would be classified as noncurrent because it relates to property, plant and equipment.

This is not the case anymore. Under the FAS 96 provisions, only those deferred tax liabilities and assets that relate to temporary differences that will result in taxable income or deductible amounts in the next year are considered to be current. Referring to Table 6, no deferred taxes relate to temporary differences that result in taxable income or deductible amounts in Year 1. Accordingly, all of our $23,800 deferred tax is noncurrent.

Under existing rules, the $40,800 deferred tax liability related to book/tax depreciation differences would be noncurrent, $3,400 of the deferred tax asset related to the $10,000 current portion of the warranty reserve would be considered current, and the $13,600 balance would be noncurrent. Therefore, we end up with a $3,400 current deferred tax asset and a $27,200 noncurrent deferred tax liability.

There are several additional items in FAS 96 that will affect only select companies. For those companies, however, the impact of these items may be more significant than some of the statement's basic changes.

Deferred Investment Tax Credit. Current accounting literature permits a company to recognize investment tax credit (ITC) in its income statement during the same period that it is recovered through its tax return. This is commonly referred to as the flow through method of accounting for ITC. Under this accounting method, there is no temporary difference, and nothing will change as a result of FAS 96.

Current accounting literature, however, also permits a company to defer and amortize ITC over a period of years for financial statement purposes even though it is recovered through the tax return in a single period. This is referred to as the deferral method of accounting for ITC. If a company currently uses this method, reported net income under FAS 96 will be different from that under APB 11.

If we refer to our definition of a temporary difference being the difference between the book basis of an asset or liability and its tax basis, we see that deferred ITC has a financial statement (book) basis equal to its unamortized value and a tax basis of zero because it was previously recognized in the tax return.

Following the requirements of the liability method, it is necessary for us to provide a deferred tax on this temporary difference. Although this is consistent with the underlying logic of the liability method, it may be difficult to explain to management, particularly considering that we are tax-affecting a tax credit!

A simplified example will show how this single item can affect income at the date of adopting FAS 96 and in subsequent years. First, we assume that a company has $50,000 of deferred ITC as of the beginning of Year 1. We also assume the $50,000 will be amortized to income over a five-year period. For the purpose of this example, a tax rate of 34% is assumed.

Prior to adoption of FAS 96, the net income of the company would have reflected only the amortization of deferred ITC as shown in Table 7.

If FAS 96 is adopted at the beginning of Year 1, a transition adjustment of $17,000 would be recorded (assuming the debit meets the offset or NOL utilization criteria) as follows:

Debit
Deferred Tax Asset $17,000
Credit
Transition Income $17,000

In each of the next five years, the $17,000 would be amortized as follows:

Debit
Deferred Tax Expense $3,400
Credit
Deferred Tax Asset $3,400

As a result of adopting FAS 96, the net income of the company will reflect the amounts in Table 7 related to deferred ITC:

Business Combinations. FAS 96 has changed the way a company must account for the difference between the tax basis and book basis of assets and liabilities acquired in a business combination accounted for using the purchase method of accounting. If prior years' financial statements are restated at the time FAS 96 is adopted, then all purchase business combinations that occurred during the years being restated must be accounted for in accordance with FAS 96. If FAS 96 is adopted prospectively, a specific transition procedure prescribed in the new statement must be followed.

TABLE 6 / DEFERRED TAX CLASSIFICATION

Existing Rules	Current	Noncurrent	Total
Depreciation	$ -0-	$40,800	$40,800
Warranty Reserve	(3,400)	(13,600)	(17,000)
	$(3,400)	$27,200	$23,800
FAS 96	$ -0-	$23,800	$23,800

TABLE 7 / DEFERRED INVESTMENT TAX CREDIT

	Transition Deferred Tax	Transition Deferred Tax Amortization	ITC Amortization	Net
Year 1	$17,000+	$ 3,400–	$10,000+	$23,600+
Year 2	–	3,400–	10,000+	6,600+
Year 3	–	3,400–	10,000+	6,600+
Year 4	–	3,400–	10,000+	6,600+
Year 5	–	3,400–	10,000+	6,600+
	$17,000+	$17,000–	$50,000+	$50,000+

What has not changed...
The requirement to provide deferred taxes on all items that affect the financial statements and the tax returns in different years has been retained. This is sometimes referred to as the comprehensive approach to income tax accounting. Also, FAS 96 keeps the indefinite reversal items described in APB Opinion 23.

What Has Changed...
The following is a summary of changes to the basic provisions of "accounting for income taxes."

