Demystifying deferred tax accounting

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In brief

Regulatory and legislative developments in the United States and abroad have generated continued interest in the financial accounting and reporting framework, including accounting for income taxes. Fundamental to the income tax accounting framework is an understanding of deferred tax accounting. In this publication we provide a refresher of the deferred tax accounting model and why deferred taxes are an important measure within the financial statements. The income tax accounting model applies only to taxes based upon income, and therefore excludes some other taxes, such as taxes based upon gross revenue or certain transactional taxes. This discussion specifically addresses accounting concepts under US Generally Accepted Accounting Principles (US GAAP), although certain elements may also apply under International Financial Reporting Standards (IFRS) or other non-US accounting standards.

In detail

Overview - why are deferred income taxes important and what do they represent?

Simply stated, the deferred tax model allows the current and future tax consequences of book income or loss generated by the enterprise to be recognized within the same reporting period, providing a complete measure of the net earnings. A deferred tax often represents the mathematical difference between the book carrying value (i.e., an amount recorded in the accounting balance sheet for an asset or liability) and a corresponding tax basis (determined under the tax laws of that jurisdiction) in the asset or liability, multiplied by the applicable jurisdiction’s statutory income tax rate.

Example: Generally, the income tax basis in a fixed asset is the purchase price less tax depreciation previously allowed under the applicable tax law. The timing of the cost recovery of the fixed asset may differ between the tax law for a particular jurisdiction and the applicable accounting rules, which can result in a deferred tax asset or liability.

The following chart illustrates when an accounting asset or liability (excluding income tax accounts) generates a corresponding deferred tax asset or liability:
Additionally, a deferred tax asset can result from an income tax credit, loss carryover or other tax attribute that is available to reduce future income tax obligations.

Fundamentally, deferred tax balances represent the future tax impacts of recovering or otherwise consuming assets (e.g., by depreciating the asset) and settling liabilities (e.g., by cash settlement of the obligations) at the respective book values.

- In a fixed asset example where the book carrying value exceeds the corresponding tax basis, the deferred tax liability can represent the tax consequences of recovering or disposing of the asset at its book carrying value. In the case of disposal, a sales price equal to the book carrying value would result in a taxable gain, given the lower corresponding tax basis.

- Conversely, in a pension liability example where the book carrying value exceeds the corresponding tax basis, the deferred tax asset represents the future tax benefit of the anticipated cash settlement of the liability. Specifically, the recognition of pension book expense (and the corresponding liability) often occurs prior to the recognition of the related tax deduction (which generally occurs when the pension liability is funded or otherwise settled with cash or other property.)

Causes for differences between accounting carrying values and tax bases

Often, differences between book carrying values and the related tax bases are the result of separate objectives between financial reporting standards and income tax regimes.

Generally, the objective of general purpose financial reporting (e.g., US GAAP reporting standards) is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. The focus is on the consolidated results of the reporting entity. In contrast, tax regimes are generally not similarly focused and often include aspects of tax policy that seek to incentivize certain behaviors. For example, accelerated cost recovery measures promote investment in a specific area or asset class. Other credits promote the investment in more clean energy sources.

Importantly, differences between applicable accounting standards and the relevant income tax law which only impact the timing of when an asset or liability is recovered (e.g., immediately expensing of capital expenditures for income tax purposes, with a corresponding multiple-year depreciation period for accounting purposes) are reflected as deferred taxes. In contrast, other items (for example, certain tax-exempt income) may be permanently excluded from a local income tax base, and this does not result in the recognition of a deferred tax.

Depending on the nature of the assets and liabilities involved, timing differences may reverse within a year (e.g., differences relating to certain assets and liabilities classified as current or short term on the balance sheet), or may take several years to reverse (e.g., certain long-lived assets). Moreover, other differences may not reverse until the related asset is disposed of or otherwise impaired for book purposes (e.g., certain non-amortizing book intangible assets, such as a trade name). For example, basis differences may exist between the book carrying value and tax basis in an enterprise’s investments, such as the stock of a corporation. The reversal of such investments would generally not occur until the investment is sold or otherwise recovered. While the timing of recovery may vary,
importantly, deferred taxes will reverse as the financial statement asset is recovered or the financial statement liability is settled in the normal course of business.

With respect to the timing of the reversal of a deferred tax liability, it is important to note that factors may be present which could result in a delay in the event(s) that give rise to the reversal. This may include, for example, a delay in the recovery of a related asset or the settlement of a related liability. However, the inherent assumption within US GAAP is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Thus, the only question is when, not whether, the deferred tax liability will reverse.

US GAAP, as well as other accounting standards, generally requires that assets and liabilities acquired in a business combination are to be presented at fair market values at the time of acquisition. However, whether or not the corresponding tax bases of the acquired assets and liabilities are also adjusted to fair market values is dependent on how the business is acquired. For example, in many jurisdictions, the acquisition of the shares of an enterprise (as opposed to the direct acquisition of underlying assets and liabilities) will not result in a change in tax bases of the assets and liabilities. In some instances, the underlying assets may include intangible property which is fair valued for financial statement purposes in acquisition accounting. However, since there is no change in tax basis, differences between book carrying values and respective tax basis amounts exist in these cases and result in deferred tax liabilities.

In addition to understanding how and when existing deferred tax assets and liabilities may reverse, it is important to consider valuation allowances that may reduce the carrying value of certain (or all) deferred tax assets. The recognition of a valuation allowance generally represents the conclusion that on a "more likely than not" basis, the enterprise will not be able to receive a cash tax benefit for certain or all of its deferred tax assets. This may result from uncertainties concerning future taxable profits in certain tax jurisdictions, as well as potential limitations that a tax authority may impose on the deductibility of certain tax benefits.

**Common types of deferred taxes**

Examples of items that give rise to the recognition of deferred taxes includes:

- **Fixed assets.** In many cases, tax basis may be less than the respective book carrying value, given accelerated cost recovery measures in a number of taxing jurisdictions (e.g., immediate expensing or bonus depreciation for federal income tax purposes in the US).

- **Certain intangible assets.** Tax basis may differ from the book carrying value of certain intangible assets (e.g., trade names or customer relationships) given differences in cost recovery periods between accounting and tax, or simply the existence of an intangible asset that is recognized for book purposes but does not have a corresponding capitalized or amortizable balance for tax purposes.

- **Accrued liabilities.** In the case of certain accrued liabilities, a tax deduction may be available in a future year when the liability is settled (often with cash or other property), whereas for book purposes the liability is accrued currently, reflecting an expense that is incurred but not yet paid or settled.

- **Inventory.** Tax basis in inventory may require different cost capitalization measures as compared to book carrying values. Moreover, certain differences may exist between accounting and tax balances for last-in first-out (LIFO) inventory methods.

- **Tax attributes.** Common tax attributes, including unutilized net operating losses or tax credit carryforwards generated in prior tax year(s), may be available to reduce cash tax obligations in future year(s), thus representing a potential future tax benefit.
The takeaway

While certain complexities exist, the fundamental objective of the deferred tax accounting model is to provide a complete measure of an enterprise’s net earnings by allowing the current and future tax consequences to be recognized in the same reporting period as the book income or loss is generated. This objective is met through the measurement of the basis difference in the book carrying value and tax basis of the enterprise’s underlying assets and liabilities. While there are limited exceptions, these differences in basis generally reverse as part of the enterprise’s normal course of operations according to well-established rules.

Let’s talk

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