OTHER ACCOUNTING ISSUES

Tax Rate Considerations

In the recent past there have been relatively stable tax rates, but historically the congress has adjusted tax rates on a periodic basis. The calculations of deferred tax assets and deferred tax liabilities should be based on the best estimate as to what current income tax rates are and what they will be in the future. If we have a future tax asset or liability that will impact multiple accounting periods we need to apply the appropriate rate based on the period in which the reversal will take place.

Net Operating Losses

A net operating loss (NOL) occurs when the expenses of an enterprise exceed its revenue. This is a tax concept. The Internal Revenue Service allows the enterprise to offset this loss against taxable income in another year. There are two methods that the taxpayer can choose. The taxpayer can choose to carry back the NOL two years and then carry it forward until it is used up. If the taxpayer has not taxable income in the prior two years or was in a relatively low tax bracket, the taxpayer may elect to just carry the NOL forward to future years.

NOL Carryback

When the taxpayer chooses to carryback the NOL, the loss is applied to taxable income in the first year. This generates a refund to the extent that the taxpayer paid income taxes in that year. If there is any remaining unused NOL it is carried forward to the next year and applied against taxable income for that year. Again, this generates a refund to the extent that there were taxes paid in that year. If there is still an unused NOL it is carried forward to the year subsequent to when the NOL was first created. If the NOL is extremely large the taxpayer may carry it forward up to 20 years reducing or eliminating taxable income until the NOL is completely used up.

The application of a NOL carryback creates an immediate tax refund which is an asset to the company. If we had an NOL carryback that resulted in a \$100,000 refund the journal entry to record the refund would be as follows:

ACCOUNT	DEBIT	CREDIT
Income tax refund receivable	100,000	
Benefit due to loss carryback		100,000

The benefit due to loss carryback is a current tax benefit in the income statement and the Income tax refund receivable is a current asset in the balance sheet.

1

EXAMPLE: Spencer Company had the following tax information:

YEAR	TAXABLE INCOME	TAX RATE	TAXES PAID
1999	300,000	35%	105,000
2000	325,000	30%	97,500
2001	400,000	30%	120,000

In 2002 Spencer Company suffered a net operating loss of \$450,000, which it elected to carry back. The 2002 enacted tax rate is 29%.

Using the format provided calculate the Income Tax Refund Receivable.

			Taxable	Tax	Tax	
Transaction	NOL	Year	Income	Rate	Paid	Refund
2002 NOL Carryback						
2002 NOL						
Carryforward						
2002 NOL						
Carryforward						
Income tax refund						

Solution:

Transaction	NOL	Year	Taxable Income	Tax Rate	Tax Paid	Refund
2002 NOL Carryback	(450,000)	2002				
		2000	325,000	30%	97,500	
	325,000		(325,000)			
2002 NOL Carryforward	(125,000)	,	0	30%	0	97,500
		2001	400,000	30%	120,000	
	125,000		(125,000)			
2002 NOL Carryforward	0	,	275,000	30%	82,500	37,500
Income tax refund						135,000

Using the format provided prepare the journal entry to record the Income Tax Receivable as a result of the 2002 NOL carryback.

ACCOUNT	DEBIT	CREDIT
Income tax refund receivable		
Benefit due to loss carryback		

Solution:

ACCOUNT	DEBIT	CREDIT
Income tax refund receivable	135,000	
Benefit due to loss carryback		135,000

NOL Carryforward

If the taxpayer has no or relatively small taxable income in the previous two years it may be wise to elect to forgo the carryback and just carry the NOL forward. There are provisions in the IRS code to allow this election.

EXAMPLE: Spencer Company had a NOL in 2002 of \$500,000. The income tax rate has remained constant at 35% for the past few year and expected to remain the same in the near future. The company had taxable income in prior years as follows:

YEAR	TAXABLE INCOME	TAX RATE	TAXES PAID
1999	100,000	35%	35,000
2000	125,000	35%	43,750
2001	200,000	35%	70,000

Using the format provided calculate the Income Tax Receivable as a result of the 2002 NOL carryback.

