

Accounting for Income Taxes

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Course Description

Corporations must file income tax return following the guidelines developed by the IRS. Since GAAP and tax regulations differ in a number of ways, so frequently do pretax financial income and taxable income. In consequence, the amount that a company reports as tax expense will differ from the amount of taxes payable to the IRS. This course covers the basic guidelines that companies must follow in reporting income taxes and the disclosure requirement associated with deferred taxes, reviewing some of the concepts and items discussed in ASC 740, *Income Taxes*.

Field of Study	Accounting
Level of Knowledge	Basic to Intermediate
Prerequisite	Basic Accounting
Advanced Preparation	None

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Accounting for Income Taxes

Learning Objectives:

After completing this section, you should be able to:

- Recognize the four types of temporary differences and identify how these differences may arise.
 - Identify permanent differences and distinguish between permanent and temporary differences.
 - Recognize the impact of different expenses and investment and how they affect deferred income tax.
 - Define accounting procedures for a loss carryback and a loss carryforward.
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The scope of ASC 740, *Income Taxes: Overall* covers the tax consequences of (1) revenues, expenses, gains, and losses included in taxable income of a year other than the year when they are recognized in income for financial reporting purposes; (2) other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting purposes; and (3) operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years. **Note:** ASC 740 does not address issues such as the method of accounting for the U.S. federal investment tax credit, the discounting of income taxes, and the accounting for income taxes in general in interim periods.

Under ASC 740-10-05-1 through 05-10, income tax allocation is required. Temporary differences take place between book income (on an *accrual* basis) and taxable income (on a *modified cash* basis). The deferred tax liability or asset is measured at the tax rate that will arise when the temporary difference reverses. In determining the tax rate the fact that different rates exist for ordinary income and capital gains must be considered. The deferred tax liability or asset must be adjusted for changes in tax law or in tax rate.

As a result, the *asset and liability method* (hereafter referred to simply as the *liability method*) must be used to account for deferred income taxes. The liability method is balance sheet oriented because the major goal is to present the estimated actual taxes to be paid in future years. Comprehensive deferred tax accounting is followed, meaning that all income tax effects of all revenues, expenses, gains, losses, and other items creating differences between tax and financial reporting are considered. Tax expense equals taxes payable plus the tax impact of all temporary differences. In other words, the total provision for income taxes is the sum of the amount of tax currently payable (current tax expense) and the net change in

the deferred tax assets and deferred tax liabilities (deferred tax expense or benefit). Interperiod tax allocation is followed to account for temporary differences affecting the current year's results. Tax effects of future events should be reflected in the year they occur. Besides temporary differences, ASC 740-10-05-1 through 05-10 deals with the recognition of taxes currently payable or refundable.

Deferred tax assets and liabilities also take into account operating loss carryforwards for tax reporting purposes. Deferred tax assets are reduced by a valuation allowance account representing the amount of tax benefits not expected to be realized. In effect, the tax provision is basically the residual amount computed as the current tax provision plus the difference between the beginning and ending deferred tax balances.

If tax rates are graduated based on taxable income, aggregate calculations may be made using an estimated average rate.

This applies to federal, state, local, and foreign income taxes; consolidated and combined financial statements; investments under the equity method; and foreign companies issuing their financial statements in conformity with GAAP.

Of note to the reader is the FASB Implementation Guide, *Accounting for Income Taxes*, providing questions and answers regarding the implementation of ASC 740-10-05-1 through 05-10.

Note: Current tax expense is the amount of income taxes paid or payable for a year as determined by applying the provisions of the enacted tax law to the taxable income for that year.

Temporary Differences

The definition of temporary differences as given by ASC-740-10-20 is:

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. ASC 740-10-25-20 cites eight examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see ASC 740-10-05-10 and ASC 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

- a. Result from events that have been recognized in the financial statements.
- b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

Most transactions entered into by a company are accounted for in the same way for financial and tax reporting purposes. However, some transactions are accounted for differently. Temporary differences apply to the period in which revenue or expenses will be recognized. Temporary differences can be caused by four types of transactions as follows:

1. Revenue is included on the tax return after being presented on the books (financial records). An example is an installment sale that is recognized for the books in the year of sale but is recognized for tax purposes when cash collections are received. Another example is using the percentage-of-completion construction contract method on the books but the completed contract method on the tax return. This also occurs if the equity method is used by the investor, because the investees' earnings are recognized for book purposes by the investor but the investor recognizes only the investees' dividends for tax reporting.
2. Revenue is included on the tax return before being presented on the books. An example is deferred (unearned) revenue, such as an advance payment (retainer) that is recognized for tax purposes when the advance payment is received but is not recognized for book purposes until the services are performed.
3. Expenses are deducted on the tax return after being deducted on the books. For example, bad debts are deducted on the books in the year of sale (allowance method) but are not deductible on the tax return until the customer's balance is uncollectible (direct write-off method). Warranty expense is deducted on the books in the year of sale but is deducted on the tax return when paid. Another example is a contingent loss accrual for book purposes before being deductible for tax purposes. Sales returns and allowances are accrued for book purposes but not deducted on the tax return until the product is returned.
4. Expenses are deducted on the tax return before being deducted on the books. An example is accelerated depreciation on the tax return but straight-line depreciation on the books. Another example is a shorter depreciable life of fixed assets for tax purposes relative to book purposes. A deferred tax liability also arises when certain pre-operating costs and certain capital interest costs are deductible for tax purposes in the current year.

Other examples of temporary differences are:

- Unrealized losses or gains on trading securities or available-for-sale securities that are recorded for financial reporting purposes (on the tax return, losses or gains are recognized only when the securities are sold).
- Items relating to foreign-currency-denominated assets and liabilities.
- Use of the equity method for book purposes but the cost method for tax reporting.

- Gross profit recognized on the cost recovery method for book purposes but on the cash basis for tax purposes.
- Use of the capital lease method for book purposes but the operating method for tax reporting.
- Amortizing capitalized leases over different time periods for book and tax purposes.
- Gains or losses on fixed assets recognized for book purposes but deferred for tax purposes because of a trade-in on similar fixed assets.
- Gains on appreciation in assets distributed associated with a liquidation recognized for financial reporting and on distribution for tax purposes.
- Use of different amortization periods for intangible assets for book and tax purposes.
- Use of cost depletion for financial reporting while using statutory depletion for tax purposes.
- Net capital loss recognized in the current year for book purposes but carried forward to offset future capital gains on the tax return.
- Excess charitable contribution carried over to future years for tax reporting.
- Deferred compensation accrued for books while employee services are performed but not deductible on the tax return until actually paid.
- Amortization of bond issue costs under the interest method for book purposes but the straight-line method on the tax return.
- Accrual of sick or vacation pay as employee services are rendered for book purposes but when paid on the tax return.
- Deferral of intangible drilling costs for book purposes while expensing them on the tax return.
- Interest revenue used to offset capitalized interest on the books but recognized as income on the tax return.
- Inventories valued at the lower of cost or market value for books but at cost for tax reporting.
- Loss provision for obsolete inventory for books but not deductible on the tax return until the inventory is available for sale at discounted values or discarded.
- Inventory-related costs deducted on the books but capitalized for tax reporting.
- Use of the accrual basis for book purposes but the cash basis on the tax return.
- Effect of a change from the cash basis to the accrual basis recognized equally over four years for tax purposes.
- Imputed interest for book purposes that differs from the amount recognized for tax purposes.
- Reduction in the tax basis of depreciable assets due to tax credits.
- Increase in the tax basis of assets due to indexing whenever the local currency is the functional currency.

- Tax basis difference that results from the issuance of convertible debt with a beneficial conversion feature, as specified by ASC 740-10-55-51, *Income Taxes: Overall*. Under the EITF, the deferred taxes recognized should be adjusted to paid-in-capital.
- Tax consequences of differences between the assigned values and the tax bases of assets and liabilities in a purchase business combination.
- Tax basis adjustments required by the tax law.

Some items may be considered temporary differences in one case but not in another. For example, the amount by which the cash surrender value of life insurance exceeds insurance premiums paid is a temporary difference if there is an anticipation that the cash surrender value will be recovered. It is not a temporary difference if it is anticipated that the cash surrender value will not be recovered when the insured dies.

Deferred Tax Liability

If book income (BI) exceeds taxable income (TI), then tax expense (TE) exceeds tax payable (TP), resulting in a deferred tax liability (credit).

EXAMPLE

An increase in prepaid insurance signifies the recognition of a deduction on the tax return of a cash-basis taxpayer but not in the accrual-basis financial statements. The result is a temporary difference giving rise to taxable amounts in future years when the reported amount of the asset is recovered. An increase in rent receivable involves recognition of revenue in the accrual-basis financial statements but not in the tax return of a cash-basis taxpayer. This temporary difference also will result in future taxable amounts when the asset is recovered. A deferred tax liability records the tax consequences of taxable temporary differences. Hence, these transactions increase deferred tax liabilities.

The deferred tax liability may also be calculated by multiplying the temporary difference by the applicable tax rate.

EXAMPLE

Book income and taxable income are both \$200,000. Depreciation expense for book purposes is \$20,000 using the straight-line method, but depreciation for tax purposes is \$30,000 using an accelerated depreciation method. Assuming a 30% tax rate, the entry is:

Income tax expense ($\$180,000 \times 30\%$)	54,000
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Income tax payable ($\$170,000 \times 30\%$)	51,000
Deferred tax liability ($\$10,000 \times 30\%$)	3,000

At the end of the life of the asset, the deferred tax liability of \$3,000 will be completely reversed.

EXAMPLE

Interperiod Tax Allocation with Temporary Difference

XYZ Corporation's pretax financial income is \$500,000 for year 2X11. It has a \$200,000 temporary difference at the end of 2X11 that will reverse and result in taxable amounts as follows:

<i>Year</i>	<i>Taxable Amount</i>
2X12	\$40,000
2X13	\$70,000
2X14	\$90,000

The tax rate is 30% for all years. There were no deferred taxes at the beginning of year 2X11.

The taxes payable for year 2X11 are calculated as follows:

Pretax financial income for 2X11	\$500,000
Temporary difference at end of 2X11	(200,000)
Taxable income for 2X11	<u>\$300,000</u>
Tax rate	30%
Taxes payable for 2X11	<u>\$ 90,000</u>

The deferred tax liability is calculated as follows:

	<i>2X12</i>	<i>2X13</i>	<i>2X14</i>	<i>Total</i>
Future taxable amount	\$40,000	\$70,000	\$90,000	\$200,000
Tax rate	30%	30%	30%	30%
Deferred tax liability	\$12,000	\$21,000	\$27,000	\$ 60,000

Total tax expense for year 2X11 is as follows:

Current tax expense for 2X11	\$ 90,000
Deferred tax liability for 2X11	\$ 60,000
Total tax expense for 2X11	<u>\$150,000</u>

The journal entry to record tax expense is:

Income tax expense	150,000	
Income tax payable		90,000
Deferred tax liability		60,000

EXAMPLE

Interperiod Tax Allocation with Temporary Difference and Beginning Deferred Taxes

XYZ Corporation's pretax financial income is \$600,000 and taxable income is \$550,000 for year 2X11. Its beginning deferred tax liability account has a balance of \$75,000. Its cumulative temporary difference for year-end 2X11 is equal to \$300,000 and will reverse and result in taxable amounts as follows:

<i>Year</i>	<i>Taxable Amount</i>
2X12	\$100,000
2X13	\$ 75,000
2X14	\$125,000

The tax rate is 30% for all years.

The taxes payable for year 2X11 are calculated as follows:

Pretax financial income for 2X11	\$600,000
Temporary difference at end of 2X11	(50,000)
Taxable income for 2X11	\$550,000
Tax rate	30%
Taxes payable for 2X11	<u>\$165,000</u>

The deferred tax liability is calculated as follows:

	<i>2X12</i>	<i>2X13</i>	<i>2X14</i>	<i>Total</i>
Future taxable amount	\$100,000	\$75,000	\$125,000	\$300,000
Tax rate	30%	30%	30%	30%
Deferred tax liability	<u>\$ 30,000</u>	<u>\$22,500</u>	<u>\$ 37,500</u>	<u>\$ 90,000</u>

Total tax expense for year 2X11 is as follows:

Current tax expense for 2X11	\$165,000
Deferred tax liability at end of 2X11	\$90,000

Deferred tax liability at beginning of 2X11	75,000	
Deferred tax expense for 2X11 (additional)		15,000
Total tax expense for 2X11($\$600,000 \times 30\%$)		<u>\$180,000</u>

The journal entry to record tax expense is:

Income tax expense	180,000	
Income tax payable		165,000
Deferred tax liability		15,000

EXAMPLE

On January 1, 2X10, Levita Company purchased an \$800,000 machine with an estimated useful life of 10 years with no salvage value. The machine was depreciated using an accelerated method for both book and tax purposes. On December 31, 2X12, the carrying value of the machine was \$380,000. At the beginning of the next year (January 1, 2X13), Levita changed to the straight-line method for financial statement purposes. Levita's tax rate was 40%. On January 1, 2X13, what amount should Levita report as a deferred income tax liability as a result of the change?

After the change in accounting method was made (to the straight-line method), there would be a temporary difference because the machine was being depreciated using the straight-line method for financial statement purposes and an accelerated method for tax purposes. The temporary difference may be computed in the following manner*:

Carrying amount of the machine for financial statement purposes after the change on 1/1/2X13 $\$800,000 - (3/10 \times \$800,000)$	\$560,000
Less: carrying amount of machine for tax purposes on 1/1/2X13	380,000
Temporary difference—(future taxable amount)	<u>\$180,000</u>

Because the machine was being depreciated using the straight-line method for financial statement purposes and an accelerated method for tax purposes, the temporary difference represents a future taxable amount and therefore results in a deferred tax liability. ASC 740-10-05-1 through 05-10 requires that the deferred tax liability be measured by multiplying the amount of the temporary difference by the tax rate scheduled to be in effect when the temporary difference reverses. Therefore, the deferred income tax liability is computed in the following way:

Deferred income tax liability, January 1, 2X13:

$$\$180,000 \times .4 =$$

$$\underline{\$72,000}$$

*The carrying value of the machine was the same for both financial statement purposes and tax purposes prior to the change because during that period the machine was depreciated using an accelerated method for both book and tax purposes.

Deferred Tax Asset

If book income (BI) is less than taxable income (TI), then tax expense (TE) is less than tax payable (TP), causing a deferred tax asset (charge). An example is an increase in warranty obligations. Such an increase is a noncash expense recognized in accrual-basis financial statements but not on a modified-cash-basis tax return. The result is a deductible temporary difference and an increase in a deferred tax asset.

The deferred tax asset equals the temporary difference multiplied by the tax rate scheduled to be in effect when the difference reverses.

A net deferred tax asset may be recorded if it is more likely than not (more than a 50% probability) that the tax benefit will be realized in the future. The gross deferred tax asset is reduced by a valuation allowance (contra account) if it is more likely than not that some or all of the gross deferred tax asset will not be realized. The net deferred tax asset represents the amount likely to be realized. The deferred tax asset is presented in the following balance sheet, assuming a temporary difference of \$500,000, a tax rate of 40%, and \$350,000 of the tax benefit having more than a 50% probability of being realized.

Gross deferred tax asset (\$500,000 × .40)	\$200,000
Less: valuation allowance (\$150,000 × .40)	<u>60,000</u>
Net deferred tax asset (\$350,000 × .40)	\$140,000

EXAMPLE

There is a temporary difference of \$300,000, a 30% tax rate, and the entire temporary difference has more than a 50% probability of being realized. The balance sheet presentation follows:

Gross deferred tax asset (\$300,000 × .30)	\$90,000
Less: valuation allowance	<u>0</u>
Net deferred tax asset (\$300,000 × .30)	\$90,000

EXAMPLE

If in the previous example the entire deferred tax asset of \$300,000 had less than a 50% probability of being realized, the balance sheet presentation would be as follows:

Gross deferred tax asset ($\$300,000 \times .30$)	\$90,000
Less: valuation allowance ($\$300,000 \times .30$)	90,000
Net deferred tax asset	<u>\$ 0</u>

The following factors are reflective of there being more than a 50% probability of future realization of a temporary difference presented as a deferred tax asset:

- There has been a relatively consistent strong earnings history.
- Future earnings are assured.
- There is expected adequate future taxable income arising from the reversal of a temporary difference (deferred tax liability) to realize the benefit of the tax asset.
- Sound and prudent tax planning strategies are in place that would allow for the realization of the deferred tax asset.
- The amount per books of asset values exceeds their tax bases sufficient to realize the deferred tax asset.
- Lucrative contracts exist.
- There is a significant sales backlog.

The following factors indicate that there is a 50% or less probability of future realization of a deferred tax asset:

- A history of losses in prior years.
- An expectation of future operating losses even though prior years showed profitability.
- Tax benefits that have expired.
- Significant contingencies and uncertainties, such as lawsuits that could have a disastrous effect on the business.

The valuation allowance reduces the deferred tax asset to its realizable value. In determining whether a valuation allowance is required to reduce deferred tax assets to the amount that is more likely than not to be realized, **all available evidence** should be considered. This includes both *positive* and *negative* evidence. In considering the relative impact of positive and negative evidence, the weight given to the potential

effect of the evidence should be commensurate with the extent to which the evidence can be objectively verified. However, the more negative evidence in existence, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not necessary.

The valuation allowance account should be evaluated periodically at each year-end to determine whether any adjustments are required. For example, the valuation allowance account would be eliminated in full if positive evidence now exists indicating that the deferred tax asset is no longer impaired. Any entry required to the valuation allowance account is coupled with a related adjustment to income tax expense. For example, if the valuation allowance account is increased, so is income tax expense. The entry is to debit income tax expense and credit valuation allowance.