1. The most basic of the new requirements, and the one that has received the most attention, is a change to the "liability method" from the "deferred method". The liability method requires deferred tax balances to be adjusted whenever tax rates change. Under the deferred method required by APB 11, no such adjustment was ever made.

2. FAS 96 calls for a switch from an income statement approach to a balance sheet approach for the calculation of deferred taxes. The timing difference approach used in APB 11 has been replaced with the concept of "temporary differences", which focuses on differences between the book and tax bases of a company's assets and liabilities. Initially this approach may appear to give you the same answers as under existing rules, when in fact the answers can be quite different.

3. Under the old rules, whenever a company recognized expenses for financial statement purposes prior to receiving a tax deduction (such as an accrual for a warranty reserve), or a company recognized revenue in the tax return before it was included in financial income (such as subscriptions received in advance), a deferred tax debit was recognized. Under the new rules, this debit cannot be recognized as an asset unless it offsets tax credits that will reverse in the same periods. The statement specifically prohibits the assumption that these deductions can be used to offset future earnings, no matter how likely it is that the earnings will occur.

The new criteria for recognizing tax debits is far more stringent than the "reasonable likelihood of realization" criteria that existed under APB 11. The area of tax debits also is affected by the net operating loss (NOL) and the tax planning provisions of FAS 96.

4. Probably the most controversial, complex, and misunderstood portion of the new statement concerns tax planning strategies used to recognize deferred tax debits. These are not the traditional tax planning strategies that a company routinely considers when trying to minimize the actual payment of taxes. Rather, they are subjective techniques that enable a company to recognize the minimum net deferred tax liability. It is unlikely, however, that any of these "what-if" scenarios will ever actually be used because, for the purpose of developing these strategies, a company cannot assume that it will have any earnings in future years.


Mark Godfrey.
Supplying ingot to Alcoa plant.

These changes, in one way or another, will affect all companies that have items flowing through the income statement and the tax return in different periods. There are also new requirements that can alter reported results of operations for:

- Companies that use the deferral method of accounting for investment tax credit;
- Companies that previously entered into business combinations using the purchase method of accounting; and
- Companies with foreign operations that use the U.S. dollar as the functional currency. □

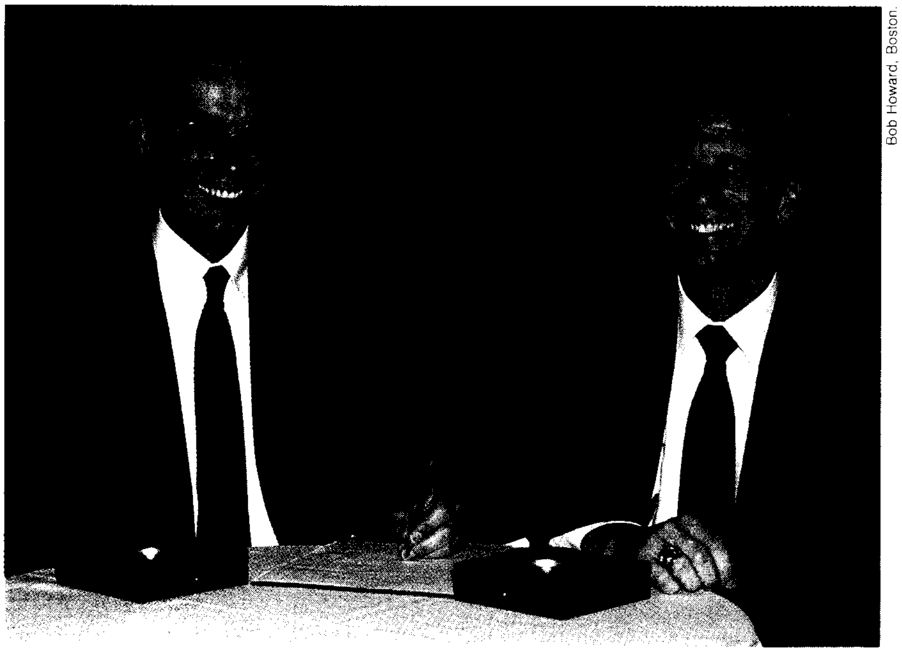
The new rules applicable to purchase business combinations are straightforward and generally consistent with other aspects of the liability method. Essentially, the difference between the book basis and tax basis of assets and liabilities is considered to be a temporary difference. As with all other temporary differences, a deferred tax must be provided for these differences. The one exception relates to goodwill.

Although goodwill appears to meet the criteria of a temporary difference, no deferred tax should be provided. The reason for this exception becomes clear if you work through an example where you do provide deferred taxes on goodwill.