Transaction	NOL	Year	Taxable Income	Tax Rate	Tax Paid	Refund
2002 NOL Carryback						
2002 NOL						
Carryforward						
2002 NOL						
Carryforward						
Income tax refund						

Solution:

Transaction	NOL	Year	Taxable Income	Tax Rate	Tax Paid	Refund
2002 NOL Carryback	(500,000)	2002				_
		2000	125,000	35%	43,750	
	125,000		(125,000)			
2002 NOL Carryforward	(375,000)		0	35%	0	43,750
		2001	200,000	35%	70,000	
	200,000		(200,000)			
2002 NOL Carryforward	(175,000)	'	0	35%	0	70,000
Income tax refund		,		•		113,750

Please note that we still have not used up \$175,000 of the 2002 NOL so we now have an NOL carryforward to 2003. This carryforward created a deferred tax asset to the extent that the company will be able to use this to off-set future income. As long as it is more likely than not that the company will continue to be profitable we can book a deferred tax asset. The calculation of the deferred tax asset would be as follows.

Analysis of NOL Carryforward

Unused NOL carryforward	175,000
Enacted future tax rate	35%
Deferred tax asset	61,250

Now that we know what the income tax refund and the deferred tax asset are we are ready to prepare the adjusting journal entry as of December 31, 2002 (the year the NOL was incurred.) Using the format provided prepare the December 31, 2002 adjusting journal entry to record the income tax refund and the deferred tax asset.

ACCOUNT	DEBIT	CREDIT
Income tax refund receivable		
Deferred tax asset		
Benefit due to loss carryback		
Benefit due to loss carryforward		

Solution:

ACCOUNT	DEBIT	CREDIT
Income tax refund receivable	113,750	
Deferred tax asset	61,250	
Benefit due to loss carryback		113,750
Benefit due to loss carryforward		61,250

Valuation Allowance-NOL Carryforward

As discussed above the recording of a deferred tax asset as a result of a NOL carryforward is based on the expectation that the company will experience profitable operations in the future. If it is more likely than not that the company will not be able to take advantage of the NOL carryforward, a valuation allowance account must be established to reduce the carrying value. The carrying value of the deferred tax asset should be reflected in the balance sheet at the anticipated future benefit that will be utilized.

Exercise: If in the previous exercise it was more likely than not that Spencer Company would never be able to utilize the NOL carryforward we would need to establish a valuation allowance account to reflect this expectation. The Valuation Allowance account entry would be record in the following manner.

ACCOUNT	DEBIT	CREDIT
Benefit due to loss carryforward	61,250	
Allowance to reduce deferred tax asset to		
expected realizable value		61,250

At the end of the next year let's assume that Spencer Company earned \$300,000 in taxable income and that there are no permanent or temporary differences between taxable income and financial statement income. The calculation of the income tax expense and liability would be as follows.

Taxable income	300,000
Income tax rate	35%
Income tax expense	105,000

It appears now that we will be able to use the deferred tax asset created by the NOL carryforward so the federal income tax liability for the year will be calculated as follows.

300,000
(175,000)
125,000
35%
43,750

There are now two adjusting journal entries. The first entry will record the current and deferred income taxes and the second entry will eliminate the allowance account.

ACCOUNT	DEBIT	CREDIT
Income tax expense	105,000	
Deferred tax asset		61,250
Income tax payable		43,750
ACCOUNT	DEBIT	CREDIT
ACCOUNT Allowance to reduce deferred tax asset to	DEBIT	CREDIT
	DEBIT 61,250	CREDIT

Financial Statement Presentation

Balance Sheet: Deferred taxes are reported on the balance sheet as either deferred tax assets or deferred tax liabilities. The nature of classification of the account as current or not current is determined based on the underlying asset or liability. If the underlying asset or liability is current then the deferred tax asset or liability is classified as current.

In most cases there will be a number of deferred tax accounts reflecting the various timing differences between book and tax income. For financial reporting purposes all of the current deferred tax assets and deferred tax liabilities should be combined into a single amount and reported at the net current deferred tax asset or liability. Likewise, all of the noncurrent amounts should be combined into a single account for financial statement presentation purposes.

It the event that there is no underlying asset or liability related to a deferred tax asset or liability, the account should be classified as current or noncurrent based on the expected date that the temporary difference will reverse. For example, an NOL carryforward does not have an underlying asset. This deferred tax asset would be classified as current if it was expected to reverse in the next operating cycle.

Income Statement: Most of the material we have presented deals with income tax expense or benefit related to income from continuing operations. An intraperiod tax allocation must be made between continuing operations, discontinued operations, extraordinary items, the cumulative effect of a change in accounting principle and prior period adjustments. In addition, current tax expense or benefit and deferred tax expense or benefit from continuing operations must be presented in the income statement.