EXAMPLE

XYZ Company has income before taxes of \$1,100,000. The only temporary difference is warranty expense, which is recorded at \$100,000 on the books based on sales but is recognized for tax purposes at \$30,000 (which is based on the amount paid). The tax rate is 34%. Therefore, the amount of the temporary difference is \$70,000 (\$100,000 - \$30,000). It is concluded that \$60,000 of this temporary difference has a greater than 50% probability of being realized, and \$10,000 of the temporary difference has a 50% or less probability of being realized. Relevant computations follow:

	<i>Book Income</i>	<i>Tax Income</i>
Income before taxes	\$1,100,000	\$1,100,000
Warranty expense	100,000	30,000
Income	<u>\$1,000,000</u>	<u>\$1,070,000</u>

The journal entry to record the temporary difference is:

Income tax expense ($.34 \times \$1,000,000$)	340,000	
Deferred tax asset ($.34 \times \$70,000$)	23,800	
Income tax payable ($.34 \times \$1,070,000$)		363,800

The entry to record the valuation allowance is:

Income tax expense ($.34 \times \$10,000$)	3,400	
Valuation allowance ($.34 \times \$10,000$)		3,400

The balance sheet presentation follows:

Gross deferred tax asset ($.34 \times \$70,000$)	\$23,800
Less: valuation allowance ($.34 \times \$10,000$)	3,400

Net deferred tax asset ($.34 \times \$60,000$)

\$20,400

The valuation allowance for a particular tax jurisdiction should be allocated proportionately (pro rata) between the current and noncurrent deferred tax assets for that jurisdiction.

EXAMPLE

Temporary differences at year-end related to accounts receivable and fixed assets were \$40,000 and \$10,000, respectively. The company determines that the valuation allowance should be \$8,000 at year-end. The tax rate is 30%. Therefore, the valuation allowance must be proportionately allocated between current and noncurrent deferred tax assets as follows:

		<i>Percent</i>	<i>Allocation</i>
Amount			
Current:			
Deferred tax asset (for accounts receivable):			
$\$40,000 \times .30$	\$12,000	80%	\$6,400
Noncurrent:			
Deferred tax asset (for fixed assets):			
$\$10,000 \times .30$	3,000	20%	1,600
	\$15,000	100%	\$8,000

At year-end, the amounts presented in the balance sheet follow:

Current:	
Deferred tax asset	\$12,000
Less: valuation allowance	6,400
Net deferred tax asset	\$5,600
Noncurrent:	
Deferred tax asset	\$3,000
Less: valuation allowance	1,600
Net deferred tax asset	\$1,400

A deferred tax asset may be recognized up to an existing deferred tax liability balance.

EXAMPLE

In 2X13, a company sold a fixed asset at a gain of \$40,000 for book purposes, which was deferred for tax purposes (installment method) until 2X14. Also in 2X13, \$25,000 of deferred revenue was received. The income was reflected on the current year's tax return but was deferred for book purposes until the next year. The deferred tax asset may be recognized because the deductible amount in the future (\$25,000) offsets the taxable amount (\$40,000). Using a 25% tax rate and income taxes payable of \$42,000, the entry in 2X13 is

Income tax expense (balancing figure)	45,750	
Deferred tax asset ($\$25,000 \times .25$)	6,250	
Deferred tax liability ($\$40,000 \times .25$)		10,000
Income tax payable		42,000

A deferred tax asset can also be recognized for the tax benefit of deductible amounts realizable by carrying back a loss from future years to lower taxes paid in the current year or in prior years.

A deferred tax asset is recognized for the excess of the tax basis over the amount for book purposes of an investment in a subsidiary or joint venture that is permanent in nature if it is expected that the temporary difference will reverse in the future years.

ASC 740-10-15-2A, *Income Taxes: Overall*, clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with ASC 740-10-05-1 through 05-10.

There is a two-step process involved in appraising a tax position. The first step is *recognition*. The company determines if it is more likely than not that a tax position will be sustained upon examination. Consideration is given to the merits of any litigation or appeal. The second step is *measurement*. A tax position that satisfies the more-likely-than-not recognition threshold is measured to calculate the amount of benefit to be recognized. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. **Note:** *Uncertain tax positions* are positions for which the tax authorities may disallow a deduction in whole or in part.

ASC 740-10-25-9, *Income Taxes: Overall, Definition of Settlement in FASB Interpretation No. 48*, provides guidance on how a company may determine when a previously unrecognized tax position may be recognized. Companies must assess if a tax position is *more likely than not* to be sustained on review and to recognize in its financial statements only the largest benefit amount from the tax position that is greater than 50% likely to be realized.

Previously, the company could also recognize a tax position when the tax matter was eventually settled through negotiation or litigation. Under ASC 740-10-25-9, the position may be recognized upon effective settlement, which takes into account:

1. The exam procedure has been completed by the taxing authority.
2. The company does not intend to appeal or litigate the tax position of the taxing authority.
3. It is remote that the taxing authority would examine or reexamine any aspect of the tax position.

The difference between the tax shown on the tax return compared to the tax reported on the financial statements will arise from one of the following:

1. An increase in the deferred tax liability or a reduction in the deferred tax asset.
2. An increase in income taxes payable or a reduction in the income tax refund receivable.
3. Both (1) and (2).

A liability for unrecognized tax benefits should be classified as current to the degree that the company expects making payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference. The liability for unrecognized tax benefits (or reduction in amounts refundable) shall *not* be combined with deferred tax liabilities or assets.

If the company's tax position is considered 50% or less probable of being realized, then interest must be accrued. Interest equals the tax rate multiplied by the difference between the tax position taken on the tax return and the tax position likely to be ultimately upheld by the taxing body. In addition, the company may take a position on the tax return that does not satisfy the minimum statutory threshold for avoiding the penalty. In this situation, the company records an expense for the penalty. A company has discretion as to the categorization of interest and penalties.

In the event that the more-likely-than-not recognition threshold is not satisfied in the period for which a tax position is taken, the company should recognize the benefit of the tax position in the first interim period that meets any of the following conditions:

1. The tax matter is ultimately resolved through litigation or negotiation.
2. The statute of limitations to examine the tax position has expired.
3. The more-likely-than-not recognition threshold is met by the reporting date.

Interest expense on an underpayment of income taxes should be recognized in the first period the interest would begin accruing.

A company must disclose the following:

1. Policy of classifying interest and penalties.
2. Tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of year. There should be disclosure of the amounts of decreases in the unrecognized tax benefits applicable to settlements with taxing authorities or a lapse in the statutory time period.
3. The total amount of unrecognized tax benefits impacting the effective tax rates.
4. The nature of any significant uncertainties affecting taxes, including a range in the dollar amount associated with an ultimate resolution.
5. Tax years being examined.

Exhibit 1 includes a portion of the financial statement note disclosure about uncertain tax positions made by International Game Technology in 2010.

EXHIBIT 1

International Game Technology 2010 Annual Report

17. Income Taxes (in part)

Unrecognized Tax Benefits

Under the accounting guidance for uncertain tax positions, we are required to recognize uncertain tax positions taken or expected to be taken, when they are “more likely than not” to be sustained upon examination. This assessment further presumes that tax authorities evaluate the technical merits of transactions individually with full knowledge of all facts and circumstances surrounding the issue. The adoption of this guidance, as of the beginning of fiscal 2008, increased our unrecognized tax benefits and related interest and penalties \$107.0 million, increased deferred tax assets \$55.4 million, increased other non-current assets \$17.1 million and decreased retained earnings \$34.5 million.

Aggregate changes in the balance of unrecognized tax benefits

<i>Years ended September 30, (In millions)</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>
Balance at beginning of year	\$ 91.5	\$ 106.2	\$ 109.3

Increases related to prior year tax positions	23.6	4.4	8.9
Decreases related to prior year tax positions	(1.6)	(27.6)	(0.1)
Increases related to current year tax positions	11.6	13.8	5.0
Decreases related to current year tax positions	(5.8)	(1.9)	(16.9)
Reductions for settlements with taxing authorities	(35.5)	(3.4)	-
Balance at year end	\$ 83.8	\$ 91.5	\$ 106.2

The amount of unrecognized tax benefits which would impact our effective tax rate totaled \$65.6 million at September 30, 2010 and \$70.2 million at September 30, 2009. During 2010, the IRS closed its examination of our tax returns for fiscal 2002 through 2005. In connection with the settlement of our fiscal 2002 through 2005 examinations, we paid the IRS approximately \$12.4 million, including interest of \$4.3 million. In general, we are no longer subject to any significant US federal, state, local or foreign income tax examination by tax authorities for years before fiscal 2004. Our unrecognized tax benefits decreased \$7.7 million during fiscal 2010, primarily due to the IRS settlement, partially offset by current year additions. We do not believe our total unrecognized tax benefits will change significantly during the next twelve months.

Interest and penalties related to unrecognized tax benefits are included in our income tax provision. During fiscal 2010, we recognized a \$15.1 million benefit primarily for the reversal of interest and penalties related to settlements with tax authorities, partially offset by current year additions. In fiscal 2009, we recognized \$2.9 million benefit for the reversal of interest and penalties related to settlements with tax authorities and an accounting method change. Accrued interest and penalties related to uncertain tax positions totaled \$22.7 million at September 30, 2010 and \$46.5 million at September 30, 2009.

IFRS Treatment

Under IFRS, a deferred tax asset is recognized for most deductible temporary differences and for the carryforward of unused tax losses and credits, but only to the extent it is probable that taxable profit will be available. Thus, no valuation allowance is recognized.

Under GAAP, the deferred tax asset is recognized in full. It is then reduced by a valuation account if it is more likely than not that all or a portion of the deferred tax asset will not be realized.

Permanent Differences

Permanent differences do not reverse in subsequent years and therefore do not require tax allocation. They affect either book income or taxable income, but not both. Examples of expenses that are not tax deductible are penalties and fines. Premiums paid on an officer's life insurance policy for which the company is the beneficiary are not tax deductible. Some organization and start-up costs are not deductible for tax purposes (e.g., costs associated with raising capital). The amount of wages used to derive the jobs credit is not tax deductible. An example of an expense that is only partly deductible on the tax return is 50% for meals and entertainment. An example of tax-exempt income is interest on municipal bonds. The proceeds of life insurance arising from an officer's death for which the company is the beneficiary are not subject to tax. An example of income that is fully or partly nontaxable is dividends received by a corporation.

Since permanent differences affect only the period in which they occur, they do not give rise to future taxable or deductible amounts. As a result, **companies recognize no deferred tax consequences**. Exhibit 2 shows examples of permanent differences.

EXHIBIT 2 EXAMPLES OF PERMANENT DIFFERENCES

A. Items are recognized for financial reporting purposes but not for tax purposes. Examples:

- Interest received on state and municipal obligations.
- Expenses incurred in obtaining tax-exempt income.
- Proceeds from life insurance carried by the company on key officers or employees.
- Premiums paid for life insurance carried by the company on key officers or employees (company is beneficiary).
- Fines and expenses resulting from a violation of law.

B. Items are recognized for tax purposes but not for financial reporting purposes. Examples:

- "Percentage depletion" of natural resources in excess of their cost.
- The deduction for dividends received from U.S. corporations, generally 70% or 80%.

EXAMPLE

Roberta Company began its operation in 2X12. In that year, it reported income before operations of \$425,000. In 2X12, Roberta Company's tax depreciation exceeded its book depreciation by \$55,000.

Roberta's tax rate for 2X12 was 35%. Recent legislation that was enacted boosted this rate to 40% for years after 2X12. *Roberta Company also had nondeductible book expenses of \$20,000 related to permanent differences.* According to ASC 740, *Income Taxes*, what amount of deferred income tax liability should be reported by Roberta in its December 31, 2X12 balance sheet?

ASC 740 requires that a deferred tax liability be measured by multiplying the amount of temporary tax difference by the tax rate that is scheduled to be in effect when the temporary difference reverses. In the problem at hand, tax depreciation exceeded book depreciation by \$55,000. That is, there are future taxable amounts of \$55,000, which will result in a deferred tax liability currently that will reverse in the future (after 2X12). Computing the amount of the deferred tax liability requires the following:

$$\$55,000 \times 40\% \text{ (the enacted tax rate after 2X12)} = \$22,000$$

Thus, the deferred tax liability is \$22,000. As was noted previously, permanent differences do not reverse in subsequent years and therefore do not require tax allocation. They affect either book income or taxable income, but not both. In this case, the \$20,000 represents a permanent difference and as such should be ignored in computing the deferred income tax liability.

Some permanent differences arise because of different bases used for financial and tax purposes. Examples are investments in a leveraged lease, the excess of the tax bases of assets in a buyer's tax jurisdiction over the financial bases of assets as presented in consolidated financial statements, and different bases for tax versus book arising from foreign currency remeasurements.

A permanent difference is the permanent excess of the amount for financial reporting over that for tax reporting of an investment in a foreign subsidiary or a foreign corporate joint venture.

Intraperiod Tax Allocation

Intraperiod tax allocation occurs when tax expense is presented in different parts of the financial statements for the current year. The income statement shows the tax impact of income from continuing operations, of income from discontinued operations, of extraordinary items, and of the cumulative effect of a change in accounting principle. In the retained earnings statement, prior-period adjustments are shown net of tax.

EXAMPLE

Intraperiod Tax Allocation

XYZ Corporation's financial information for year ended December 31, 2X12, is as follows:

Income from continuing operations	\$600,000
Loss from discontinued operations	(150,000)
Extraordinary gain	80,000
Correction of accounting error	(30,000)
Taxable income	<u>\$500,000</u>

There is \$150,000 in deductible temporary differences at year-end December 31, 2X11. No change occurs in year 2X12. \$10,000 of tax credit is available for year 2X12. The tax rate structure is as follows:

<i>Taxable Income</i>	<i>Rate</i>
1 to 100,000	20%
100,001 to 200,000	25%
200,001 to 300,000	40%
300,001 and above	50%

Future tax rates are expected to increase from 25% on December 31, 2X11, to 35% on December 31, 2X12.

Tax on income from continuing operations is \$225,000 (including a credit of \$10,000). Based on taxable income of \$500,000 and a credit of \$10,000, the tax due is \$175,000. The \$50,000 difference should be allocated between discontinued operations, extraordinary gain, and correction of error. Deferred taxes are adjusted by \$15,000 [$\$150,000 \times (35\% - 25\%)$] for the increase in estimate of expected tax rate.

The combined statement of income and retained earnings is as follows:

Income from continuing operations, before taxes	\$600,000
Tax on income from continuing operations	
Current	\$235,000
Deferred	(15,000)
Tax credits	<u>(10,000)</u>
	<u>210,000</u>
Income from continuing operations, net of taxes	\$390,000
Loss from discontinued operations, net of tax benefit of \$75,000	(75,000)
Extraordinary gain, net of tax of \$40,000	<u>40,000</u>
Net income	<u>\$355,000</u>

Retained earnings, January 1, 2X12	435,000
Correction of accounting error, net of tax of \$15,000	(15,000)
Retained earnings, December 31, 2X12	<u>\$775,000</u>

Balance Sheet Presentation

ASC 740-10-45-7, *Income Taxes: Overall*, deals with balance sheet classification of deferred income taxes. In the balance sheet, deferred tax assets are offset against deferred tax liabilities and shown as (1) net current or (2) net noncurrent. However, a current account cannot be offset against a noncurrent account. Further, (net) current or noncurrent accounts cannot be offset for different taxpaying components or for different tax jurisdictions (e.g., federal versus local) because offsetting is prohibited unless there is a legal right of set-off.

Deferred tax assets or deferred tax liabilities are classified based on the related asset or liability they apply to. For example, a deferred tax liability due to depreciation on a fixed asset would be presented as noncurrent. A deferred tax asset related to accounts receivable would be classified as current.

Deferred taxes not related to specific assets or liabilities are classified as current or noncurrent, depending on the anticipated reversal dates of the temporary differences. Temporary differences reversing within one year are current, but those reversing after one year are noncurrent. In some cases, a given temporary difference may be a mix of current and noncurrent, such as a three-year warranty in which the first year is shown as a current account while years 2 and 3 are presented as a noncurrent account. Other examples are deferred tax assets related to a loss carryforward, and deferred tax liabilities arising when a long-term contract is accounted for by the percentage-of-completion method for financial reporting and by the completed contract method for tax purposes. Under the latter circumstances, the temporary difference becomes taxable when the contract is completed.

If a valuation allowance account exists as a reduction of a gross deferred tax asset, there must be a proration of the valuation allowance between current and noncurrent relative to the classification of the gross deferred tax asset.

Income Statement Presentation

Income tax expense should be presented in the income statement as two components —namely, the tax currently payable (the liability) and the deferred portion (portion of the expense based on temporary

differences). The total income tax expense provision is based on financial reporting income excluding permanent differences. Presentation of these two expense portions would be as follows:

Income tax expense:

Amount currently payable	\$40,000	
Deferred portion	(32,000)	8,000

The amount currently payable is the current year's taxable income multiplied by the current year's tax rate. The deferred portion equals the temporary difference times the tax rate, or the change in the deferred tax balance during the year (ending balance less beginning balance).

As indicated previously, the deferred tax provision is added to the current tax provision to derive the total tax provision for the year. The current tax provision is the income taxes for the year as reported on the tax return.

Review Questions

1. ASC 740 establishes standards of financial accounting and reporting for income taxes that are currently payable and for
 - A. The tax consequences of revenues and expenses included in taxable income in a different year from the year in which they are recognized for financial reporting purposes.
 - B. The method of accounting for the U.S. federal investment tax credit.
 - C. The discounting of income taxes.
 - D. The accounting for income taxes in general in interim periods.

2. Under current generally accepted accounting principles, which approach is used to determine income tax expense?
 - A. Asset and liability approach.
 - B. "With and without" approach.
 - C. Net-of-tax approach.
 - D. Deferred approach.

