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ACCOUNTING

DEFERRED TAXES IN PERSONAL FINANCIAL STATEMENTS

By Hugo Nurnberg

Under AICPA Statement of Position 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, assets are reported at estimated current values and liabilities are reported at estimated current amounts. Additionally, a provision for estimated income taxes on differences between these reported amounts and tax bases of assets and liabilities is presented between liabilities and net worth. The estimated provision is computed as if the estimated current values of assets had been realized and the estimated current amounts of liabilities had been liquidated on the statement date. Changes in current values of assets, current amounts of liabilities, and the estimated provision are reported as unrealized increases and decreases in net worth in the statement of changes in net worth. A user of personal financial statements needs information on this $3 million deferred tax asset, together with the likelihood of realizing it as reflected by the size of the valuation allowance (zero to $3 million), to avoid underestimating the individual's net worth.

A shortcoming of SOP 82-1 is that this presentation of the estimated provision between liabilities and net worth is ambiguous. (A similarly ambiguous presentation was formerly given to deferred tax credits under APB Opinion No. 11.) I believe that the estimated provision is a deferred tax liability, and that FASB Statement 109, *Accounting for Income Taxes*, provides guidance in measuring and recognizing it.

FASB 109 Summary

FASB 109 notes a critical assumption of financial accounting—that the reported amounts or book bases of assets and liabilities will be recovered and settled, respectively. With a few exceptions, discussed later, differences between tax and book bases of assets and liabilities are either taxable or deductible temporary differences.

Taxable temporary differences result in taxable amounts in future years when book bases of assets are recovered and liabilities are settled. Deferred tax liabilities represent deferred tax consequences of taxable temporary differences—future tax payments from future reversals of existing taxable temporary differences.

Deductible temporary differences result in deductible amounts in future years when book bases of assets are recovered and liabilities are settled. Deferred tax assets represent deferred tax consequences of deductible temporary differences and carryforwards—future tax benefits from future reversals of existing deductible temporary differences and future utilizations of existing carryforwards.

Deferred tax assets are reduced by a valuation allowance when, based on all available evidence, realization of some portion or all of the deferred tax benefits fails the "more likely than not" test. This means that there is a greater than 50% probability that realization will occur.

The beginning-of-year valuation allowance is adjusted when new information results in modifying judgments about the realization of deferred tax assets. The adjustment is recognized and disclosed in the period in which it occurs, usually as a component of income tax expense (or benefit) from continuing operations.

Throughout, FASB 109 seeks to report deferred tax assets and liabilities that are the best estimates of the future tax consequences of temporary differences. For this reason, the measurement and recognition of deferred tax assets and liabilities reflects currently enacted tax laws and rates, expected actions and elections, and anticipated tax-planning strategies. Additionally, deferred tax assets and liabilities are adjusted for changes in estimates and changes in tax laws and rates. FASB 109 is applicable to all taxable business entities, whether their assets and liabilities are reported at historical costs or current values.

Recognition and Measurement

In my opinion, the credit provision for estimated income taxes under SOP 82-1 is a deferred tax liability under FASB 109. But the recognition and measurement rules of SOP 82-1 differ from the recognition and measurement rules of FASB 109.

Under SOP 82-1, the estimated tax provision is computed as if the estimated current values of all nontax assets are realized and the estimated current amounts of all nontax liabilities are settled on the balance sheet date, using applicable tax laws and regulations, and considering recapture provisions and available carryovers. Implicitly, SOP 82-1 uses current tax laws and rates in effect at the balance sheet date and assumes near-term liquidation even if liquidation is not expected. Thus, taxable temporary differences are tax effected at short-term capital gains tax rates on investments not held long-

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A USER OF PERSONAL FINANCIAL STATEMENTS

needs information on deferred tax assets in order to avoid underestimating the individual's net worth.

term at the balance sheet date, even when it is expected that the investment will be held and sold long-term or held to the death of the owner and escape capital gains tax altogether.

In contrast, FASB 109 assumes an expected outcomes perspective. Under FASB 109, a deferred tax liability is computed using tax laws and rates currently enacted to apply to the future years when temporary differences reverse and the deferred tax liability is paid, i.e., the future years when nontax assets and liabilities are expected to be realized and settled, respectively. In this way, the deferred tax liability reflects the best estimate of the future tax consequences of taxable temporary differences. FASB 109 does not assume near-term liquidation unless liquidation is expected.

