

Corporate taxation Part I

Income of an incorporated business is generally subject to federal and provincial income taxes (proprietorships and partnerships are not subject to income taxes as separate entities). In computing income taxes payable, corporations must complete tax returns, including a statement showing the amount of net income subject to tax. This **taxable income** (*the amount on which taxes paid is based*) in the tax return is computed in accordance with prescribed tax regulations and rules. **Accounting income**¹ (*the amount on which tax expense is based*) in the income statement is, however, measured in accordance with generally accepted accounting principles (GAAP). Therefore, differences between taxable income and accounting income may exist because the basic objectives, rules, and principles of measuring taxable income are different from those of measuring accounting income.

Differences between taxable income and accounting income, called **tax differences**, give rise to important issues regarding financial statement reporting. Our interest in examining these differences is to determine their effect on the measurement of income tax expense and related balance sheet accounts for corporations.

This chapter deals primarily with **interperiod tax allocation**, which is the *accounting for tax differences between periods*. The *accounting requirements for tax allocation within a period*, called **intra-period tax allocation**, are reviewed briefly at the end of the chapter because they were discussed in Chapter 4.

OBJECTIVES RELATED TO THE DETERMINATION OF ACCOUNTING INCOME AND TAXABLE INCOME

A major cause of problems in accounting for income taxes is that the objectives of reporting income on financial statements to shareholders and others are not the same as the objectives for determining taxable income reported to the government.

Determination of income for financial statement purposes is based on the belief that revenues should be recognized when the criteria for revenue recognition are met (revenue realization principle) and expenses should be charged to the period in which related revenues are recognized (matching principle). In this framework, income taxes are considered a cost incurred in the process of earning income. The underlying objective of such an income determination is to provide relevant information to assist owners and others in making decisions.

From a company's point of view, determination of taxable income should rest on the objective of minimizing the present value of income taxes paid over the life of the company. This is accomplished by excluding all revenues and including all expenses permitted within the law when deter-

¹ *CICA Handbook* (Toronto: CICA), Section 3470, defines "accounting income" as "the net income for the period, shown in the financial statements prepared for submission to the shareholders, before the provision for income taxes (including any income taxes applicable to discontinued operations and extraordinary items) but after excluding items that are non-taxable or non-deductible for income tax purposes on a once-and-for-all basis. Similarly, the term 'accounting loss' is used in this Section to mean the converse of accounting income." This definition is used throughout this chapter.

mining taxable income, regardless of their recognition for purposes of determining accounting income (avoidance but not evasion of tax). Furthermore, to be consistent with this objective, a company should calculate taxable income in a manner that would defer payment of taxes into the future rather than pay them in the present period. Therefore, for purposes of taxable income determination, this would mean deferring the inclusion of revenues or gains to future years and including all expenses and losses in the present year when such options exist under tax laws. Because these calculation principles are different from generally accepted accounting principles, the result can be a difference between taxable income and accounting income.

NATURE OF DIFFERENCES BETWEEN TAXABLE INCOME AND ACCOUNTING INCOME

Differences between taxable income and pretax income to be reported in financial statements as determined under Canadian GAAP arise from two sources: (1) permanent differences and (2) timing differences.

Permanent Differences

Permanent differences refer to (1) items that appear on the income statement prepared under GAAP but never enter into the determination of taxable income and (2) items that enter into the determination of taxable income but are never reported on an income statement. Such differences arise from tax laws that (a) exclude certain accounting revenues from taxation (e.g., dividends received from another Canadian corporation; life insurance proceeds received on the death of an insured company officer), (b) exclude certain accounting expenses as tax deductions (e.g., premiums paid on company officers' life insurance; membership fees for dining, sporting, and recreation organizations), and (c) allow certain deductions that are not taken into the determination of reported income (e.g., resource allowances; earned depletion allowances). When permanent difference items are reported in an income statement, they are simply treated as nontaxable or nondeductible items in the determination of the amount of tax expense. If a permanent difference item is on the tax return, it is used to calculate tax expense to be reported in the income statement even though the item itself is not in the statement.