3. The provisions of ASC 740, *Income Taxes: Overall*, are applicable to
 - A. All foreign, state, and local taxes.
 - B. Foreign, state, and local taxes based on income.
 - C. An enterprise's foreign operations accounted for by the cost method.
 - D. Financial statements of foreign enterprises

4. Rein, Inc. reported deferred tax assets and deferred tax liabilities at the end of both 2X11 and 2X12. For the year ended in 2X12, Rein should report deferred income tax expense or benefit equal to the

- A. Sum of the net changes in deferred tax assets and deferred tax liabilities.
- B. Decrease in the deferred tax assets.
- C. Increase in the deferred tax liabilities.
- D. Amount of the income tax liability plus the sum of the net changes in deferred tax assets and deferred tax liabilities.

5. With respect to deferred tax assets, future income can come from which of the following?

- A. Estimated future taxable income, including the reversal of temporary differences
- B. Switching from tax-exempt to taxable investments as part of a tax-planning strategy
- C. Reversal of existing taxable temporary differences assuming taxable income is greater than book income
- D. Current year tax losses

6. GAAP states that a deferred tax asset shall be reduced by a valuation allowance if it is

- A. Probable that some portion will not be realized.
- B. Reasonably possible that some portion will not be realized.
- C. More likely than not that some portion will not be realized.
- D. Likely that some portion will not be realized.

7. Intraperson income tax allocation arises because

- A. Items included in the determination of taxable income may be presented in different sections of the financial statements.
- B. Income taxes must be allocated between current and future periods.
- C. Certain revenues and expenses appear in the financial statements either before or after they are included in taxable income.
- D. Certain revenues and expenses appear in the financial statements but are excluded from taxable income.

8. In financial statements prepared on the income tax basis, how should the nondeductible portion of expenses such as meals and entertainment be reported?

- A. Included in the expense category in the determination of income.
- B. Included in a separate category in the determination of income.
- C. Excluded from the determination of income but included in the determination of retained earnings.
- D. Excluded from the financial statements.

Loss Carrybacks

Tax effects of net operating loss carrybacks are allocated to the loss period (the current year). A company may carry back a net operating loss two years and receive a tax refund for taxes paid in profitable years. The tax benefit is recognized as a receivable for the refundable amount. Further, the tax benefit reduces the current year's tax expense, but the amount is based on the tax rates in effect in the carryback period. The loss is first applied to the earliest year, with any remaining loss carried forward. (A company may elect to forgo the carryback.) Loss carryforwards are discussed in the next section.

The presentation of a loss carryback with recognition of the refund during the loss year follows:

Loss before refundable income taxes	\$120,000
Refund of prior years' income taxes arising from carryback of operating loss	40,000
Net loss	<u>\$ 80,000</u>

Note: The refund should be computed at the amount actually refundable regardless of current tax rates.

EXAMPLE

In 2X13, a net loss of \$100,000 occurred. Prior years' net incomes were \$250,000 in 2X11 and \$80,000 in 2X12. The tax rates over the years were 30% in 2X11, 31% in 2X12, and 32% in 2X13.

The 2X13 net loss may be carried back starting in 2X11. The loss carryback of \$100,000 can be used in 2X11 because the net profit that year was higher. The tax benefit of the carryback is calculated based on the 2X11 tax rate of 30%, since 2X11 was when the tax was paid. The amount of the tax benefit is \$30,000 ($\$100,000 \times 30\%$). The journal entry in 2X13 to recognize the loss carryback benefit is:

Receivable from the IRS	30,000	
Income tax expense		30,000

EXAMPLE

The same facts as in the previous example are again assumed, except that the net income in 2X11 was \$75,000. In that case, the tax benefit of the carryback loss is first applied to 2X11 with the balance (\$25,000) in 2X12. The relevant computations follow:

2X11 $\$75,000 \times 30\%$	\$22,500
2X12 $\$25,000 \times 31\%$	<u>7,750</u>

Total		<u>\$30,250</u>
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The journal entry in 2X13 to reflect the loss carryback benefit is:

Receivable from the IRS	30,250	
Income tax expense		30,250

Loss Carryforwards

A net operating loss may be carried forward up to 20 years. A loss carryforward may be recognized to the extent that there are net taxable amounts in the carryforward period (deferred tax liabilities) to absorb them. A loss carryforward benefit may also be recognized if there exists more than a 50% probability of future realization. In this case, a net deferred tax asset may be recorded for the tax benefit (the gross deferred tax asset amount becomes the net deferred tax asset balance because the valuation allowance is zero). In other words, the tax benefit of a loss carryforward is recognized as a deferred tax asset if the loss is to be carried forward to offset future amounts of taxable income. The tax benefit is measured at the tax rates scheduled to be in effect for the carryforward period. When the net deferred tax asset is recorded, income tax expense is reduced. In later years, as income is realized, the deferred tax asset is reduced. If there is a 50% or less probability of future realization, a net deferred tax asset is not recorded (the valuation allowance equals the gross deferred tax asset, resulting in a zero balance in the net deferred tax asset). In this case, the tax effect of the operating loss carryforward cannot be recognized until the year realized (the year in which the tax liability is reduced). In other words, the amount of the gross deferred tax asset is reduced by a valuation allowance if it is more likely than not that some or all of the benefit of the loss carryforward will not be realized (that is, sufficient taxable income will not be earned in the carryforward period). When the tax benefit of a loss carryforward is recognized upon being realized in a later year, it is classified in the same way as the income-enabling recognition (typically reducing tax expense).

Presentation of the loss carryforward with recognition of benefit in the year realized follows:

Income tax expense:		
Without carryforward	\$50,000	
Reduction of income taxes arising from carryforward of prior years' operating losses	<u>(30,000)</u>	\$20,000

Note: For purposes of intraperiod tax allocation, GAAP, with certain exceptions, requires that the tax benefit of an operating loss carryforward be reported in the same manner as the source of the income

offset by the carryforward in the *current year*. Similarly, the tax benefit of an operating loss carryback is reported in the same manner as the source of the current-year loss.

Special rules and exceptions exist. The tax benefit of operating losses arising in a business combination accounted for under the purchase method subsequent to the acquisition date should be applied first to reduce goodwill and other noncurrent intangible assets related to the purchase to zero. The tax benefits of carryforwards related to contributed capital and expenses for employee stock options should be allocated to the related equity components. The tax benefit of operating losses as of the date of a quasi-reorganization that are later recognized usually should be added to contributed capital.

There should be footnote disclosure of the amount and expiration dates of operating loss carryforwards.

Tax Rates

As stated in ASC 740:

ASC 740-10-35-4:

Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. A change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets.

ASC 740-10-45-15:

When deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.

Deferred taxes are recorded at the amounts of settlement when the temporary differences reverse.

EXAMPLE

Assume that in 2X12 a total temporary difference of \$300,000 will reverse in later years, resulting in the following taxable amounts and tax rate:

	2X13	2X14	2X15	Total
Reversals	\$110,000	\$140,000	\$50,000	\$300,000
× Tax rate	× .30	× .28	× .25	

Deferred tax liability	\$ 33,000	\$ 39,200	\$12,500	\$ 84,700
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On 12/31/2X12, the deferred tax liability has an \$84,700 balance.

According to federal tax law, there is a graduated tax rate structure (tax rates increase when taxable income reaches the next tax level). However, GAAP requires deferred federal taxes to be based on a flat tax rate (currently 35%) unless the effect of the graduated rate is significant or special rates apply to the temporary difference. Enterprises for which graduated tax rates are significant measure a deferred tax liability or asset using the *average graduated tax rate* applicable to the amount of estimated annual taxable income in the periods in which the enterprise estimates the deferred tax liability or asset will be settled or recovered. The average tax rate equals the tax divided by taxable income.

EXAMPLE

It is assumed that the first \$100,000 of income is taxed at 15%, the next \$100,000 is taxed at 25%, and income above \$200,000 is taxed at 35%. If taxable income in the next year is estimated at \$240,000, the expected average graduated tax rate is computed as follows:

Tax Computation

\$100,000 × .15	\$15,000
\$100,000 × .25	25,000
\$ 40,000 × .35	14,000
Total tax	\$54,000
Average tax rate = \$54,000/\$240,000 = 22.5%	

The use of a single average graduated tax rate based on average estimated annual taxable income during the reversal period will usually suffice.

EXAMPLE

A company has a taxable temporary difference of \$400,000. The difference is anticipated to reverse \$300,000 in year 1 and \$100,000 in year 2. The company also anticipates \$120,000 of taxable income from other sources per year. The relevant computations follow:

Year 1: expected taxable income (\$300,000 + \$120,000)	\$420,000
Year 2: expected taxable income (\$100,000 + \$120,000)	\$220,000
Average taxable income = (\$420,000 + \$220,000)/2 =	\$320,000

The company should use an average graduated tax rate based on the estimated annual taxable income of \$320,000. This is computed as follows:

\$100,000 × .15	\$15,000
\$100,000 × .25	25,000
\$120,000 × .35	<u>42,000</u>
Total Tax	<u>\$82,000</u>

Average tax rate = \$82,000/\$320,000 = 25.63%

A change in tax rate or other provisions of the tax law (e.g., tax deductibility of expenses) must immediately be reflected by adjusting tax expense and deferred taxes. If less taxes are owed, tax expense and deferred taxes will be decreased. If more taxes are owed, tax expense and deferred taxes will be increased.

EXAMPLE

On December 31, 2X12, a new tax law increases the tax rate from 28% to 33%. The effective date of the increase is January 1, 2X14. If the temporary difference is expected to reverse in 2X14, the company should calculate the deferred tax liability at December 31, 2X12, at the newly enacted tax rate of 33%.

EXAMPLE

At the end of 2X14, a new tax law reduces the tax rate from 36% to 30% starting in 2X16. In 2X14, the business had a deferred profit of \$400,000 and showed a deferred tax liability of \$144,000. The gross profit is to be reflected equally in 2X15, 2X16, 2X17, and 2X18. Thus, the deferred tax liability at year-end 2X14 of \$18,000 is derived as follows:

	2X15	2X16	2X17	2X18	Total
Reversals	\$100,000	\$100,000	\$100,000	\$100,000	\$400,000
× Tax rate	× .36	× .30	× .30	× .30	

Deferred tax liability	\$36,000	\$30,000	\$30,000	\$30,000	\$126,000
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The required journal entry in 2X14 is:

Deferred tax liability	18,000	
Income tax expense (\$144,000 - \$126,000)		18,000

A short-cut to obtain \$18,000 follows:

Income subject to change in tax rate	\$300,000
× Change in tax rate	.06
Adjustment	\$18,000

If a new tax law occurs after year-end but before the audit report date, the company should use the tax rate in effect at the year-end financial statement date but disclose in a footnote as a subsequent event the new rate.

EXAMPLE

After December 31, 2X12, but before the financial statements are issued, a new tax law reduces the tax rate from 32% to 31%. The decrease in rate is effective January 1, 2X15. The 32% tax rate should be used in computing the deferred tax liability at December 31, 2X12, because that is the rate expected to be in effect in 2X15 based on the tax law in effect on the balance sheet date. However, the effect of the rate change should be a subsequent event footnote disclosure in the December 31, 2X12 financial statements. Of course, on the December 31, 2X13 financial statements, the company should compute the deferred tax liability at the newly enacted tax rate of 31%.

Multiple Tax Jurisdictions

The determination of tax liability for federal reporting purposes may differ from that of state or city reporting requirements. As a consequence, temporary differences, permanent differences, and loss carrybacks or carryforwards may be different between federal and local reporting. If the temporary differences are significant, separate deferred tax calculations and recording will be required.

If temporary differences are treated the same for federal and local reporting purposes, a combined tax rate may be used in determining deferred taxes. The combined tax rate equals:

Federal tax rate \times (1 - state tax rate) + state tax rate

Tax Credits

According to ASC 740-10-25-39 and 25-40, *Income Taxes: Overall*, if a company pays a dividend, any tax credit associated with it acts to reduce income tax expense.

According to ASC 718-740-45-8, *Compensation—Stock Compensation: Income Taxes*, tax benefits of dividends on unvested restricted stock are to be recognized in equity as “excess tax benefits.” If the related awards are forfeited or are no longer expected to vest, the benefits from equity to the income statement should be reclassified.

Tax Status Changes

The effect of any change in tax status affecting a company requires an immediate adjustment to deferred tax liabilities (or assets) and to income tax expense. For example, if a company changes to S corporation status, a tax advantage generally arises, resulting in a reduction in both the deferred tax liability and income tax expense. Another example of a tax status change requiring an adjustment on the accounts is a company electing C corporation status. There should be a footnote explaining the nature of the status change and its effect on the accounts.

If an entity's tax status changes from nontaxable to taxable, a deferred tax asset or liability should be recorded for any temporary differences at the time the status changes. On the other hand, if the status change is from taxable to nontaxable, any deferred tax asset or liability should be eliminated.

Business Investments

If the market value method is used to account for an investment in the common stock of other companies, no temporary difference arises. However, if the equity method is used to account for an investment in another company, a temporary difference arises because the investor recognizes in its earnings the profit of the investee but recognizes for tax purposes the dividends received from the investee. As a result, the

investor's book income exceeds its tax income because profit is usually in excess of dividends. In consequence, a deferred tax liability will likely arise.

Business Combinations

As stated in ASC 805-740:

ASC 805-740-25-2:

An acquirer shall recognize a deferred tax asset or deferred tax liability arising from the assets acquired and liabilities assumed in a business combination and shall account for the potential tax effects of temporary differences, carryforwards, and any income tax uncertainties of an acquiree that exist at the acquisition date, or that arise as a result of the acquisition, in accordance with the guidance in Subtopic 740-10 together with the incremental guidance provided in this Subtopic.

ASC 805-740-25-3:

As of the acquisition date, a deferred tax liability or asset shall be recognized for an acquired entity's taxable or deductible temporary differences or operating loss or tax credit carryforwards except for differences relating to the portion of goodwill for which amortization is not deductible for tax purposes, leverage leases, and the specific acquired temporary differences identified in paragraph 740-10-25-3(a). Taxable or deductible temporary differences arise from differences between the tax bases and the recognized values of assets acquired and liabilities assumed in a business combination. Example 1 (see paragraph 805-740-55-2) illustrates this guidance. An acquirer shall assess the need for a valuation allowance as of the acquisition date for an acquired entity's deferred tax asset in accordance with Subtopic 740-10.

ASC 805-740-25-4:

Guidance on tax-related matters related to the portion of goodwill for which amortization is not deductible for tax purposes is in paragraphs 805-740-25-8 through 25-9; guidance on accounting for the acquisition of leveraged leases in a business combination is in paragraph 840-30-30-15; and guidance on the specific acquired temporary differences identified in paragraph 740-10-25-3(a) is referred to in that paragraph.

ASC 805-740-45-2:

The effect of a change in a valuation allowance for an acquired entity's deferred tax asset shall be recognized as follows:

- a. Changes within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be recognized through a corresponding

adjustment to goodwill. However, once goodwill is reduced to zero, an acquirer shall recognize any additional decrease in the valuation allowance as a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4. See paragraphs 805-10-25-13 through 25-19 and 805-10-30-2 through 30-3 for a discussion of the measurement period in the context of a business combination.

b. All other changes shall be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital as required by paragraphs 740-10-45-20 through 45-21).

ASC 805-740-10-45-4:

The effect of a change to an acquired tax position, or those that arise as a result of the acquisition, shall be recognized as follows:

a. Changes within the measurement period that result from new information about facts and circumstances that existed as of the acquisition date shall be recognized through a corresponding adjustment to goodwill. However, once goodwill is reduced to zero, the remaining portion of that adjustment shall be recognized as a gain on a bargain purchase in accordance with paragraphs 805-30-25-2 through 25-4.

b. All other changes in acquired income tax positions shall be accounted for in accordance with the accounting requirements for tax positions established in Subtopic 740-10.

In a business combination accounted for under the grandfathered purchase method or the acquisition method, the fair values assigned to the acquired company's net assets may differ from the valuation of those net assets on the tax return. This may result in a temporary difference arising in either a deferred tax liability or deferred tax asset reported on the acquirer's consolidated financial statements.

In some cases, companies may have unrecognized tax benefits associated with operating losses or tax credits arising from a business combination accounted for under the grandfathered purchase method or the acquisition method. This may give rise to other similar tax advantages subsequent to the date of combination. In the absence of a provision in the tax law to the contrary, the tax benefits realized should be apportioned for book reporting between pre-and post-acquisition tax benefits.

EXAMPLE

Tax Effects of Purchase Business Combination

XYZ Corporation's information about a nontaxable acquisition method business combination is as follows:

- The fair value of consideration transferred is \$800,000.
- The fair value of assets acquired is \$950,000 and XYZ's carryforward tax bases is \$700,000.
- The \$250,000 difference between the fair and tax carryforward bases of assets acquired consists of taxable temporary differences of \$350,000 and deductible temporary differences of \$100,000.
- The fair and carryforward tax bases of liabilities assumed is \$150,000.
- Assume deductible temporary differences will be realized.
- The tax rate is a flat 30%.