To summarize, the recognition and measurement rules of FASB 109 result in greater representational faithfulness and decision usefulness of personal financial statements than those of SOP 82-1, because the former are designed to reflect the best estimate of the future tax consequences of taxable temporary differences consistent with currently enacted tax laws and rates, whereas the latter are not so designed unless liquidation is imminent. Representational faithfulness and decision usefulness of personal financial statements would be enhanced by reporting the deferred tax liability consistent with the expected outcomes perspective of FASB 109 rather than the liquidation perspective of SOP 82-1.

Debit Provisions Are Deferred Tax Assets

Although not explicitly addressed in SOP 82-1, tax bases of net assets may exceed book bases due to declining net asset current values. In practice, an estimated tax debit provision for estimated income tax benefits on the excess of tax bases over book bases is usually recognized as an offset to an estimated tax credit provision. Conceptually, this balance sheet debit provision is a deferred tax asset under FASB 109. It represents estimated future tax benefits on future deductible amounts resulting from recovering book bases of net assets with higher tax bases.

To illustrate, an individual subject to the 20% capital gains tax owning investments with a $25 million current value and a $40 million tax basis would generate a $15 million capital loss and a $3 million potential capital gains tax savings from their current sale, providing she has offsetting capital gains in the current or future years. A user of personal financial statements needs information on deferred tax assets, together with the likelihood of their realization as reflected by the size of the valuation allowance, in order to avoid underestimating the individual's net worth. It is more informative to disclose the deferred tax asset and its valuation allowance, even if the two net to zero, than to disclose neither.

Consistent with FASB 109, recognizing deferred tax assets in excess of deferred tax liabilities requires substantial positive evidence of offsetting sources of taxable income other than existing taxable temporary differences or carryback income. An example of substantial positive evidence is an existing noncancelable sales contract that will generate future taxable capital gain income.

Interrelationship Between FASB 109 and SOP 82-1

Because the SOP 82-1 balance sheet debit and credit provisions are deferred tax assets and liabilities, they should be called as such to make them more understandable. Additionally, FASB 109 provides the following detailed guidance for their recognition and measurement:

- Deferred tax assets and liabilities should not be recognized on basis differences without deferred tax consequences.
- Deferred tax assets and liabilities should be measured and recognized consistent with expected actions and elections, anticipated qualifying tax-planning strategies, and estimated average annual tax rates.
- Deferred tax assets and liabilities should be adjusted with separate disclosure for changes in accounting estimates.
- Deferred tax assets and liabilities should be adjusted with separate disclosure for changes in tax laws and rates.
- The beginning-of-year deferred tax asset valuation allowance should be adjusted with separate disclosure when new information results in modifying judgments about the realization of deferred tax assets.

Basis Differences Without Tax Consequences

Certain basis differences may not result in taxable or deductible amounts in future years when the related asset is recovered and the related liability is settled, and therefore may not be temporary differences for which deferred tax assets and liabilities should be recognized. For example, the excess of life insurance cash surrender value over premiums paid is not a taxable temporary difference if the asset will be recovered without tax consequences upon the death of the insured. Similarly, the first $250,000 ($500,000 if married and filing jointly) of the excess of current value over tax basis of a personal residence is nontaxable when the property is sold, provided the owner meets certain conditions. All appreciation generally is nontaxable if the residence (or any other asset) is held until death.

Not recognizing deferred tax liabilities and assets on basis differences without tax consequences is consistent with FASB 109's aim of reporting the most likely tax consequences. A more controversial application of FASB 109 would be to not recognize deferred tax liabilities on the appreciation of other assets when intending to avoid capital gains taxes by holding appreciated assets until death.

For full and fair disclosure, the following information should be presented in the notes to personal financial statements whenever deferred tax liabilities or assets are not recognized on differences between book bases and tax bases of individual assets and liabilities:

- A description of the types of basis differences for which deferred tax liabilities or assets have not been recognized and the types of events that would cause those differences to become taxable or deductible, respectively;

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- The cumulative amount of each type of basis difference; and
- The amount of unrecognized deferred tax liability or asset for those basis differences if they were to become taxable or deductible temporary differences, respectively, provided that determining the amount is practicable, or a statement that determining the amount is not practicable.