When only permanent differences exist, both the tax payable and the tax expense for the period are equal to the tax rate multiplied by the taxable income. For example, assume that taxable income was \$100,000 and income before tax to be reported was \$98,000, the difference being due to a permanent difference expense item appearing in the latter. If the statutory tax rate was 45%, both the tax payable and the tax expense would be \$45,000 as shown below.

$$\begin{aligned}
 \text{Tax payable} &= \text{tax rate} \times \text{taxable income} \\
 &= 0.45 \times \$100,000 \\
 &= \$45,000 \\
 \text{Tax expense} &= \text{tax rate} \times \left[\begin{array}{l} \text{Income before tax to be reported} \\ + \text{permanent difference} \\ \text{expenses in income to be reported} \\ + \text{permanent difference revenues} \\ \text{in taxable income} \\ - \text{permanent difference revenues} \\ \text{in income to be reported} \\ - \text{permanent difference expenses} \\ \text{in taxable income} \end{array} \right] \\
 &= 0.45 (\$98,000 + \$2,000 + 0 - 0 - 0) \\
 &= \$45,000
 \end{aligned}$$

It should be recognized that when permanent differences exist, the **effective tax rate** of 46% in this example (tax expense of \$45,000 divided by reported income before tax of \$98,000) would not correspond to the 45% statutory tax rate. Disclosure of such discrepancies is required in the

Timing Differences

A **timing difference** exists when an item of revenue, expense, gain, or loss is included in the computation of accounting income in one period but is included in the computation of taxable income in another period.

Timing differences **originate** in one period and **reverse** or “turn around” in one or more subsequent periods. The *CICA Handbook* identifies five situations from which timing differences arise:

1. where expenses are claimed for tax purposes in one period but are not charged against income for accounting purposes until some later period, e.g., capital cost allowances in excess of depreciation charged, and certain other costs which are sometimes deferred in the accounts but claimed immediately for taxes, such as exploration and development costs, start-up costs, past service pension contributions, and accounting and legal expenses in connection with bond financing;
2. where expenses are charged against income for accounting purposes in one period but are not deducted for tax purposes until some later period, e.g., provisions for warranties, provisions for deferred compensation payments, and depreciation of fixed assets or write-downs of inventories in excess of amounts allowed for tax purposes;
3. where revenues are included in accounting income in one period but are not taxable until some later period, e.g., profit on instalment sales;
4. where revenues are deferred in the accounts to a later period but are taxable in the current period, e.g., unearned profits on certain types of construction contracts and intercompany profits in inventories that are eliminated on consolidation;
5. where capital gains and losses are recorded for accounting purposes in periods different from those in which they are recognized for tax purposes.³

EXERCISES

(PERMANENT VERSUS TIMING DIFFERENCES; ORIGINATING EFFECT ON DEFERRED TAXES) Listed below are 18 items that are treated differently for accounting and tax purposes:

1. Excess of capital cost allowance over depreciation.
2. Tax-exempt interest income.
3. Excess of depletion allowance for tax purposes over depletion expense for accounting income determination.
4. Excess of charge to tax return over charge to books for estimated uncollectibles.
5. Excess of accrued pension expense over amount paid.
6. Excess of fair market value of a charitable contribution (deductible for taxes) over cost (charged to expense).
7. Instalment sales income for accounting purposes exceeds taxable income from instalment sales.
8. Expenses incurred in obtaining tax-exempt income.
9. A trademark acquired directly from the government is amortized more rapidly for tax purposes than it is expensed for accounting purposes.
10. Prepaid advertising is deducted as an expense for tax purposes but set up as a prepaid asset on the books.
11. Premiums paid on life insurance of officers (the corporation is the beneficiary).
12. Receipt of tax-free dividends from a Canadian corporation.
13. Proceeds of life insurance policies on lives of officers.
14. Estimated future warranty costs that are expensed for accounting purposes but are not deductible for tax purposes until they are incurred.
15. Excess of research and development cost per tax return over book amount.
16. Charitable contributions—excess of accounting amount over tax limitation.
17. Fine for polluting.
18. Income discovered after closing but included in the tax return.

Instructions

Indicate whether each item results in a *permanent* difference or a *timing* difference and whether any *originating* difference results in a debit or a credit to deferred taxes.

To illustrate timing differences, assume that Baker Ltd. bought a Class 10 (capital cost allowance (CCA) rate of 30%) asset on January 10, 1994 at a cost of \$100,000.[†] While the company deducted the maximum allowed CCA for tax purposes, the asset was depreciated over a period of 10 years for financial reporting purposes using the straight-line method. The appropriate depreciation and CCA expense charges year by year would be as follows.