The allocation of the purchase price is as follows:

Purchase price		\$800,000
Allocation to Identifiable assets and (liabilities)		
Fair value of assets	\$950,000	
Fair value of liabilities		(150,000)
Deferred tax benefits	30,000	
Deferred tax obligations	(105,000)	
		<u>725,000</u>
Allocation to goodwill		<u>\$ 75,000</u>

EXAMPLE

On 1/1/2X12, XYZ Company bought ABC Company for \$4,000,000 in a business combination accounted for under the acquisition method. Goodwill was not involved. The tax basis of the net assets is \$12,000,000. Therefore, deductible temporary differences equal \$8,000,000. The tax rate is 40%. It has been determined that a valuation allowance for the entire amount of the deferred tax asset is required. However, at year-end 2X13, it is determined that the valuation allowance account is no longer needed. Income results for 2X12 and 2X13 are as follows:

	2X12	2X13
Before-tax for book income	\$3,000,000	\$1,800,000
Reversal of acquired deductible temporary differences	<u>(3,000,000)</u>	<u>(1,800,000)</u>
Taxable income	<u>0</u>	<u>0</u>

On the purchase date, the deferred tax asset is recorded at \$3,200,000 ($\$8,000,000 \times 40\%$), with a valuation allowance for \$3,200,000. On 12/31/2X12, the deferred tax asset is \$2,000,000 equal to 40% of \$5,000,000 ($\$8,000,000 - \$3,000,000$), with a valuation allowance for the same amount (\$2,000,000). On 12/31/2X13 the valuation allowance account, which is no longer required, is eliminated, resulting in a deferred tax benefit or in a reduction of deferred tax expense. **Caution:** If goodwill arose in the purchase business combination, the tax benefit would first reduce goodwill to zero, with any residual balance left reducing to zero any acquired intangible assets.

The journal entries applicable to deferred taxes follow:

1/1/2X12 (date of purchase combination)			
Net assets		4,000,000	
Deferred tax asset		3,200,000	
Cash			4,000,000
Valuation allowance			3,200,000
12/31/2X12			
Valuation allowance		1,200,000	
Deferred tax asset		1,200,000	
\$3,200,000 - \$2,000,000			
12/31/2X13			
Valuation allowance		2,000,000	
Deferred tax asset			720,000
Income tax benefit deferred			1,280,000

Separate Financial Statements of a Subsidiary

As stated in ASC 740:

ASC 740-10-30-27:

The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Subtopic does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria. In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intra-entity

transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

ASC 740-10-30-28:

Examples of methods that are not consistent with the broad principles established by this Subtopic include the following:

- a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences
- b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Subtopic (for example, the deferred method that was used before 1989)
- c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

ASC 740-10-50-17:

An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

- a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax related balances due to or from affiliates as of the date of each statement of financial position presented
- b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented.

If separate financial statements are prepared, the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return should be allocated to each of the subsidiaries. The allocation basis should be logical and in conformity with the liability method of tax allocation. Typically, the same method should be used to allocate tax expense to each member of the consolidated tax group. However, depending on the individual facts and circumstances, it may be acceptable to use more than one allocation method for different subsidiaries in a consolidated group.

Leases

Components of a leveraged lease have to be recomputed from the beginning of the rental when modifications occur in tax laws or other relevant financial variables (e.g., cash flows). The effects of a change must be accounted for and reflected in the income statement for the year of change. Lease calculations must incorporate the impact of the alternative minimum tax.

Convertible Debt

ASC 740-10-55-51, *Income Taxes: Overall*, deals with accounting for convertible debt issued with a non-detachable conversion feature that is “in-the-money,” and requires that this beneficial conversion feature be accounted for separately. The feature is recognized and measured separately by allocating to additional paid-in-capital a portion of the proceeds equal to its intrinsic value.

Quasi-Reorganization

A quasi reorganization is a voluntary accounting procedure by which a company with an accumulated retained earnings deficit adjusts its accounts to obtain a “fresh start.” The tax benefits associated with deductible temporary differences and carryforwards on the date of a quasi-reorganization should typically be recorded as an increase in paid-in-capital if the tax benefits will occur in later years.

Review Questions

9. On September 15, 2X12, the county in which Spirit Company operates enacted changes in the county's tax law. These changes are to become effective on January 1, 2X13. They will have a material effect on the deferred tax accounts that Spirit reported. In which of the following interim and annual financial statements issued by Spirit should the effect of the changes in tax law initially be reported?

- A. The interim financial statements for the 3-month period ending September 30, 2X12.
- B. The annual financial statements for the year ending December 31, 2X12.
- C. The interim financial statements for the 3-month period ending March 31, 2X13.
- D. The annual financial statements for the year ending December 31, 2X13.

10. Enterprises for which graduated tax rates are a significant factor measure a deferred tax liability or asset using the

- A. Alternative minimum tax rate.
- B. Average graduated tax rate.
- C. Marginal tax rate.
- D. Flat tax rate.

11. West Corp. leased a building and received the \$36,000 annual rental payment on June 15, Year 4. The beginning of the lease was July 1, Year 4. Rental income is taxable when received. West's tax rates are 30% for Year 4 and 40% thereafter. West had no other permanent or temporary differences. West determined that no valuation allowance was needed. What amount of deferred tax asset should West report in its December 31, Year 4, balance sheet?

- A. \$5,400
- B. \$7,200

- C. \$10,800
- D. \$14,400

12. Last year, before providing for taxes, Ajax Company had income from continuing operations of \$930,000 and an extraordinary gain of \$104,000. The current effective tax rate on continuing operations income was 40% and the total tax liability was \$398,000 ignoring any temporary differences. The amount of the extraordinary gain net of tax effect was

- A. \$41,600
- B. \$62,400
- C. \$78,000
- D. \$104,000

Disclosures

Disclosure is required of:

- Current tax expense or benefit.
- Deferred tax expense or benefit.
- Types of temporary differences and cumulative amounts.
- Reconciliation between tax expense per books and tax payable per the tax return.
- Reconciliation between the actual and expected tax rates.
- Components of the net deferred tax liability or asset.
- Valuation allowance provision and changes therein during the year. (The reasons for the changes should be specified.)
- Factors considered in determining the realizability of deferred tax assets.
- Adjustments to tax expense due to a change in tax law, tax rates, or tax status.
- Operating loss carryforwards and their tax benefits, including expiration dates.
- Amount of any unrecognized deferred tax liability because of undistributed foreign earnings.
- Amount of any unrecognized deferred tax liability for temporary differences applicable to undistributed domestic earnings.
- Tax expense arising from allocating tax benefits to contributed capital or to reduce the goodwill of an acquired company.
- Major aspects of the method used by which consolidated tax expense is allocated to subsidiaries.
- Method to account for the sale or purchase of tax benefits arising through tax leases.
- Government grants that reduce tax expense.
- Intercorporate tax sharing arrangements.
- Tax-related balances due to or from affiliates.

ASC 605-45-15-2, *Revenue Recognition: Principal Agent Considerations*, requires disclosure of a company's accounting policy with respect to the presentation of taxes collected on a revenue-producing transaction between a seller and a customer (e.g., sales, use, value-added, and some excise taxes, on either a gross [included in revenue and costs] or net [excluded from revenue] basis). Disclosure should be made of the taxes included in the financial statements.

Indefinite Reversal

Deferred taxes should not be recognized for the following types of temporary differences unless it is evident that they will reverse in the future years:

- Temporary differences applicable to an investment in a foreign subsidiary or foreign corporate joint venture that is permanent in nature.
- Undistributed earnings of a domestic subsidiary or domestic joint venture that is permanent in nature that arose in fiscal years beginning on or before December 15, 1992.

The kind of disclosure typically made for income taxes is illustrated by an excerpt from the notes to 2010 financial statements of Texas Instruments, presented in Exhibit 3.

EXHIBIT 3 Texas Instruments 2010 Annual Report

5. Income Taxes. (in part)

<i>Income before income taxes</i>	<i>U.S.</i>	<i>Non-U.S.</i>	<i>Total</i>
2010	\$ 3,769	\$ 782	\$ 4,551
2009	1,375	642	2,017
2008	1,749	732	2,481

<i>Provision (benefit) for income taxes</i>	<i>U.S. Federal</i>	<i>Non-U.S.</i>	<i>U.S. State</i>	<i>Total</i>
2010:				
Current	\$ 1,347	\$ 146	\$ 18	\$ 1,511
Deferred	(128)	(62)	2	(188)
Total	\$ 1,219	\$ 84	\$ 20	\$ 1,323
2009:				
Current	\$ 334	\$ 63	\$ 4	\$ 401
Deferred	117	30	(1)	146
Total	\$ 451	\$ 93	\$ 3	\$ 547
2008:				
Current	\$ 646	\$ 89	\$ 8	\$ 743
Deferred	(214)	43	(11)	(182)
Total	\$ 432	\$ 132	\$ (3)	\$ 561

Principal reconciling items from income tax computed at the statutory federal rate follow:

	2010	2009	2008
Computed tax at statutory rate	\$ 1,593	\$ 706	\$ 868
Effect of non-U.S. rates	(182)	(101)	(197)
Research and development tax credits	(54)	(28)	(75)
U.S. tax benefits for manufacturing	(63)	(21)	(18)
Other	29	(9)	(17)
Total provision for income taxes	\$ 1,323	\$ 547	\$ 561

The primary components of deferred income tax assets and liabilities were as follows:

	<i>December 31,</i>	
	2010	2009
Deferred income tax assets:		
Inventories and related reserves	\$ 525	\$ 347
Postretirement benefit costs recognized in AOCI	404	380
Stock-based compensation	357	339
Accrued expenses	251	219
Deferred loss and tax credit carryforwards	220	201
Intangibles	62	71
Investments	43	49
Other	103	98
	1,965	1,704
Less valuation allowance	(3)	(2)
	1,962	1,702
Deferred income tax liabilities:		
Accrued retirement costs (defined benefit and retiree health care)	(190)	(176)
Property, plant and equipment	(83)	(53)
Other	(78)	(68)
	(351)	(297)
Net deferred income tax asset	\$ 1,611	\$ 1,405

As of December 31, 2010 and 2009, net deferred income tax assets of \$1.61 billion and \$1.41 billion were presented in the balance sheets, based on tax jurisdiction, as deferred income tax assets of \$1.70 billion and \$1.47 billion and deferred income tax liabilities of \$86 million and \$67 million. The increase in net deferred income tax assets from December 31, 2009, to December 31, 2010, exceeds the \$188 million deferred tax provision due to the recording of deferred tax assets associated with postretirement benefit costs recognized in Accumulated other comprehensive income (AOCI). We make an ongoing assessment

regarding the realization of U.S. and non-U.S. deferred tax assets. While these assets are not assured of realization, our assessment is that a valuation allowance is not required for the remaining balance of the deferred tax assets. This assessment is based on our evaluation of relevant criteria including the existence of (a) deferred tax liabilities that can be used to absorb deferred tax assets, (b) taxable income in prior carryback years and (c) expectations for future taxable income.

We have U.S. and non-U.S. tax loss carryforwards of approximately \$257 million, of which \$134 million expire through the year 2024.

Provision has been made for deferred taxes on undistributed earnings of non-U.S. subsidiaries to the extent that dividend payments from these subsidiaries are expected to result in additional tax liability. The remaining undistributed earnings (approximately \$3.44 billion at December 31, 2010) have been indefinitely reinvested; therefore, no provision has been made for taxes due upon remittance of these earnings. It is not practicable to determine the amount of unrecognized deferred tax liability on these unremitted earnings.

Cash payments made for income taxes (net of refunds) were \$1.47 billion, \$331 million and \$772 million for the years ended December 31, 2010, 2009 and 2008.

Comprehensive Example

ABC Company uses the accelerated depreciation method for tax reporting and the straight-line depreciation method for financial reporting. At December 31, 2X12, there was a taxable temporary difference of \$250,000, which will reverse equally over 2X13 and 2X14. The current and expected future tax rate is 30%. Therefore, on December 31, 2X12 the company presented a noncurrent deferred tax liability of \$75,000 ($\$250,000 \times 30\%$) for this temporary difference.

During 2X13, ABC earned book income of \$600,000. The following five differences arose between financial and tax reporting:

1. Nondeductible officers' life insurance premiums recorded in 2X13 were \$30,000.
2. Gross profit on installment sales in 2X13 of \$150,000 will be taxed evenly in 2X14, 2X15, and 2X16.
3. Depreciation for books exceed that for tax by \$125,000 in 2X13. This represents the reversal of 50% of the \$250,000 temporary difference referred to previously as of December 31, 2X12.
4. An estimated loss provision was made in 2X13 for \$40,000. The loss is deductible in 2X15 for tax purposes because that is when it will be paid. Of course, as on December 31, 2X13, the accrued liability is a noncurrent liability.
5. A valuation allowance is not required at December 31, 2X13.

A schedule follows, presenting the taxable income and the current portion of income tax expense for 2X13:

Pretax financial statement income	\$ 600,000
Reversal of 2X12 depreciation temporary difference	125,000
Deferral of gross profit on installment sales	(150,000)
Contingent loss	40,000
Officers' life insurance premium	30,000
Taxable income	<u>\$ 645,000</u>

Current income tax expense and liability equals:

$$645,000 \times 30\% = 193,500$$

The deferred tax liability at December 31, 2X13, is \$70,500 calculated as follows:

Depreciation temporary difference (\$250,000 - \$125,000)	\$125,000
Deferred gross profit on installment sales	150,000
Contingent loss	(40,000)
Net temporary difference	<u>\$235,000</u>
Deferred tax liability \$235,000 × 30%	\$ 70,500

The deferred portion of tax expense as of December 31, 2X13, is \$4,500 calculated as follows:

Deferred tax liability—12/31/2X12	\$75,000
Deferred tax liability—12/31/2X13	70,500
Net change in deferred tax liability (expense credit)	<u>\$ 4,500</u>

Total income tax expense for the year ended December 31, 2X13, is \$189,000 computed as follows:

Current portion	\$193,500
Deferred portion (credit)	(4,500)
Total income tax expense	<u>\$189,000</u>

The composition of the deferred tax liability as of December 31, 2X13, follows:

Current portion (based on the installment sales temporary difference) \$150,000 × 30%	\$45,000
Noncurrent portion:	
Depreciation temporary difference \$125,000 × 30%	\$37,500
Less contingent loss temporary difference \$40,000 × 30%	12,000
Total deferred tax liability—12/31/2X13	<u>\$70,500</u>

On December 31, 2X13, the following journal entry is made:

Income tax expense	189,000	
Deferred tax liability (noncurrent)	49,500	
Income taxes payable		193,500
Deferred tax liability (current)*		45,000

* $\$150,000 \times 30\% = \$45,000$.

With respect to the journal entry, note the following:

- The \$49,500 charge to deferred tax liability (noncurrent) adjusts the December 31, 2X12 balance of \$75,000 to the required \$25,500 net noncurrent balance at December 31, 2X13. The two elements of this account are noncurrent because they apply to items classified as noncurrent in the balance sheet (the depreciation difference applying to fixed assets, and the loss contingency applying to a reversal in more than one year).
- The deferred tax liability (current) of \$45,000 applies to the installment sales temporary difference. A current classification is appropriate because installment receivables are typically considered current based on the operating cycle of the business.

Other Issues

Dividends on Restricted Stock and Options

Employees may receive dividends on their awards during a vesting period as part of stock-based compensation awards, or, in the case of options, during the period before they exercise the options (“dividend protection”). ASC 718 provides guidance on the accounting for these dividends and states that dividends paid on restricted stock and dividend-protected options that are expected to vest are factored into the fair value of the award. With a dividend-paying stock, the fair value already incorporates the expected payment of dividends. Therefore the entity would make no adjustment to the fair value of restricted shares for the expected payment of dividends during the vesting period. However, the fair value of an *option for stock* that pays dividends should be adjusted to appropriately reflect the dividend protection. ASC 718 states that the payment of dividends on restricted stock or options should be accounted for in retained earnings if the shares are expected to vest. When the related award is not expected to vest, the payment of the dividends or dividend equivalents are recognized as additional compensation cost.

From the IRS tax perspective, dividends paid to employees on restricted stock are not treated as dividends paid to a shareholder because the IRS does not recognize the employee as having received the restricted stock until the shares vest. As such, the tax code treats the payment of these dividends as compensation, and the entity is entitled to receive a deduction on the dividends paid. Likewise, dividends paid as part of a dividend-protection plan for option grants are treated as compensation for U.S. tax purposes.

Consequently, entities that pay dividends on options and restricted stock during the vesting period will receive a tax benefit from the deduction on those dividends. ASC 718-740-45-8 states that a realized tax benefit from dividends, or dividend equivalents, that is charged to retained earnings and paid to employees for equity-classified restricted stock, restricted stock units, and outstanding options should be recognized as an increase to additional paid-in capital. Following the guidance in ASC 718-740-25-10, the tax benefit would not be recognized in additional paid-in capital until the tax benefit actually reduces income taxes payable.

Employee Stock Ownership Plans (ESOPs)

Retained earnings are increased for the tax benefit arising from tax deductible dividends paid on unallocated shares held by an ESOP. However, dividends paid on allocated shares are includable in income tax expense.

Jobs Act

ASC 740-10-55, 27-30, *Income Taxes: Overall*, applies to the special tax deduction allowed under the Jobs Act for income from qualified domestic production activities. The impact of the deduction is to be reported in the year in which the deduction is claimed on the U.S. tax return. The Act states that the manufacturer's deduction should be accounted for as a special deduction as earned instead of as a tax rate change. The special deduction will not affect deferred tax assets and liabilities existing at the enactment date. This deduction equals 3% of qualified income for the years 2005 and 2006, then increases to a 6% deduction for years 2007 through 2009, and finally increases to a 9% deduction beginning in 2010. Under the Jobs Act, there is a special one-time dividends received deduction on certain foreign earnings repatriated to qualifying U.S. taxpayers during a one-year period. To qualify for this deduction the profit must be reinvested in the U.S. pursuant to a domestic reinvestment plan. A company taking advantage of the Jobs Act will reduce its federal income tax rate on dividends from non-U.S. subsidiaries.

Health Care Act

According to **Accounting Standards Update (ASU)** No. 2010-12 (ASC 740, *Income Taxes*), *Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts* and the *Patient Protection and Affordable Care Act*, the measurement of present and deferred tax obligations and assets are based on enacted tax law. The two health care acts should be considered together for financial reporting purposes. (ASC 740-10-S99-4)

Property Taxes

Accounting Requirements

Real and personal property taxes are based, by law, on the assessed valuation of property as of a particular date. Although the states differ as to when this date should be, generally taxes are recognized on the date on which they are assessed by the taxing authority. Although the exact amount owed may not be known on the assessment date, a reasonable estimate should be made by the taxpayer (on that date) so that the expected amount of taxes and related liability may be accrued and recognized. The entry should be accounted for as a debit to the deferred property taxes account and a credit to a property taxes payable account, a current liability. After this entry is made (on the assessment date), a portion of the property taxes should be recognized in income by amortizing the deferred property taxes account over the fiscal period of the taxing authority.