In APB 16, goodwill is defined as the residual after allocating the purchase price to all assets and liabilities. If a deferred tax is provided on the initially calculated value of goodwill, then recording the deferred tax will change the value of goodwill. This in turn changes the value of the deferred tax which again changes the value of the goodwill. For practical purposes, FAS 96 excludes goodwill because it is simply the residual value in the purchase accounting allocation.

Another business combination issue is how to account for temporary differences related to prior business combinations. As indicated above, if a business combination occurred in a year that is being restated because of FAS 96, then the business combination accounting transactions must be recalculated in accordance with the provisions of FAS 96.

If the combination occurred in an earlier year, or if the statement is adopted prospectively, then a special transition rule must be followed. Specifically, at the date of adoption, the difference between the tax bases and book bases of assets and liabilities are to be treated as temporary differences, and appropriate deferred taxes should be recorded. For a company that recorded assets acquired in a business combination net-of-tax, as permitted by paragraph 89 of APB 16, this produces a deferred tax on a



Authors (l.-r.) James B. Savage and John P. Klingler with Lybrand Gold Medal.

number that includes a deferred tax. Considering the effort required to remeasure assets acquired in business combinations that may have occurred many years ago, the special rule represents a pragmatic solution.

It should be noted that remeasuring assets and providing a deferred tax on that remeasured value will produce a different income statement impact in future years than providing a deferred tax on the net temporary difference at the date of adoption. If a company has been involved in large business combinations in the past, this can be a significant issue when it comes time to determine whether or not to adopt the statement retroactively.

Foreign Operations Where the U.S. Dollar is the Functional Currency. When FAS 96 was issued, it contained an example of a temporary difference on which deferred taxes must be provided that was not included in the Exposure Draft. This item affects companies with foreign operations where the U.S. dollar is the functional currency. For companies with substantial foreign operations, the impact of this particular temporary difference could be the most significant cost or benefit associated with adopting this statement.

The basic issue relates to the remeasuring of certain assets and liabilities from the foreign currency into U.S. dollars using historical rates, as required by FAS 52, Foreign Currency Translation. This remeasurement creates a difference between the foreign tax basis and the foreign currency equivalent of the U.S. dollar historical cost of the remeasured assets and liabilities. In FAS 96 terminology, this difference is a temporary difference and should be tax-affected. How this particular issue affects a particular company depends on the combination of whether the dollar has strengthened or weakened in relation to the particular foreign currency and the difference between the remeasured assets and liabilities of the foreign operations.

Because this temporary difference involves the interaction between FAS 52 and 96, it can become complicated. Any company with significant foreign operations should carefully analyze this item.

OTHER ISSUES

Disclosure. The disclosure requirements of FAS 96 are not drastically different from those of APB 11. There are, however, two particular items worth noting. First, with regard to the APB 23 exceptions, the disclosures have been expanded to include an estimate of the unrecognized deferred tax liability on these items, if determination of that amount is practical. Second, the disclosure of the components of tax expense is expanded to include the effects of tax rate changes or tax law changes on deferred tax liability or asset balances.

Transition. FAS 96 is effective for fiscal years beginning after December 15, 1988. Therefore, for calendar year companies, the standard must be implemented by 1989. The Board has encouraged early application of the standard, and some companies, although very few, did so in 1987.

The statement can be implemented in one of two ways. Either prior periods' financial statements can be restated, or the effect of implementation can be included in current year's net income as the cumulative effect of an accounting change.

If the statement is adopted in other than the first quarter of a year, the previous quarters must be restated. The options present significant planning opportunities for companies affected by FAS 96.

RECOMMENDATIONS

FAS 96 represents a significant change from our existing method of accounting for income taxes. While these provisions appear to be well thought out and internally consistent, they may be difficult to apply. In addition, reporting results of operations after adopting this statement may be inconsistent because of the artificial nature of the tax planning strategies and other provisions of the statement.

Our recommendations for the accountant faced with the task of adopting this statement are, therefore, to understand the underlying concepts in sufficient detail to explain why reported results of operations are significantly different than what they would have been under APB 11 and to understand the transition options in sufficient detail to recommend the most appropriate course of action for a company, based on the company's particular circumstances. ■

John P. Klingler, CPA, is manager of Employee Benefits Accounting and James B. Savage, CMA, CPA, is manager of Corporate Accounting Services at Aluminum Company of America. The authors are members of the Pittsburgh Chapter of NAA, through which this article was submitted.