Tax-Planning Strategies

Under FASB 109, tax-planning strategies are considered in assessing the need for a deferred tax asset valuation allowance. A tax-planning strategy is an action or election for tax purposes not ordinarily undertaken but that would be undertaken, if necessary, to prevent carryforwards from expiring unused and therefore would result in realizing deferred tax assets. To qualify as a tax-planning strategy under FASB 109, the action or election must be prudent and feasible, and the taxpayer must have the ability to implement the strategy and expect to implement it unless the need to do so is eliminated in future years. For example, taxpayers do not normally accelerate taxable income but might do so to utilize an NOL carryforward before it expires unused.

Tax-planning strategies should be considered in assessing the need for a deferred tax asset valuation allowance in personal financial statements. For example, individuals may accelerate estimated future taxable income to earlier future years by structuring future sales of appreciated property as regular sales rather than as installment sales or by changing depreciation procedures for tax purposes to slow down deductions. Similarly, individuals may accelerate future reversals of taxable temporary differences by selling installment receivables to accelerate deferred income to the year the receivable is sold; and they may accelerate future reversals of deductible temporary differences by selling conventional receivables to accelerate bad debt deductions. Individuals may also change the character of income, for example, from nontaxable to taxable income, by switching from tax-exempt to taxable investments. Finally, individuals may make certain tax elections, for example, to claim either a deduction or a credit for foreign taxes paid, and to forego an NOL carryback and instead carry it forward.

Graduated Tax Rates

Under FASB 109, when graduated tax rates are significant, the average tax rate is used to measure deferred tax liabilities and assets. The average tax rate is the estimated average tax rate applicable to the amount of estimated average annual taxable income in the future years in which the deferred tax liabilities or assets are expected to be settled or realized, respectively. An aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income for all future years is usually sufficient.

Changes in Accounting Estimates

To be consistent with FASB 109, the recognition and measurement of deferred tax liabilities and assets in personal financial statements should be based on actions or elections expected, tax-planning strategies anticipated, and average graduated tax rates estimated as of the end of the year. Differences in expected actions or elections, anticipated strategies, and estimated average graduated tax rates from the end of the prior year result in changes in the reported amounts of deferred tax liabilities and assets. These changes should be reported (with separate disclosure if material) as an unrealized increase or decrease in net worth in the statement of changes in net worth for the year that includes the change.

Changes in Tax Laws and Rates

Under FASB 109, deferred tax liabilities and assets are adjusted for the effect of newly enacted changes in tax laws or rates, even when they are not effective until future years, and the effect is included in income from continuing operations (with separate disclosure if material) for the period that includes the enactment date. Presently enacted changes in tax laws and rates that become effective in particular future years are used to measure deferred tax liabilities and assets on temporary differences reversing in those particular future years. Tax laws and rates for the current year are used if no changes have been enacted for future years.

Consistent with FASB 109, deferred tax liabilities and assets in personal financial statements should be adjusted for the effect of newly enacted changes in tax laws or rates, even when they are not effective until future years. The effect of the adjustment should be reported (with separate disclosure if material) as an unrealized increase or decrease in net worth in the statement of changes in net worth for the period that includes the enactment date.

Change in Valuation Allowance

Under FASB 109, the beginning-of-year deferred tax asset valuation allowance is adjusted when changes in circumstances cause changes in judgments about the realization of deferred tax assets. The effect of such an adjustment should be reported (with separate disclosure if material) as an unrealized increase or decrease in net worth in the statement of changes in net worth for the period in which the change in circumstances occurs. For example, reconsider the individual subject to the 20% capital gains tax owning investments with a $25 million current value, a $40 million tax basis, and a $3 million deferred tax asset for the potential capital gains tax savings. Absent substantial positive evidence of future offsetting capital gains, the valuation allowance is also $3 million, but would decrease to $1 million if newly acquired investments appreciate $10 million above their tax bases.

Case Closed

A persuasive case can be made that the balance sheet credit provision for estimated taxes in personal financial statements under SOP 82-1 is equivalent to a deferred tax liability under FASB 109. The detailed recognition and measurement rules of FASB 109 provide much more guidance than the scanty guidance provided by SOP 82-1. It is time for the AICPA Accounting Standards Executive Committee to address this issue and give authoritative guidance. ❑

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