When the exact amount of property taxes is determined, an adjustment to the estimated tax liability of the prior year is made. Frequently, this adjustment is made to the current year's property tax provision (either increasing it or reducing it) in the current income statement (the year in which the exact amount of the tax liability is determined) or as a separate item there.

Property taxes assessed on property that will be sold to customers or under construction for an entity's own use are generally capitalized as part of the cost of these items.

Reporting Requirements

Because real and personal taxes are considered bona fide expenses of doing business, they should be disclosed and reported as:

- Expenses allocated to other related expense accounts, such as manufacturing, overhead, and, general and administrative expenses,
- Operating expenses, or
- Deductions from income.

Real and property taxes should not be combined with income taxes.

EXAMPLE

On October 1, 2X13, Levita Company is assessed property taxes of \$24,000 for the city's fiscal period from October 1, 2X13 through September 30, 2X13.

Levita Company's accounting and financial reporting year ends December 31, 2X13.

Levita Company should record its property taxes on October 1, 2X13, the assessment day, and make the following entry:

October 1, 2X13:	Deferred property taxes	24,000	
	Property taxes payable		4,000

Each month a portion of the deferred property taxes should be amortized, providing recognition for the appropriate amount of property tax expense. The entry that should be made follows:

Property tax expense	2,000 (1/12 × \$24,000)	
Deferred property taxes		2,000

IFRS Treatment

The classification of deferred taxes under IFRS is always noncurrent, while U.S. GAAP classifies deferred taxes based on the classification of the asset or liability to which it relates.

ASC, FASB, AND DIFFERENCE BETWEEN GAAP AND IFRS

Topic	FASB Accounting Standards Codification (ASC)	Original FASB Standard	Corresponding IASB Standard	Differences between U.S. GAAP and IFRS
<i>Use of current enacted tax rates</i>	ASC 740-10-10 par. 3	FAS No. 109 par. 18	IAS 12 par. 46	Under U.S. GAAP currently enacted tax rates for future years are used in valuing deferred tax assets and liabilities. Under IFRS, tax rates that have been "substantively enacted" are also used. Substantively enacted tax rates are future tax rates that have been announced by the government but that have not yet been formally enacted into law.
<i>Current/noncurrent classification of deferred tax assets and liabilities</i>	ASC 740-10-45 par. 4	FAS No. 109 par. 41	IAS 1 par. 56	Under U.S. GAAP deferred tax assets and liabilities are classified current or noncurrent based on the classification of the associated asset or liability. Under IFRS, all deferred tax items are classified as noncurrent.
<i>Recognition of deferred tax assets</i>	ASC 740-10-30 par. 5e	FAS No. 109 par. 17e	IAS 12 par. 24	Under U.S. GAAP deferred tax assets are recognized if it is "more likely than not" (50%+ probability) that the future tax benefits will be realized. Under IFRS, the probability threshold is "probable," which is generally seen to be higher than "more likely than not."
<i>Cash paid for income taxes</i>	ASC 230-10-50 Par. 2	FAS No. 95 Par. 121	IFRS 7 Par. 35	Both U.S. GAAP and IFRS require separate disclosure of the amount of cash paid for income taxes. Under IFRS, this amount may be allocated among operating, investing, and financing activities.

Glossary

Alternative minimum tax. An alternative tax system used to ensure that corporations do not avoid paying a fair share of income taxes through various tax avoidance approaches.

Asset-liability method. A method used to account for taxes that recognizes the amount of taxes payable or refundable for the current year and records deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the financial statements or tax returns.

Average tax rate. The amount of income taxes payable for the period divided by the taxable income.

Carrybacks. Deductions or credits that cannot be utilized on the tax return during a year and that may be carried back to reduce taxable income or taxes paid in a prior year.

Carryforwards. Deductions or credits that cannot be utilized on the tax return during a year and that may be carried forward to reduce taxable income or taxes payable in a future year.

Current tax expense (benefit). The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income of excess of deductions over revenues for that year.

Deductible temporary difference. Temporary differences that results in deductible amounts in future years when the related asset or liability is recovered or settled respectively.

Deferred tax asset. The deferred tax consequence attributable to deductible temporary differences and carryforwards.

Deferred tax consequence. The future effects of income taxes as measured by the enacted tax rate and provisions of the enacted tax law resulting from temporary differences and carryforwards at the end of the current year.

Deferred tax expense (benefit). The change during the year in an enterprise's deferred tax liabilities and assets.

Deferred tax liability. the deferred tax consequence attributable to taxable temporary differences.

Effective tax rate. Total income tax expense for the period divided by pretax financial income.

Income taxes. Domestic and foreign (national), state, and local (including franchise) taxes based on income.

Income taxes currently payable (refundable). Refer to current tax expense (benefit).

Income tax expense (benefit). The sum of current tax expense (benefit).

Interperiod tax allocation. The allocation of income tax between periods whereby there is a recognition of deferred income taxes.

Intraperiod tax allocation. The allocation of income tax expense (or benefit) to continuing operations, discontinued operations, extraordinary items, cumulative effect of accounting changes and prior period adjustments.

Net operation loss (NOL). When tax deductible expenses exceed taxable revenues for the tax year.

Originating temporary difference- The initial difference between the book basis and the tax basis of an asset or liability, regardless of whether the tax basis of the asset or liability exceeds or is exceeded by the book basis of the asset or liability.

Permanent differences. Differences between taxable income and pretax financial income that are caused by items that (1) enter into pretax financial income but never into taxable income or (2) enter into taxable income but never into pretax financial income.

Pretax financial income. Financial accounting term often referred to as income before income taxes, income for financial reporting purposes, or income for book purposes.

Reversing difference. A temporary difference that originated in prior periods is eliminated and the related tax effect is removed from the deferred tax account.

Taxable income. The excess of taxable revenues over tax deductible expense and exemptions for the year as defined by the governmental taxing authority.

Taxable temporary differences. Temporary differences that result in taxable amounts in future years when the related asset or liability is recovered or settled, respectively.

Tax-planning strategy. An action that meets certain criteria and that would be implemented to realize a tax benefit for an operation loss or tax credit carryforward before it expires.

Temporary difference. A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.

Valuation allowance. The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

Review Questions

13. Because Jab Co. uses different methods to depreciate equipment for financial statement and income tax purposes, Jab has temporary differences that will reverse during the next year and add to taxable income. Deferred income taxes that are based on these temporary differences should be classified in Jab's balance sheet as a

- A. Contra account to current assets.
- B. Contra account to noncurrent assets.
- C. Current liability.
- D. Noncurrent liability.

14. In its first 4 years of operations, Alder, Inc.'s depreciation for income tax purposes exceeded its depreciation for financial statement purposes. This temporary difference was expected to reverse over the next 3 years. Alder had no other temporary differences. Alder's balance sheet for its fourth year of operation should include

- A. A noncurrent contra asset for the effects of the difference between asset bases for financial statement and income tax purposes.
- B. Both current and noncurrent deferred tax assets.
- C. A current deferred tax liability only.
- D. A noncurrent deferred tax liability only.

15. In its Year 4 income statement, Cere Co. reported income before income taxes of \$300,000. Cere estimated that, because of permanent differences, taxable income for Year 4 would be \$280,000. During Year 4, Cere made estimated tax payments of \$50,000, which were debited to income tax expense. Cere is subject to a 30% tax rate. What amount should Cere report as income tax expense?

- A. \$34,000

- B. \$50,000
- C. \$84,000
- D. \$90,000

16. On its December 31, Year 2, balance sheet, Shin Co. had income taxes payable of \$13,000 and a current deferred tax asset of \$20,000 before determining the need for a valuation account. Shin had reported a current deferred tax asset of \$15,000 at December 31, Year 1. No estimated tax payments were made during Year 2. At December 31, Year 2, Shin determined that it was more likely than not that 10% of the deferred tax asset would not be realized. In its Year 2 income statement, what amount should Shin report as total income tax expense?

- A. \$8,000
- B. \$8,500
- C. \$10,000
- D. \$13,000

17. Under IFRSs, a deferred tax asset is

- A. Reduced by a valuation allowance if necessary.
- B. Measured by applying the enacted tax rate to the deferred tax consequences.
- C. Recognized to the extent that realization is probable.
- D. Recognized to reflect the deferred tax consequences of a taxable temporary difference.

18. According to U.S. GAAP, which of the following items should affect current income tax expense for Year 3?

- A. Interest on a Year 1 tax deficiency paid in Year 3.

- B. Penalty on a Year 1 tax deficiency paid in Year 3.
- C. Change in income tax rate for Year 3.
- D. Change in income tax rate for Year 4.

19. A company is required to record a valuation account against a deferred income tax asset if it is _____ that some portion or all of the deferred tax asset will not be realized.

- A. Probable
- B. Reasonably possible
- C. More likely than not
- D. Highly likely

20. Under existing GAAP, how should a deferred tax liability be classified on the balance sheet?

- A. Current and long-term based on the estimated reversal date
- B. Current and long-term based on the classification of the related asset or liability
- C. Long-term
- D. Current

More Annual Report References

ANNUAL REPORT REFERENCES

Ariba

2011 Annual Report

Note 8—Income Taxes

The provision for income taxes for the years ended September 30, 2011, 2010 and 2009 was comprised of the following (in thousands):

	<u>Current</u>	<u>Deferred</u>	<u>Total</u>
2011:			
Federal	\$—	\$ —	\$—
State	214	—	214
Foreign	1,357	(975)	382
Total	\$1,571	\$ (975)	\$596
2010:			
Federal	\$—	\$ —	\$—
State	118	—	118
Foreign	1,620	(470)	1,150
Total	\$1,738	\$ (470)	\$1,268
2009:			
Federal	\$—	\$ —	\$—
State	42	—	42
Foreign	1,076	(14)	1,062
Total	\$1,118	\$ (14)	\$1,104

The Company's (loss) income from continuing operations before income taxes for the years ended September 30, 2011, 2010 and 2009 consisted of the following components (in thousands):

	2011	2010	2009
Domestic	<u>\$(23,603)</u>	<u>\$11,577</u>	<u>\$566</u>
Foreign	21,216	2,916	2,194
(Loss) income from continuing operations before income taxes	\$(2,387)	\$14,493	\$2,760

The reconciliation between the amount computed by applying the United States federal statutory tax rate of 35% to the income from continuing operations before income taxes and actual income tax expense for the years ended September 30, 2011, 2010 and 2009 is as follows (in thousands):

	2011	2010	2009
Computed tax benefit	<u>\$(835)</u>	<u>\$5,073</u>	<u>\$966</u>
State taxes, net of federal benefit	(818)	864	427
Nondeductible expenses and other permanent differences	8,236	5,102	805
Foreign taxes	(7,043)	105	274
Provision to return adjustments	5,039	3,712	4,337
Other	999	494	161
Change in valuation allowance	(4,982)	(14,082)	(5,866)
Provision for income taxes	\$596	\$1,268	\$1,104

Included in tax expense from discontinued operations is a decrease in valuation allowance and corresponding utilization of net operating losses of \$15.0 million, \$1.0 million, and \$2.0 million for the years ended September 30, 2011, 2010, and 2009, respectively.

The tax effects of temporary differences that give rise to significant portions of net deferred tax assets as of September 30, 2011 and 2010 are as follows (in thousands):

	2011	2010
<i>Deferred Tax Assets</i>		
Accruals and allowances	\$68,750	\$65,906

Capitalized research and experimentation costs	64,880	81,868
Depreciation and amortization	73,305	85,193
Credit carryforwards	64,850	64,871
Net operating loss and other carryforwards	588,123	584,934
Deferred tax assets	859,908	882,772
Valuation allowance	(855,509)	(875,553)
Deferred tax assets, net of valuation allowance	4,399	7,219
<i>Deferred Tax Liabilities</i>		
Unremitted earnings of foreign subsidiaries	—	(832)
Acquired intangibles	(1,571)	(5,189)
Net deferred tax assets	2,828	1,198
<i>Recorded As:</i>		
Current deferred tax asset	\$31,879	\$39,298
Valuation allowance	(30,130)	(38,852)
Net current deferred tax asset	1,749	446
Non-current deferred tax asset	828,031	843,475
Valuation allowance	(825,381)	(836,702)
Net non-current deferred tax asset	2,650	6,773
Current deferred tax liability	—	(832)
Non-current deferred tax liability	(1,571)	(5,189)
Net deferred tax assets	\$2,828	\$1,198

The Company has provided a valuation allowance due to the uncertainty of generating future profits that would allow for the realization of such deferred tax assets. The net decrease in the total valuation allowance for the year ended September 30, 2011 was \$20.0 million. The net decrease in the total valuation allowance for the year ended September 30, 2010 was \$15.1 million. Utilization of the Company's net operating loss and tax credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations imposed by Internal Revenue Code Sections 382 and

383 and similar state provisions. Such an annual limitation could result in the expiration of the Company's federal and state net operating loss and tax credit carryforwards before utilization.

As of September 30, 2011, the Company had net operating loss carryforwards for federal, state and foreign tax purposes of approximately \$1.5 billion, \$784.0 million and \$2.0 million, respectively, before consideration of any annual limitation as described above. These federal, state and foreign net operating loss carryforwards expire in various years from fiscal year 2012 through fiscal year 2031, from fiscal year 2012 through fiscal year 2031 and from fiscal year 2012 through fiscal year 2014, respectively. As of September 30, 2011, the Company had research credit carryforwards for federal and state tax purposes of approximately \$39.0 million and \$25.0 million, respectively. If not utilized, the federal research credit carryforwards will expire in various years from fiscal year 2012 through fiscal year 2024. The state research credit carryforwards will continue indefinitely.

The Company also had manufacturer's credit carryforwards as of September 30, 2011 for state tax purposes of approximately \$119,000, which will expire in fiscal year 2012. The Company's net operating loss and tax credit carryforwards include net operating loss and research credit carryforwards of approximately \$270.0 million and \$4.8 million, respectively, generated by FreeMarkets, which are subject to annual limitations which could reduce or defer the utilization of those losses and credits.

The undistributed earnings of the foreign subsidiaries are approximately \$48.9 million as of September 30, 2011. The Company has decided to permanently reinvest those earnings and accordingly has not provided for any taxes thereon. Determination of the amount of unrecognized deferred U.S. income tax liability on these undistributed earnings is not practicable.

The aggregate changes in the balances of the Company's gross unrecognized tax benefits were as follows (in thousands):

	Year Ended September 30, 2011	Year Ended September 30, 2010
Gross unrecognized tax benefits as of October 1	\$ 4,698	\$ 4,718
Increases related to tax positions from prior fiscal years, including acquisitions	512	—
Decreases related to tax positions from prior fiscal years	—	—
Increases related to tax positions taken during the fiscal year	260	133
Lapses of statutes of limitations	(3,106)	(312)
Changes in unrecognized tax benefits due to foreign currency translation	(555)	159

Total gross unrecognized tax benefits as of
September 30

\$ 1,809

\$ 4,698

The Company does not expect any significant changes to the unrecognized tax benefits in the next twelve months.

As of September 30, 2011, approximately \$1.8 million of unrecognized benefits would affect the Company's effective tax rate if realized. The Company released interest and penalties related to lapses of statute of limitations of uncertain tax positions of \$1.0 million during fiscal year 2011. Interest and penalties were insignificant in fiscal years 2010 and 2009. The gross amount of interest and penalties accrued as of September 30, 2011 and 2010 was \$568,000 and \$1.7 million, respectively. Interest and penalties are recorded in the provision for income taxes in the statement of operations.

The Company has numerous tax audits in progress globally which could affect its unrecognized tax benefits. At this time, the Company cannot reasonably predict the outcomes of those audits or the impacts on its unrecognized tax benefits. The Company believes that it has adequately provided for any reasonably foreseeable outcomes related to the Company's tax audits. However, there can be no assurances as to the possible outcomes. The Company's United States federal income tax return is open to examination for the fiscal year ended September 30, 2008 and forward. Globally, the Company's income tax returns are open to examination among various jurisdictions ranging from fiscal year ended September 30, 2005 and forward.

International Game Technology

2010 Annual Report

17. Income Taxes

Income Tax Provision

Distribution of income before tax

<i>Years ended September 30, (In millions)</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>
U.S.	\$ 224.9	\$ 157.3	\$ 484.9
Non - U.S.	88.1	62.0	92.7

Total income from continuing operations before tax	\$ 313.0	\$ 219.3	\$ 577.6
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Reconciliation of statutory federal rate to effective rate for continuing operations

<i>Years ended September 30,</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>
Federal statutory tax	35.0%	35.0%	35.0%
State income tax, net	0.7%	1.4%	2.0%
Foreign subsidiaries tax, net	-0.4%	0.6%	-0.1%
Domestic production activities	-1.4%	-2.5%	-1.2%
Change in income tax contingencies	-10.4%	-3.5%	0.0%
Changes in valuation allowance	2.4%	0.9%	1.7%
Other, net	2.4%	-1.4%	4.7%
Effective rate	28.3%	30.5%	42.1%

Components of income tax provision

<i>Years ended September 30, (In millions)</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>
Federal	\$ 16.2	\$ 51.5	\$ 206.4
State	8.1	9.6	16.1
Foreign	22.4	23.2	33.7
Total current	46.7	84.3	256.2
<i>Years ended September 30, (In millions)</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>
Federal	41.2	(10.3)	(8.9)
State	(4.3)	(4.7)	1.2
Foreign	5.1	(2.5)	(5.2)
Total deferred	42.0	(17.5)	(12.9)
Total income tax provision from continuing operations	\$ 88.7	\$ 66.8	\$ 243.3

Income Taxes Receivable

Presented as a component of current other assets and deferred costs, income taxes receivable is comprised of prepaid US taxes on intercompany sales, as well as tax overpayments in various US and foreign jurisdictions. Income taxes receivable increased to \$104.6 million at September 30, 2010 from \$53.1 million at September 30, 2009, primarily due to a favorable US tax law change enacted near the end of fiscal 2010.