<u>Year</u>	<u>Amount of Expense</u>	
	<u>CCA for Tax Purposes</u>	<u>Depreciation for Accounting Purposes</u>
1994	\$15,000*	\$ 10,000
1995	25,500	10,000
1996	17,850	10,000
1997	12,495	10,000
1998	8,746	10,000
1999	6,123	10,000
2000	4,286	10,000
2001	3,000	10,000
2002	2,100	10,000
2003	1,470	10,000
Total	<u>\$96,570 **</u>	<u>\$100,000</u>

* For the first year of ownership, CCA equals one-half of the CCA rate times the undepreciated capital cost. Thereafter, CCA equals the CCA rate times the undepreciated capital cost.

** Assume the asset class continues even though this asset may be disposed of after 10 years.

is debited to Income Tax Expense, the taxes due and payable are credited to Income Tax Payable, and the difference between these two amounts is debited (or credited) to an account titled Deferred Income Taxes. In the period or periods in which timing differences reverse, the amount accumulated in Deferred Income Taxes is reduced, as it absorbs the difference between reported tax expense and the tax actually payable for those later years.

Example 1: Interperiod Tax Allocation When Tax Expense Is Initially Greater Than Tax Payable

To illustrate comprehensive interperiod tax allocation accounting, the information presented previously for Baker Ltd. will be used. The income tax expense reported in the income statement each year would be \$18,000. This is determined by multiplying the tax rate (45%) by the accounting income (\$40,000: the \$50,000 income before taxes and depreciation less the depreciation expense of \$10,000). The tax payable equals the tax rate multiplied by the taxable income. The difference between the tax expense and the tax payable from 1994 through 2003 is shown below.

Baker Ltd.
Tax Expense versus Tax Payable

<u>Year</u>	<u>Tax Expense</u>	<u>Tax Payable</u>	<u>Difference Expense – Payable</u>
1994	\$18,000	\$15,750	\$ 2,250
1995	18,000	11,025	6,975
1996	18,000	14,468	3,532
1997	18,000	16,877	1,123
1998	18,000	18,564	(564)
1999	18,000	19,745	(1,745)
2000	18,000	20,571	(2,571)
2001	18,000	21,150	(3,150)
2002	18,000	21,555	(3,555)
2003	18,000	21,838	(3,838)

During the first four years, the tax expense is greater than the tax payable and the difference is credited to the Deferred Income Taxes account as indicated in the following entries.

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Income Tax Expense	18,000	18,000	18,000	18,000
Income Tax Payable	15,750	11,025	14,468	16,877
Deferred Income Taxes	2,250	6,975	3,532	1,123

At the end of four years, the Deferred Income Taxes account has four credit entries, as follows.

<u>Deferred Income Taxes</u>	
	1994 2,250
	1995 6,975
	1996 3,532
	1997 1,123

A credit balance in Deferred Income Taxes is presented in the balance sheet, likely under a liability classification or as a unique item between liabilities and shareholders' equity.

During the next six years, the income statement will continue to show income of \$40,000 before taxes and a tax expense of \$18,000. Tax payable, however, is greater than this tax expense. Therefore, for each of these years, the Deferred Income Taxes account is debited for the difference between the expense and payable amount, as illustrated below for the years 1998, 1999, and 2003.

	1998	1999	2003
Income Tax Expense	18,000	18,000	18,000
Deferred Income Taxes	564	1,745	3,838
Income Tax Payable	18,564	19,745	21,838

At the end of 2003, the Deferred Income Taxes account is as follows.

Deferred Income Taxes			
1998	564	1994	2,250
1999	1,745	1995	6,975
2000	2,571	1996	3,532
2001	3,150	1997	1,123
2002	3,555		
2003	3,838		
Balance 1,543 Dr.			

The \$1,543 debit balance at the end of 2003 resulted from the fact that application of the CCA method left some undepreciated capital cost for tax purposes. The disposition of the Deferred Income Taxes balance depends on the nature of disposition of the undepreciated capital cost.

Thus, by this allocation of income taxes, the income tax expense during each period is unaffected by the decision to use CCA for income tax purposes. The temporary tax advantage, although of real significance for financial reasons, has no influence on reported net income, which would be \$22,000 per year. The calculation of tax payable is unaffected by the allocation of tax expense to periods based on accounting income.