Deferred Income Taxes

Significant Components of Deferred Income Taxes

<i>September 30, (In millions)</i>	<i>2010</i>	<i>2009</i>
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Deferred Tax Assets

Reserves	\$ 90.7	\$ 70.5
Jackpot payment timing difference	128.8	142.3
Share-based compensation	27.6	22.9
Net operating loss carry forwards	33.5	32.5
State income taxes, net	18.8	14.9
Foreign	20.1	27.5
Property, plant and equipment	2.3	10.0
Goodwill and intangibles	31.3	34.7
Capital loss carryover	19.9	1.0
Other	14.6	29.5
Total deferred income tax assets	387.6	385.8
Valuation allowance	(62.6)	(37.1)
Total deferred income tax assets, net	325.0	348.7

Deferred Tax Liabilities

Interest expense on convertible debt	(35.6)	(22.4)
Foreign	(2.6)	(3.8)
Intangibles	(51.4)	(61.7)
Other	(14.3)	(5.8)
Total deferred income tax liabilities	(103.9)	(93.7)

Net deferred income tax assets	\$ 221.1	\$ 255.0
---------------------------------------	-----------------	-----------------

Net operating loss carry forwards at September 30, 2010 of \$13.9 million for the US and \$77.3 million for foreign countries expire in tax years 2012 through 2020. Capital loss carryover at September 30, 2010 of \$57.3 million expire in tax years 2012 through 2015.

Our valuation allowance is based on our assessment that it is more likely than not that certain deferred tax assets will not be realized in the foreseeable future. The valuation allowance increased by \$25.5 million in fiscal 2010, primarily due to foreign operating losses and capital losses not expected to be fully realized, of which \$7.5 million was reflected in continuing operations.

At September 30, 2010, we had not provided for US deferred income taxes or foreign withholding taxes on \$179.7 million in unrecognized temporary differences related to the basis of our investments in foreign subsidiaries expected to be permanently reinvested in operations outside the US. Determination of the amount of any unrecognized deferred income tax liability on these undistributed earnings is not practicable.

Unrecognized Tax Benefits

Under the accounting guidance for uncertain tax positions, we are required to recognize uncertain tax positions taken or expected to be taken, when they are “more likely than not” to be sustained upon

examination. This assessment further presumes that tax authorities evaluate the technical merits of transactions individually with full knowledge of all facts and circumstances surrounding the issue. The adoption of this guidance, as of the beginning of fiscal 2008, increased our unrecognized tax benefits and related interest and penalties \$107.0 million, increased deferred tax assets \$55.4 million, increased other non-current assets \$17.1 million and decreased retained earnings \$34.5 million.

Aggregate changes in the balance of unrecognized tax benefits

<i>Years ended September 30, (In millions)</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>
Balance at beginning of year	\$ 91.5	\$ 106.2	\$ 109.3
Increases related to prior year tax positions	23.6	4.4	8.9
Decreases related to prior year tax positions	(1.6)	(27.6)	(0.1)
Increases related to current year tax positions	11.6	13.8	5.0
Decreases related to current year tax positions	(5.8)	(1.9)	(16.9)
Reductions for settlements with taxing authorities	(35.5)	(3.4)	-
Balance at year end	\$ 83.8	\$ 91.5	\$ 106.2

The amount of unrecognized tax benefits which would impact our effective tax rate totaled \$65.6 million at September 30, 2010 and \$70.2 million at September 30, 2009. During 2010, the IRS closed its examination of our tax returns for fiscal 2002 through 2005. In connection with the settlement of our fiscal 2002 through 2005 examinations, we paid the IRS approximately \$12.4 million, including interest of \$4.3 million. In general, we are no longer subject to any significant US federal, state, local or foreign income tax examination by tax authorities for years before fiscal 2004. Our unrecognized tax benefits decreased \$7.7 million during fiscal 2010, primarily due to the IRS settlement, partially offset by current year additions. We do not believe our total unrecognized tax benefits will change significantly during the next twelve months.

Interest and penalties related to unrecognized tax benefits are included in our income tax provision. During fiscal 2010, we recognized a \$15.1 million benefit primarily for the reversal of interest and penalties related to settlements with tax authorities, partially offset by current year additions. In fiscal 2009, we recognized \$2.9 million benefit for the reversal of interest and penalties related to settlements with tax authorities and an accounting method change. Accrued interest and penalties related to uncertain tax positions totaled \$22.7 million at September 30, 2010 and \$46.5 million at September 30, 2009.

Jacobs Engineering Group

2010 Annual Report

9. Income Taxes

The following table presents the components of our consolidated income tax expense for each of the last three fiscal years (in thousands):

	2010	2009	2008
Current income tax expense:			
Federal	\$ 123,154	\$ 146,865	\$ 145,483
State	23,477	30,137	17,255
Foreign	22,909	42,597	71,625
Total current tax expense	169,540	219,599	234,363
Deferred income tax expense (benefit):			
Federal	(19,518)	(733)	(8,005)
State	(675)	397	1,695
Foreign	(3,700)	5,656	8,616
Total deferred tax expense (benefit)	(23,893)	5,320	2,306
Consolidated income tax expense	\$ 145,647	\$ 224,919	\$ 236,669

Deferred taxes reflect the tax effects of the differences between the amounts recorded as assets and liabilities for financial reporting purposes and the comparable amounts recorded for income tax purposes. Deferred tax assets and liabilities are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The following table presents the components of our net deferred tax assets at October 1, 2010 and October 2, 2009 (in thousands):

	2010	2009
Deferred tax assets:		
Obligations relating to:		
Defined benefit pension plans	\$ 108,826	\$ 83,734
Other employee benefit plans	137,810	129,279
Self-insurance programs	19,481	26,213
Contract revenues and costs	13,602	15,102
Foreign tax credits carryforward	14,305	-
Office closings / consolidations	-	1,076
Other	10,719	17,631
Gross deferred tax assets	304,743	273,035
Deferred tax liabilities:		
Depreciation and amortization	(81,693)	(91,501)
Residual U.S. tax on unremitted, non-U.S. earnings	-	(222)
Other, net	(792)	(1,954)
Gross deferred tax liabilities	(82,485)	(93,677)
Net deferred tax assets	\$ 222,258	\$ 179,358

The following table presents the income tax benefits realized from the exercise of nonqualified stock options, and disqualifying dispositions of stock sold under our employee stock purchase plans during each of the last three fiscal years (in millions):

	2010	2009	2008
Income tax benefits realized under stock plans	\$ 4.0	\$ 4.7	\$ 51.1

The reconciliation of total income tax expense using the statutory U.S. federal income tax rate to the consolidated income tax expense shown in the accompanying Consolidated Statements of Earnings for each of the last three fiscal years follows (dollars in thousands):

	2010	2009	2008
Statutory amount (computed using 35%)	\$ 137,177	\$ 218,446	\$ 230,289
State taxes, net of the federal benefit	14,821	19,848	12,317
Utilization of foreign tax credit carryover	-	(5,856)	(6,703)
Tax differential on foreign earnings	(7,178)	(9,838)	(5,565)
Other, net	827	2,319	6,331
Consolidated income tax expense	\$ 145,647	\$ 224,919	\$ 236,669
Rates used to compute statutory amount	35.0 %	35.0 %	35.0 %
Consolidated effective income tax rate	37.2 %	36.0 %	36.0 %

The following table presents income tax payments made during each of the last three fiscal years (in millions):

	2010	2009	2008
Income tax payments	\$ 170.8	\$ 255.5	\$ 177.7

The following table presents the components of our consolidated earnings before taxes for each of the last three fiscal years (in thousands):

	2010	2009	2008
United States earnings	\$ 295,144	\$ 449,065	\$ 394,191
Foreign earnings	96,790	175,067	263,777
	\$ 391,934	\$ 624,132	\$ 657,968

United States income taxes, net of applicable credits, have been provided on the undistributed earnings of the Company's foreign subsidiaries, except in those instances where the earnings are expected to be permanently reinvested. At October 1, 2010, approximately \$26.1 million of such undistributed earnings of certain foreign subsidiaries was expected to be permanently reinvested. Should these earnings be repatriated, approximately \$7.5 million of income taxes would be payable.

Sonic Foundry

2010 Annual Report

6. Income Taxes

The provision for income taxes consists of the following (in thousands):

	<i>Years Ended September 30,</i>	
	<i>2010</i>	<i>2009</i>
Federal income tax	\$ 240	\$ 142
Federal income tax refundable research credit	(15)	-
Deferred income tax expense (benefit)	1,373	(1,033)
Change in valuation allowance	(1,373)	1,033
Provision for income taxes	\$ 225	\$ 142

The reconciliation of income tax expense (benefit) computed at the U.S. federal statutory rate to income tax expense (benefit) is as follows (in thousands):

	<i>Years Ended September 30,</i>	
	<i>2010</i>	<i>2009</i>
Income tax expense (benefit) at U.S. statutory rate of 34%	\$ 35	\$ (851)
Federal income tax refundable research credit	(15)	-
State income tax expense (benefit)	5	(130)
Permanent differences, net	13	14
Adjustment of temporary differences to income tax returns	1,560	76
Change in valuation allowance	(1,373)	1,033
Income tax expense	\$ 225	\$ 142

The significant components of the deferred tax accounts recognized for financial reporting purposes are as follows (in thousands):

	<i>September 30,</i>	
	<i>2010</i>	<i>2009</i>
Deferred tax assets:		
Net operating loss and other carryforwards	\$ 34,663	\$ 34,566
Common stock warrants	398	1,997
Allowance for doubtful accounts	41	41
Other	117	74
Total deferred tax assets	35,219	36,678
Valuation allowance	(35,219)	(36,678)
Goodwill amortization	(1,490)	(1,250)
Deferred tax liability for goodwill amortization	\$ (1,490)	\$ (1,250)

At September 30, 2010, the Company had net operating loss carryforwards of approximately \$88 million for both U.S. Federal and state tax purposes. For Federal tax purposes, the carryforwards expire in varying amounts between 2018 and 2030. For State tax purposes, the carryforwards expire in varying

amounts between 2013 and 2025. Utilization of the Company's net operating loss may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization. In addition, the Company has research and development tax credit carryforwards of approximately \$530 thousand, which expire in varying amounts between 2017 and 2020. The Company's net deferred tax asset has been offset by a valuation allowance of the same amount. The valuation allowance has been recorded due to the uncertainty of realization of the deferred tax asset.

Beginning with an acquisition in fiscal year 2002, the Company has amortized Goodwill for tax purposes over a 15 year life. Goodwill is not amortized for book purposes. Annual impairment tests are performed for book purposes and the balance of goodwill is to be written down if impairment occurs. The impairment tests have not indicated any goodwill impairment.

In accordance with accounting guidance for uncertainty in income taxes, the Company has concluded that a reserve for income tax contingencies is not necessary. The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company had no accruals for interest and penalties on the Company's Consolidated balance sheets at September 30, 2010 and 2009, and has not recognized any interest or penalties in the Consolidated statement of operations for the years ended September 30, 2010 or 2009.

The Company is subject to taxation in the U.S. and various state jurisdictions. All of the Company's tax years are subject to examination by the U.S. and state tax authorities due to the carryforward of unutilized net operating losses.

J & J Snack Foods

2009 Annual Report

Note I—Income Taxes

Income tax expense (benefit) is as follows:

<i>(in thousands)</i>	<i>September 26, 2009</i>	<i>Fiscal year ended September 27, 2008</i>	<i>September 29, 2007</i>
Current			
U.S. Federal	\$18,574	\$11,417	\$15,485
Foreign	706	844	423

State	3,744	2,270	2,581
	23,024	14,531	18,489
Deferred			
U.S. Federal	3,106	2,983	474
Foreign	109	(168)	-
State	658	631	83
	3,873	3,446	557
	\$26,897	\$17,977	\$19,046

The provisions for income taxes differ from the amounts computed by applying the statutory federal income tax rate of approximately 35% to earnings before income taxes for the following reasons:

	<i>Fiscal year ended</i>		
	<i>September 26,</i>	<i>September 27, 2008</i>	<i>September 29, 2007</i>
<i>(in thousands)</i>	<i>2009</i>		
Income taxes at statutory rates	\$23,873	\$16,059	\$17,905
Increase (decrease) in taxes resulting from:			
State income taxes, net of federal income tax benefit	2,958	1,918	1,819
Other, net	66	-	(678)
	\$26,897	\$17,977	\$19,046

Deferred tax assets and liabilities consist of the following:

<i>(in thousands)</i>	<i>September 26, 2009</i>	<i>September 27, 2008</i>
Deferred tax assets		
Vacation accrual	\$ 1,233	\$ 1,117
Insurance accrual	2,943	2,634
Deferred income	67	105
Allowances	1,902	1,865
Inventory capitalization	499	519
Share-based compensation	1,113	896
Other, net	65	104
	7,822	7,240
Deferred tax liabilities		
Amortization of goodwill and other intangible assets	13,388	11,899
Depreciation of property and equipment	17,793	14,818
Other, net	15	24

	31,196	26,741
	\$23,374	\$19,501

Sherwin-Williams

2009 Annual Report

Note 15—Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes using the enacted tax rates and laws that are currently in effect. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2009, 2008 and 2007 were as follows:

	2009	2008	2007
Deferred tax assets:			
Exit costs, environmental and other similar items	\$ 82,378	\$ 76,237	\$ 77,725
Deferred employee benefit items	65,550	61,340	
Other items (each less than 5 percent of total assets)	111,094	106,341	122,938
Total deferred tax assets	\$259,022	\$243,918	\$200,663
Deferred tax liabilities:			
Depreciation and amortization	\$161,916	\$144,715	\$111,311
Deferred employee benefit items			16,227
Total deferred tax liabilities	\$161,916	\$144,715	\$127,538

Netted against the Company's other deferred tax assets were valuation reserves of \$15,735, \$6,611 and \$3,728 at December 31, 2009, 2008 and 2007, respectively, resulting from the uncertainty as to the realization of the tax benefits from certain foreign net operating losses and certain other foreign assets.

Significant components of the provisions for income taxes were as follows:

	2009	2008	2007
Current:			
Federal	\$151,492	\$144,789	\$208,508
Foreign	25,964	34,367	28,388
State and local	18,118	28,078	27,485
Total current	195,574	207,234	264,381
Deferred:			
Federal	(4,887)	25,668	24,770
Foreign	(1,592)	(666)	3,602
State and local	(2,126)	5,363	4,612

Total deferred		30,365	32,984
Total provisions for income taxes	\$186,969	\$237,599	\$297,365

The provisions for income taxes included estimated taxes payable on that portion of retained earnings of foreign subsidiaries expected to be received by the Company. The effect of the repatriation provisions of the American Jobs Creation Act of 2004 and the provisions of the Income Taxes Topic of the ASC was \$1,899 in 2009, \$(1,337) in 2008 and \$1,925 in 2007. A provision was not made with respect to \$14,971 of retained earnings at December 31, 2009 that have been invested by foreign subsidiaries. It was not practicable to estimate the amount of unrecognized deferred tax liability for undistributed foreign earnings.

Significant components of income before income taxes as used for income tax purposes, were as follows:

	2009	2008	2007
Domestic	\$591,558	\$602,934	\$802,211
Foreign	31,259	111,541	110,732
	\$622,817	\$714,475	\$912,943

A reconciliation of the statutory federal income tax rate to the effective tax rate follows:

	2009	2008	2007
Statutory federal income tax rate	35.0%	35.0%	35.0%
Effects of:			
State and local income taxes	1.7	3.0	2.3
Investment vehicles	(3.6)	(1.9)	(1.1)
ESOP dividends	(2.0)	(1.8)	(1.6)
Other—net	(1.1)	(1.0)	(2.0)
Effective tax rate	30.0%	33.3%	32.6%

The 2009 state and local income tax component of the effective tax rate decreased compared to 2008 primarily due to the impact of favorable audit settlements, favorable tax deductions available to the Company and the benefits of state tax credits. The increase in the tax deduction related to investment vehicles was the result of an increase in the impact of investments in tax favorable vehicles in 2009 compared to 2008.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for the 2006 and 2007 tax years in the fourth quarter of 2008. Fieldwork is anticipated to be completed prior to December 31, 2010. At this time, the Company has determined that \$3,135 of additional tax is due. The only open issue for the period 2004 to 2005 relates to

the Company's ESOP. As of December 31, 2009, the Company is subject to non-U.S. income tax examinations for the tax years of 2002 through 2009. In addition, the Company is subject to state and local income tax examinations for the tax years 1992 through 2009.

Effective January 1, 2007, the Company adopted FIN No. 48, "Accounting for Uncertainty in Income Taxes," which is now codified in the Income Taxes Topic of the ASC. As a result, the Company recognized a cumulative-effect adjustment of \$3.4 million, increasing its liability for unrecognized tax benefits, interest and penalties and reducing the January 1, 2007 balance of Retained Earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits in 2009, 2008 and 2007 is as follows:

	2009	2008	2007
Balance at beginning of year	\$38,051	\$39,378	\$37,807
Additions based on tax positions related to the current year	3,357	3,709	5,570
Additions for tax positions of prior years	9,170	4,212	4,070
Reductions for tax positions of prior years	(4,111)	(3,863)	(4,998)
Settlements	(7,937)	(3,212)	(1,915)
Lapses of Statutes of Limitations	(1,567)	(2,173)	(1,156)
Balance at end of year	\$36,963	\$38,051	\$39,378

Included in the balance of unrecognized tax benefits at December 31, 2009, 2008 and 2007 is \$32,543, \$32,420 and \$34,235 in unrecognized tax benefits, the recognition of which would have an effect on the effective tax rate. This amount differs from the gross unrecognized tax benefits presented in the table due to the decrease in U.S. federal income taxes which would occur upon recognition of the state tax benefits included therein.

Included in the balance of unrecognized tax benefits at December 31, 2009 is \$9,586 related to tax positions for which it is reasonably possible that the total amounts could significantly change during the next twelve months. This amount represents a decrease in unrecognized tax benefits comprised primarily of items related to a payment related to a federal audit of a partnership investment, assessed state income tax audits, the receipt of outstanding partnership investment filings and state settlement negotiations currently in progress and expiring statutes in foreign jurisdictions.

The Company classifies all income tax related interest and penalties as income tax expense. During the tax year ended December 31, 2009 and 2008 the Company recognized a release of \$3,157 and \$215, respectively, in income tax interest and penalties. During the tax year ended December 31, 2007, the Company recognized a net increase of \$1,095 in income tax interest and penalties. As of December 31, 2009, 2008 and 2007, the Company has accrued \$11,783, \$15,563 and \$15,812, respectively, for the potential payment of interest and penalties.

NCR

2008 Annual Report

Note 7. Income Taxes

For the years ended December 31, income from continuing operations before income taxes consisted of the following:

<i>In millions</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>
Income before income taxes			
United States	\$ 80	\$141	\$ 87
Foreign	209	91	72
Total income from continuing operations before income taxes	<u>\$289</u>	<u>\$232</u>	<u>\$159</u>

For the years ended December 31, income tax (benefit) expense consisted of the following:

<i>In millions</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>
Income tax (benefit) expense			
Current			
Federal	\$(15)	\$ 8	\$ (46)
State and local	(1)	2	6
Foreign	74	58	40
Deferred			
Federal	25	\$ 75	\$ 62
State and local	1	(4)	(6)
Foreign	(26)	(78)	(48)
Total income tax expense	<u>\$ 58</u>	<u>\$ 61</u>	<u>\$ 8</u>

The following table presents the principal components of the difference between the effective tax rate and the U.S. federal statutory income tax rate for the years ended December 31:

<i>In millions</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>
Income tax expense at the U.S. federal tax rate of 35%	\$101	\$ 81	\$ 56
Foreign income tax differential	(42)	(68)	(58)
U.S. permanent book to tax differences	1	(2)	1
Tax audit settlements	(19)	-	6
Change in liability for unrecognized tax benefits	18	35	-
Prior period corrections—Note 1	-	10	-
Other, net	(1)	5	3
Total income tax expense	<u>\$ 59</u>	<u>\$ 61</u>	<u>\$ 8</u>

NCR's tax provisions include a provision for income taxes in certain tax jurisdictions where its subsidiaries are profitable, but reflect only a portion of the tax benefits related to certain foreign subsidiaries' tax losses due to the uncertainty of the ultimate realization of future benefits from these losses. During 2008, we favorably settled examinations with the Internal Revenue Service (IRS) for the tax years of 2000 through 2006 that resulted in a \$19 million tax benefit. In addition, income tax expense was benefited in 2008 by \$26 million from the repatriation of earnings from international subsidiaries at an effective tax rate lower than previously estimated.

Deferred income tax assets and liabilities included in the Consolidated Balance Sheets as of December 31 were as follows:

<i>In millions</i>	<i>2008</i>	<i>2007</i>
Deferred income tax assets		
Employee pensions and other benefits	\$ 604	\$ -
Other balance sheet reserves and allowances	72	140
Tax loss and credit carryforwards	406	399
Capitalized research and development	50	71
Property, plant and equipment	21	79
Other	44	59
Total deferred income tax assets	<u>1,197</u>	<u>748</u>
Valuation allowance	<u>(478)</u>	<u>(441)</u>
Net deferred income tax assets	<u>719</u>	<u>307</u>
Deferred income tax liabilities		
Property, plant and equipment	10	13
Employee pensions and other benefits	-	20
Other	5	49
Total deferred income tax liabilities	<u>15</u>	<u>82</u>
Total net deferred income tax assets	<u>\$ 704</u>	<u>\$ 225</u>

Our total, net deferred income tax assets increased \$479 million to \$704 million as of December 31, 2008. This increase in net deferred income tax assets is primarily related to the tax effect of the adjustment to other comprehensive income as a result of the significant declines in the fair values of our pension plan assets due to market conditions.

NCR recorded valuation allowances related to certain deferred income tax assets due to the uncertainty of the ultimate realization of the future benefits from those assets. The valuation allowances cover deferred tax assets, primarily tax loss carryforwards, in tax jurisdictions where there is uncertainty as to the ultimate realization of a benefit from those tax losses. As of December 31, 2008, NCR had U.S. federal and foreign tax loss carryforwards of approximately \$1,049 million. The tax loss carryforwards, subject to expiration, expire in the years 2009 through 2027.

As described in Note 1, “Description of Business and Significant Accounting Policies”, the Company adopted FIN 48 as of January 1, 2007. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon settlement.

The aggregate changes in the balance of our gross unrecognized tax benefits were as follows for the years ended December 31:

<i>In millions</i>	<i>2008</i>	<i>2007</i>
Gross unrecognized tax benefits—January 1	\$ 319	\$ 296
Increase related to tax positions from prior years	76	31
Decreases related to tax positions from prior years	(54)	(17)
Increases related to tax positions taken during current year	56	42
Settlements with tax authorities	(106)	(25)
Lapses of statutes of limitation	(4)	(8)
Total gross unrecognized tax benefits—December 31	<u>\$ 287</u>	<u>\$ 319</u>

In 2008, the \$106 million decrease in gross unrecognized tax benefits due to settlements with tax authorities is primarily related to the settlement with the IRS for the tax years of 2000 through 2006. The total amount of gross unrecognized tax benefits as of December 31, 2008 was \$287 million, of which, up to \$79 million would affect NCR's effective tax rate if realized.

We recognized interest and penalties associated with uncertain tax positions as part of the provision for income taxes in our Consolidated Statements of Operations of \$4 million and \$19 million for the years ended December 31, 2008 and 2007, respectively. The gross amount of interest and penalties accrued as of December 31, 2008 and 2007 was \$57 million and \$53 million, respectively.

In the U.S., NCR files consolidated federal and state income tax returns where statutes of limitations generally range from three to five years. Although the Company resolved examinations for the tax years of 2000 through 2006 with the IRS in 2008, U.S. federal tax years are open from 2003 forward. NCR and its subsidiaries also file income tax returns in international jurisdictions where statutes of limitations generally range from three to five years. Years beginning after 1995 are still open to examination by certain foreign taxing authorities, including several major taxing jurisdictions. In Canada, we are open to examination from 1997 onward. In Japan, we are open to examination from 2001 onward. At this time, the Company does not expect any significant changes in unrecognized tax benefits in the next year.

NCR did not provide for U.S. federal income taxes or foreign withholding taxes in 2008 on approximately \$797 million of undistributed earnings of its foreign subsidiaries as such earnings are

intended to be reinvested indefinitely. Quantification of the deferred tax liability, if any, associated with these undistributed earnings is not practicable.

See the Consolidated Statements of Changes in Stockholders' Equity for details of the tax effects on the components of other comprehensive income and Note 9, "Employee Benefit Plans".

Sherwin-Williams

2008 Annual Report

Note 14. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes using the enacted tax rates and laws that are currently in effect. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2008, 2007 and 2006 were as follows:

	2008	2007	2006
Deferred tax assets:			
Exit costs, environmental and other similar items	\$ 76,237	\$ 77,725	\$ 56,914
Deferred employee benefit items	61,340		
Other items (each less than 5 percent of total assets)	106,341	122,938	161,447
Total deferred tax assets	<u>\$243,918</u>	<u>\$200,663</u>	<u>\$218,361</u>
Deferred tax liabilities:			
Depreciation and amortization	\$144,715	\$111,311	\$ 98,445
Deferred employee benefit items		16,227	171
Total deferred tax liabilities	<u>\$144,715</u>	<u>\$127,538</u>	<u>\$ 98,616</u>

Netted against the Company's other deferred tax assets were valuation reserves of \$6,611, \$3,728 and \$739 at December 31, 2008, 2007 and 2006, respectively, resulting from the uncertainty as to the realization of the tax benefits from certain foreign net operating losses and certain other foreign assets.

Significant components of the provisions for income taxes were as follows:

	2008	2007	2006
Current:			
Federal	\$142,985	\$213,767	\$208,835
Foreign	34,367	28,388	22,684
State and local	28,078	27,485	38,087
Total current	<u>205,430</u>	<u>269,640</u>	<u>269,606</u>
Deferred:			

Federal	27,472	19,511	(8,129)
Foreign	(666)	3,602	(2,705)
State and local	5,363	4,612	(518)
Total deferred	32,169	27,725	(11,352)
Total provisions for income taxes	\$237,599	\$297,365	\$258,254

The provisions for income taxes included estimated taxes payable on that portion of retained earnings of foreign subsidiaries expected to be received by the Company. The effect of the repatriation provisions of the American Jobs Creation Act of 2004 and the provisions of APBO No. 23, "Accounting for Income Taxes—Special Areas," was \$(1,337) in 2008, \$1,925 in 2007 and \$1,834 in 2006. A provision was not made with respect to \$14,845 of retained earnings at December 31, 2008 that have been invested by foreign subsidiaries. It was not practicable to estimate the amount of unrecognized deferred tax liability for undistributed foreign earnings.

Significant components of income before income taxes as used for income tax purposes, were as follows:

	2008	2007	2006
Domestic	\$602,934	\$802,211	\$736,875
Foreign	111,541	110,732	97,437
	<u>\$714,475</u>	<u>\$912,943</u>	<u>834,312</u>

A reconciliation of the statutory federal income tax rate to the effective tax rate follows:

	2008	2007	2006
Statutory federal income tax rate Effect of:	35.0%	35.0%	35.0%
State and local income taxes	3.0	2.3	2.9
Investment vehicles	(1.9)	(1.1)	(2.8)
ESOP dividends	(1.8)	(1.6)	(2.6)
Other—net	(1.0)	(2.0)	(1.5)
Effective tax rate	<u>33.3%</u>	<u>32.6%</u>	<u>31.0%</u>

The 2008 state and local income tax component of the effective tax rate increased compared to 2007 primarily due to the impact of prior audit settlements and the effects of current state law changes. The increase in the tax deduction related to investment vehicles was the result of an increase in the impact of investments in tax favorable vehicles in 2008 compared to 2007.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for the 2006 and 2007 tax years in the fourth quarter of 2008. Fieldwork is anticipated to be completed prior to December 31, 2009. At this time, the Company cannot

determine if an additional payment may be due. The IRS substantially completed the audit of the 2004 and 2005 tax years. The Company has paid \$1,298 to date related to the audit. The 2004 and 2005 audit remains open as it relates to the Company's ESOP. As of December 31, 2008, the Company is subject to non-U.S. income tax examinations for the tax years of 2001 through 2008. In addition, the Company is subject to state and local income tax examinations for the tax years 1992 through 2008.

Effective January 1, 2007, the Company adopted FIN No. 48, "Accounting for Uncertainty in Income Taxes." In accordance with FIN No. 48, the Company recognized a cumulative-effect adjustment of \$3.4 million, increasing its liability for unrecognized tax benefits, interest and penalties and reducing the January 1, 2007 balance of Retained Earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits in 2008 and 2007 is as follows:

	2008	2007
Balance at beginning of year	\$39,378	\$37,807
Additions based on tax positions related to the current year	3,709	5,570
Additions for tax positions of prior years	4,212	4,070
Reductions for tax positions of prior years	(3,863)	(4,998)
Settlements	(3,212)	(1,915)
Lapses of Statutes of Limitations	(2,173)	(1,156)
Balance at end of year	\$38,051	\$39,378

Included in the balance of unrecognized tax benefits at December 31, 2008 and 2007, is \$32,420 and \$34,235 in unrecognized tax benefits, the recognition of which would have an effect on the effective tax rate. This amount differs from the gross unrecognized tax benefits presented in the table due to the decrease in U.S. federal income taxes, which would occur upon recognition of the state tax benefits included therein. Included in the balance of unrecognized tax benefits at December 31, 2008 is \$7,486 related to tax positions for which it is reasonably possible that the total amounts could significantly change during the next twelve months. This amount represents a decrease in unrecognized tax benefits comprised primarily of items related to a payment related to a federal audit of a partnership investment, assessed state income tax audits, state settlement negotiations currently in progress and expiring statutes in foreign jurisdictions.

The Company classifies all income tax related interest and penalties as income tax expense. During the tax year ended December 31, 2008, the Company recognized a net release of \$215 in income tax interest and penalties and during the tax year ended December 31, 2007 the Company recognized a net increase of \$1,095 in income tax interest and penalties. As of December 31, 2008 and 2007, the Company has accrued \$15,563 and \$15,812 for the potential payment of interest and penalties.

Humana

2008 Annual Report

10. Income Taxes

The provision for income taxes consisted of the following for the years ended December 31, 2008, 2007 and 2006:

<i>(in thousands)</i>	2008	2007	2006
Current provision:			
Federal	\$336,870	\$452,286	\$192,878
States and Puerto Rico	30,829	36,066	11,722
Total current provision	<u>367,699</u>	<u>488,352</u>	<u>204,600</u>
Deferred benefit	(22,005)	(32,736)	70,062
Provision for income taxes	<u>\$345,694</u>	<u>\$455,616</u>	<u>\$274,662</u>

The provision for income taxes was different from the amount computed using the federal statutory rate for the years ended December 31, 2008, 2007 and 2006 due to the following:

<i>(in thousands)</i>	2008	2007	2006
Income tax provision at federal statutory rate	\$347,497	\$451,255	\$266,730
State, net of federal benefit and Puerto Rico	12,412	23,377	18,301
Tax exempt investment income	(21,253)	(20,254)	(15,713)
Contingent tax reserves (benefits)	-	-	1,570
Other, net	7,038	1,238	3,774
Provision for income taxes	<u>\$345,694</u>	<u>\$455,616</u>	<u>\$274,662</u>

Deferred income tax balances reflect the impact of temporary differences between the tax bases of assets or liabilities and their reported amounts in our consolidated financial statements, and are stated at enacted tax rates expected to be in effect when the reported amounts are actually recovered or settled. Principal components of our net deferred tax balances at December 31, 2008 and 2007 were as follows:

	<i>Assets (Liabilities)</i>	
<i>(in thousands)</i>	2008	2007
Compensation and other accrued expenses	\$ 117,037	\$ 98,852
Future policy benefits payable	121,259	65,919
Investment securities	113,854	7,739
Net operating loss carryforward	60,342	39,842
Unearned premiums	25,203	22,894
Professional liability risks	10,331	13,235
Capital loss carryforward	9,272	-
Benefits payable	1,543	-
Total deferred income tax assets	<u>458,841</u>	<u>248,481</u>

Valuation allowance	(28,063)	-
Total deferred income tax assets, net of valuation allowance	430,778	248,481
Depreciable property and intangible assets	(211,012)	(186,673)
Prepaid expenses and other	(68,612)	(75,029)
Investment securities	-	(6,894)
Benefits payable	-	(605)
Total deferred income tax liabilities	(279,624)	(269,201)
Total net deferred income tax assets (liabilities)	\$ 151,154	\$ (20,720)
Amounts recognized in the consolidated balance sheet:		
Other current assets	\$ 96,349	\$ 14,986
Other long-term assets	54,805	(35,706)
Total net deferred income tax assets	\$ 151,154	\$ (20,720)

At December 31, 2008, we had approximately \$164.7 million of net operating losses to carry forward related to prior acquisitions. These net operating loss carryforwards, if not used to offset future taxable income, will expire from 2009 through 2026. Due to limitations and uncertainty regarding our ability to use some of the carryforwards, a valuation allowance was established on \$76.6 million of net operating loss carryforwards ("SRLY NOLs") related to our 2007 acquisition of KMG. For the remainder of the net operating loss carryforwards, based on our historical record of producing taxable income and profitability, we have concluded that future operating income will be sufficient to give rise to tax expense to recover all deferred tax assets.

We file income tax returns in the United States and certain foreign jurisdictions. In 2007, the Internal Revenue Service (IRS) completed its examination of our U.S. income tax returns for 2003 and 2004 which did not result in any material adjustments. With few exceptions, which are immaterial in the aggregate, we are no longer subject to state, local and foreign tax examinations by tax authorities for years before 2005. The IRS commenced an examination of our U.S. income tax returns for 2005 and 2006 during 2007 that is anticipated to be completed in 2009. As of December 31, 2008, we are not aware of any material adjustments the IRS may propose.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. We recognize interest accrued related to unrecognized tax benefits and penalties in tax expense. The liability for unrecognized tax benefits was \$16.8 million and \$16.0 million at December 31, 2008 and 2007, respectively all of which would affect the effective tax rate if recognized. The only change to the liability during the twelve months ended December 31, 2008, was accrued interest. The Company believes it is reasonably possible that its liability for unrecognized tax benefits will decrease in the next twelve months by approximately \$16.8 million as a result of audit settlements.

Corning 2007 Annual Report

6. Income Taxes

Income (loss) from continuing operations before income taxes follows (in millions):

	<i>Years ended December 31,</i>		
	<i>2007</i>	<i>2006</i>	<i>2005</i>
U.S. companies	\$ 235	\$175	\$(213)
Non-U.S. companies	1,056	786	772
Income from continuing operations before income taxes	\$1,291	\$961	\$559

The current and deferred amounts of the provision (benefit) for income taxes follow (in millions):

	<i>Years ended December 31,</i>		
	<i>2007</i>	<i>2006</i>	<i>2005</i>
Current:			
Federal			\$(14)
State and municipal	\$ 2	\$ (8)	
Foreign	176	164	167
Deferred:			
Federal			443
State and municipal	(3)		
Foreign	(95)	(101)	(18)
Provision for income taxes	\$ 80	\$ 55	\$ 578

Amounts are reflected in the preceding tables based on the location of the taxing authorities.