Baker Ltd.
Partial Income Statement
 (With Interperiod Tax Allocation – Accounting Income
 Initially Exceeds Taxable Income)

	<u>For Tax Purposes</u>	<u>For Accounting Purposes</u>
<u>1994</u>		
Income before CCA or depreciation and taxes	\$50,000	\$50,000
CCA or depreciation	15,000	10,000
Income before taxes	<u>\$35,000</u>	\$40,000
Income tax payable	<u>\$15,750</u>	
Income tax expense		<u>\$18,000</u>
Net income reported		<u>\$22,000</u>
Effective tax rate		45%
<u>1997</u>		
Income before CCA or depreciation and taxes	\$50,000	\$50,000
CCA or depreciation	12,495	10,000
Income before taxes	<u>\$37,505</u>	\$40,000
Income tax payable	<u>\$16,877</u>	
Income tax expense		<u>\$18,000</u>
Net income reported		<u>\$22,000</u>
Effective tax rate		45%
<u>1998</u>		
Income before CCA or depreciation and taxes	\$50,000	\$50,000
CCA or depreciation	8,746	10,000
Income before taxes	<u>\$41,254</u>	\$40,000
Income tax payable	<u>\$18,564</u>	
Income tax expense		<u>\$18,000</u>
Net income reported		<u>\$22,000</u>
Effective tax rate		45%
<u>2003</u>		
Income before CCA or depreciation and taxes	\$50,000	\$50,000
CCA or depreciation	1,470	10,000
Income before taxes	<u>\$48,530</u>	\$40,000
Income tax payable	<u>\$21,838</u>	
Income tax expense		<u>\$18,000</u>
Net income reported		<u>\$22,000</u>
Effective tax rate		45%

Exercise I

(TAX ALLOCATION ENTRIES) Following is information about Garden Inc.

	1992	1993	1994
Accounting income	\$80,000	\$95,000	\$60,000
Taxable income	70,000	70,000	80,000

Instructions

- Assuming a tax rate of 45% and that the differences between accounting and taxable income are entirely the result of timing differences, prepare the journal entries at the end of each year to reflect income tax allocation.
- Assume the same facts as in (a) except that in 1993 the accounting income includes \$10,000 for dividends received from Canadian corporations (tax-exempt). Prepare any journal entries that would be different from those in (a).

Exercise II

(TAX ALLOCATION ENTRIES: ORIGINATING AND REVERSING) Spartan Corporation has an item costing \$90,000 that is expensed for tax purposes in 1994 but is amortized over three years (1994, 1995, 1996) for accounting purposes. The tax rate is 40% in the year of origination, 1994, and 30% in the years of turnaround, 1995 and 1996. The accounting and tax data for the three years are shown below.

	Financial Accounting	Tax Return
1994 (40% tax rate)		
Income before timing difference	\$100,000	\$100,000
Timing difference	<u>30,000</u>	<u>90,000</u>
Income after timing difference	<u>\$ 70,000</u>	<u>\$ 10,000</u>
1995 (30% tax rate)		
Income before timing difference	\$100,000	\$100,000
Timing difference	<u>30,000</u>	<u>-0-</u>
Income after timing difference	<u>\$ 70,000</u>	<u>\$100,000</u>
1996 (30% tax rate)		
Income before timing difference	\$100,000	\$100,000
Timing difference	<u>30,000</u>	<u>-0-</u>
Income after timing difference	<u>\$ 70,000</u>	<u>\$100,000</u>

Prepare the journal entries to record the income tax expense and the deferred income taxes at the end of each year, applying the individual item basis and the deferral method.

(DEFERRED TAX COMPUTATIONS) During the audit of Taco Sales Co. Ltd., the following information was obtained:

1.

<u>Year</u>	<u>Amount Due Per Tax Return</u>
1994	\$80,000
1995	\$65,000

2. On January 1, 1994, equipment costing \$110,000 was purchased. The equipment had a life of five years and a salvage value of \$10,000. Capital cost allowance was taken for income tax purposes and the straight-line depreciation method was used for accounting purposes. The appropriate CCA rate was 30%.
3. In January 1995, \$75,000 was collected in advance rental of a building for a three-year period. The entire \$75,000 was reported as taxable income in 1995 but \$50,000 was reported as unearned revenue in 1995 for accounting purposes.
4. The tax rate was 45% in both years.
5. The client company used the deferral method of income tax allocation.

Instructions

- (a) Determine the balance in the Deferred Income Taxes account at the end of 1994 and whether it is a debit or a credit.
- (b) Determine the balance in the Deferred Income Taxes account at the end of 1995 and whether it is a debit or a credit.