Reconciliation of the U.S. statutory income tax rate to our effective tax rate for continuing operations follows:

	<i>Years ended December 31,</i>		
	<i>2007</i>	<i>2006</i>	<i>2005</i>
Statutory U.S. income tax (benefit) rate	35.0%	35.0%	35.0%
State income tax (benefit), net of federal benefit	0.5	(0.2)	(1.9)
Worthless stock deduction	(12.1)	(1.4)	(272.7) ⁽²⁾
Tax holidays ⁽⁶⁾	(1.7)	(10.1)	(8.9)
Investment & other tax credits ⁽⁷⁾	(3.1)	(3.6)	(12.7)
Rate difference on foreign earnings		6.1	10.2
Minimum pension obligation			(14.6) ⁽⁸⁾
Currency translation adjustment			(5.2)
Tax rate changes	13.2 ⁽⁹⁾		
Valuation allowances:			
Provision (release) of prior period valuation allowances	(12.4) ⁽⁵⁾	(8.6) ⁽⁵⁾	94.0 ⁽¹⁾

Tax (expenses) benefits not recorded on (income) losses	(13.5) ⁽⁴⁾	(13.4) ⁽⁴⁾	280.0 ⁽²⁾⁽³⁾
Other items, net	0.3	1.9	0.2
Effective income tax rate	6.2%	5.7%	103.4%

Significant items that cause our effective tax rate to vary from the U.S. statutory rate of 35% are as follows:

- ⁽¹⁾ In 2004, significant events occurred which required us to increase our valuation allowance against our U.S. deferred tax assets. At that time, we believed that it was more likely than not that we could realize the remaining net U.S. deferred tax assets of approximately \$525 million through a tax planning strategy involving the sale of our investment in Dow Corning, a non-strategic appreciated asset, if we were faced with expiring net operating loss carryforwards. During 2005, Dow Corning's performance was much stronger than expected and Dow Corning resumed paying a dividend; both of which are expected to continue in the future. Due to this improved performance, we concluded that Dow Corning provides strong financial, geographic and market balance to Corning's portfolio of businesses, the profitability of which has become more concentrated due to the success of the display operating segment. As a result, we considered Dow Corning to be a strategic investment and could no longer assert that a potential tax planning strategy involving the sale of Dow Corning would be prudent, as required by FAS 109. Therefore, we no longer believed, in the fourth quarter of 2005, that it was more likely than not that we would realize the remaining net deferred tax assets. Accordingly, we increased our valuation allowance by \$525 million to fully reserve our net U.S. deferred tax assets in the fourth quarter of 2005, which increased our effective tax rate by 94%.
- ⁽²⁾ During the third quarter of 2005, Corning filed its 2004 consolidated U.S. Federal income tax return, which included a \$3.9 billion worthless stock deduction for the loss on our investment in the photonic technologies business associated with the Pirelli acquisition. This acquisition was completed in December 2000 and was substantially impaired in the second quarter of 2001. Prior to the third quarter of 2005, we did not record a deferred tax asset for this item as the ultimate realization of such deduction was uncertain, and consistent with the requirements of SFAS 5, recognition of an asset prior to the time management determines the realization of the asset is probable is prohibited. On September 2, 2005, Corning and the Commissioner of the IRS entered into a closing agreement under section 7121 of the Internal Revenue Code of 1986 which provides that Corning is entitled to this worthless stock deduction. We recorded a \$1.5 billion deferred tax asset for this item in the third quarter, which was concurrently offset by a valuation allowance of an equal amount due to our inability to record tax benefits for U.S. net operating losses. The net result had no impact of our effective tax rate for 2005.
- ⁽³⁾ We were unable to record tax benefits on net operating losses generated in the U.S. and certain foreign jurisdictions, resulting in an increase in the effective tax rate of 7.3% for 2005.

- ⁽⁴⁾ In both 2007 and 2006, we generated income from continuing operations in the U.S. The tax expense on such income was fully offset by the tax benefit of releasing a portion of the valuation allowance to reflect the realization of deferred taxes resulting from the generation of U.S. income. The impact of the release of valuation allowance and, thus, not recording tax expense on income generated in the U.S. is a reduction in the rate of 14.2% for both 2007 and 2006, respectively.
- ⁽⁵⁾ In 2004, we recorded valuation allowances against our entire German and Australian deferred tax assets due to losses in recent years. In 2007, due to sustained profitability and positive earnings projections for our overall German operations, we have concluded that it is more likely than not that the German national deferred tax assets are realizable and that the related valuation allowance is no longer required. In 2006, due to sustained profitability and positive earnings projections in Australia and at certain of our German operations, we concluded that it was more likely than not that a portion of the German local and the entire Australian deferred tax assets were realizable and that the related valuation allowances were no longer required. The impact of the release of the valuation allowances on our effective rate is a reduction in the rate of 12.4% and 8.7% for 2007 and 2006, respectively.
- ⁽⁶⁾ Certain foreign subsidiaries in China, South Africa and Taiwan are operating under tax holiday arrangements. The nature and extent of such arrangements vary, and the benefits of existing arrangements phase out in future years (through 2011) according to the specific terms and schedules of the relevant taxing jurisdictions. The impact of the tax holidays on our effective rate is a reduction in the rate of 12.1%, 10.1% and 8.9% for 2007, 2006 and 2005, respectively.
- ⁽⁷⁾ Taiwan grants investment tax credits for investments in qualifying machinery and equipment. The impact of such credits on our effective tax rate is a reduction in the rate of 0.4%, 3.1%, and 12.3%, for 2007, 2006, and 2005, respectively.
- ⁽⁸⁾ The elimination of our minimum pension liability for the domestic qualified plan in 2005 resulted in a decrease in the effective tax rate of 14.6%.
- ⁽⁹⁾ In 2007, U.S. and German deferred taxes were revised for enacted law changes. The impact on the effective rate is an increase of 13.2%.

The tax effects of temporary differences and carryforwards that gave rise to significant portions of the deferred tax assets and liabilities follows (in millions):

	<i>December 31,</i>	
	<i>2007</i>	<i>2006</i>
Loss and tax credit carryforwards	\$ 2,145	\$ 2,399
Capitalized research and development	106	142
Restructuring reserves	194	215
Postretirement medical and life benefits	303	309

Inventory	39	63
Intangible and other assets	64	64
Other accrued liabilities	398	339
Other employee benefits	117	182
Other		17
Gross deferred tax assets	3,366	3,730
Valuation allowance	(3,091)	(3,542)
Total deferred tax assets	275	188
Fixed assets	(40)	(50)
Total deferred tax liabilities	(40)	(50)
Net deferred tax assets	\$ 235	\$ 138

The net deferred tax assets are included in (in millions):

	<i>December 31,</i>	
	<i>2007</i>	<i>2006</i>
Current assets	\$ 54	\$ 47
Other assets	202	114
Other current liabilities	(1)	
Other noncurrent liabilities	(21)	(22)
Net deferred tax assets	\$235	\$138

Details on deferred tax assets for loss and tax credit carryforwards at December 31, 2007 follow (in millions):

	<i>Amount</i>	<i>Expiration</i>			
		<i>2008-2012</i>	<i>2013-2017</i>	<i>2018-2026</i>	<i>Indefinite</i>
Net operating losses	\$1,829	\$ 42	\$ 40	\$1,539	\$208
Capital losses	55	55			
Contributions	8	8			
Tax credits	253	82	77	52	42
Total as of December 31, 2007	\$2,145	\$187	\$117	\$1,591	\$250

FAS 123 (R) prohibits the recognition of windfall tax benefits from stock-based compensation deducted on the tax return until realized through a reduction of income tax payable. Cumulative tax benefits totaling \$202 million will be recorded in additional paid-in-capital when the net operating loss carryforward is utilized and the windfall tax benefit can be realized.

SFAS No. 109 provides that deferred tax assets are to be reduced by a valuation allowance if, based on the weight of available positive and negative evidence, it is more likely than not (a likelihood of greater than 50 percent) that some portion or all of the deferred tax assets will not be realized. SFAS No. 109 further requires that in assessing the realizability of deferred tax assets, objective evidence (e.g., actual, historical information) should be given greater weight than subjective evidence (e.g., the outlook for future profitability). The valuation allowance should be sufficient to reduce the deferred tax assets to the amount that is more likely than not to be realized.

In both 2006 and 2007, we generated income from continuing operations in the U.S. The tax expense on such income was fully offset by the tax benefit of releasing a portion of the valuation allowance to reflect the realization of deferred taxes resulting from the generation of U.S. income. The impact of the release of the valuation allowances, and thus not recording tax expense on income generated in the U.S., is a reduction in our effective tax rate of 14.2% for both 2007 and 2006.

We continue to provide a full valuation allowance against all of our U.S. deferred tax assets as of December 31, 2007 because we do not believe it is more likely than not that we will be able to generate in the future sufficient levels of profitability in the U.S. to realize some or all of the deferred tax assets. U.S. profits of approximately \$8.3 billion dollars would be required to fully realize the deferred tax assets as of December 31, 2007. Of that amount, \$4.2 billion of U.S. profits would be required over the next 19 years to fully realize the deferred tax assets associated with federal net operating loss carry forwards. Our evaluation of the realizability of our deferred tax assets is inherently subjective and is based on our analysis and weighting of all positive and negative evidence available to us. This evaluation includes estimates and assumptions about a number of market, execution and economic variables. Our judgment as of December 31, 2007 has been formed based on these variables which include:

- We had a taxable loss in the U.S. in 2005 and, absent nonrecurring items, we would have also had a taxable loss in the U.S. in 2006. 2007 is the only year in the last three years in which we have generated income in the U.S. when considering only recurring items.
- Although our consolidated net income has reached record levels, we have continued to incur losses or have generated only marginal profitability in the U.S. because (a) Display Technologies, the key driver of our consolidated profitability, is largely a foreign-based business with only net royalty income occurring in the U.S.; (b) our Environmental and Life Sciences segments have lost money or have been only marginally profitable due to very significant U.S.-based factory start-up costs and developmental spending; and (c) improvement in our Telecommunications segment has been more than offset by higher U.S.-based research, development, and engineering, stock and incentive compensation and other administrative expenses.

- A significant factor in our forecasts of future U.S. taxable profitability is the amount of assumed royalties to be paid by our Display Technologies businesses to the U.S. The amount of such royalties could decline if our sales of LCD glass are impacted by:
 - Manufacturing capacity constraints;
 - Reduced demand due to the slowing of corporate information technology and consumer spending or (b) challenges to pricing, both of which may arise from global economic pressures; or
 - Shifts in the global market share of our customers which manufacture flat panel TV and computer monitors.

Additionally, a change in our judgment regarding the sustainability of the level of these royalties in accordance with the principles of FIN 48, "Accounting for Uncertainty in Income Taxes" may also impact our forecasts of U.S. profitability.

Although we remain optimistic about our consolidated outlook for 2008 and beyond, as of December 31, 2007, we are sufficiently uncertain about our U.S.-based results, primarily due to the current economic uncertainty, but also due to a number of market and execution risks in our operating segments, particularly those pertaining to Display Technologies, as noted above that we have concluded that the positive evidence supporting realization of our U.S. deferred tax assets does not sufficiently outweigh the negative evidence that we will not realize our U.S. deferred tax assets.

We will update our assessment of the realizability of our U.S. deferred tax assets on a quarterly basis in 2008, taking into account year-to-date actual as well as forecasted U.S. results. If, after considering the actual results and the potential impact of the economic uncertainties and business risks considered in our 2007 year-end assessment as well as our FIN 48 assessment of the Display Technologies U.S. royalties we conclude that it is more likely than not that we will be profitable in the U.S. in 2008 and future years, we will quantify the portion of our U.S. deferred tax assets we believe to be realizable and reduce our valuation allowance accordingly. Until that time, we will continue to adjust the valuation allowance to offset the current U.S. income tax expense (or benefit) that would otherwise be recorded on income (or losses) in the U.S. and, therefore, reflect no net U.S. income tax expense.

We do not provide income taxes on the post-1992 earnings of domestic subsidiaries that we expect to recover tax-free without significant cost. Income taxes have been provided for post-1992 unremitted earnings of domestic corporate joint ventures that we do not expect to recover tax-free. Unremitted earnings of domestic subsidiaries and corporate joint ventures that arose in fiscal years beginning on or before December 31, 1992 have been indefinitely reinvested. We currently provide income taxes on the earnings of foreign subsidiaries and affiliated companies to the extent these earnings are currently taxable or expected to be remitted. As of December 31, 2007, taxes have not been provided on approximately \$4.0 billion of accumulated foreign unremitted earnings which are expected to remain invested indefinitely.

We adopted the provisions of FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes," (FIN 48) effective January 1, 2007. As a result of the implementation of FIN 48, we recognized a \$25 million increase in the liability for unrecognized tax benefits and a decrease to the January 1, 2007, balance of retained earnings of \$4 million. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in millions):

Balance at January 1, 2007	\$ 56
Additions based on tax positions related to the current year	2
Additions for tax positions of prior years	13
Reductions for tax positions of prior years	(23)
Settlements and lapse of statute of limitations	(8)
Balance at December 31, 2007	\$ 40

Included in the balance at December 31, 2007 is \$25 million of unrecognized tax benefits which would impact our effective tax rate if recognized.

We recognize accrued interest and penalties associated with uncertain tax positions as part of tax expense. During the years ended December 31, 2007, 2006, and 2005, we recognized approximately \$1 million of interest expense, \$0.5 million and \$2.6 million in interest income, respectively. We had approximately \$7.1 million and \$4.1 million accrued at December 31 2007 and 2006, respectively, for the payment of interest and penalties.

Corning Incorporated, as the common parent company, and all 80%-or-more-owned U.S. subsidiaries join in the filing of consolidated U.S. federal income tax returns. All such returns for periods ended through December 31, 2004, have been audited by and settled with the Internal Revenue Service (IRS). We expect the IRS to begin the examination of our consolidated U.S. federal income tax returns for the years ended December 31, 2005 and December 31, 2006 in the first quarter of 2008.

Corning Incorporated and U.S. subsidiaries file income tax returns on a combined, unitary or stand-alone basis in multiple state and local jurisdictions, which generally have statutes of limitations ranging from 3 to 5 years. Various state income tax returns are currently in the process of examination or administrative appeal.

Our foreign subsidiaries file income tax returns in the countries in which they have operations. Generally, these countries have statutes of limitations ranging from 3 to 7 years. Years still open to examination by foreign tax authorities in major jurisdictions include Japan (2000 onward) and Taiwan (2004 onward).

While we expect the amount of unrecognized tax benefits to change in the next 12 months, we do not expect the change to have a significant impact on the results of operations or our financial position.

15. Income Tax Expense

Schlumberger and its subsidiaries operate in more than 100 taxing jurisdictions where statutory tax rates generally vary from 0% to 50%.

As more fully described in Note 3 *Charges and Credits*, Schlumberger recorded a pretax credit outside the United States in 2007 of \$25 million, pretax charges in 2006 of \$46 million (\$19 million in the United States; \$27 million outside the United States) and net pretax credits in 2005 of \$172 million (\$19 million of net credits in the United States; \$153 million of credits outside the United States).

Pretax book income subject to United States and non-United States income taxes for each of the three years ended December 31, was as follows:

<i>(Stated in millions)</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
United States	\$1,754	\$1,582	\$ 892
Outside United States	4,870	3,366	2,080
Pretax income	\$6,624	\$4,948	\$2,972

The components of net deferred tax assets were as follows:

<i>(Stated in millions)</i>	<i>2007</i>	<i>2006</i>
Postretirement and other long-term benefits	\$244	\$394
Current employee benefits	29	31
Fixed assets, inventory and other	124	151
	\$397	\$576

The above deferred tax assets at December 31, 2007 and 2006 are net of valuation allowances relating to net operating losses in certain countries of \$214 million and \$218 million, respectively. The deferred tax assets are also net of valuation allowances relating to a capital loss carryforward of \$144 million at December 31, 2007 (\$151 million at December 31, 2006) which expires in 2009 and 2010, and a foreign tax credit carryforward of \$55 million at December 31, 2007 (\$55 million at December 31, 2006) which expires in 2009 through 2012.

The components of consolidated income tax expense were as follows:

<i>(Stated in millions)</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
Current:	\$ 538	\$ 495	\$256
United States—Federal	54	49	24
United States—State	834	641	372
Outside United States	\$1,426	\$1,185	\$652
Deferred:			

United States—Federal	\$ (3)	8	\$ 12
United States—State	8	12	2
Outside United States	38	(10)	77
Valuation allowance	(21)	(5)	(61)
	\$ 22	\$ 5	\$ 30
Consolidated taxes on income	\$1,448	\$1,190	\$682

A reconciliation of the United States statutory federal tax rate (35%) to the consolidated effective tax rate is:

<i>(Stated in millions)</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
US statutory federal rate	35%	35%	35%
US state income taxes	1	1	1
Non-US income taxed at different rates	(12)	(10)	(8)
Effect of equity method investment	(1)	(1)	(1)
Minority partner's share of LLC earnings	-	-	(1)
Charges and credits	-	-	(2)
Other	(1)	(1)	(1)
Effective income tax rate	22%	24%	23%

Schlumberger adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109* (“FIN 48”) on January 1, 2007. This interpretation clarifies the accounting for uncertain tax positions and requires companies to recognize the impact of a tax position in their financial statements, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The adoption of FIN 48 did not have any impact on the total liabilities or stockholders' equity of Schlumberger.

A reconciliation of the beginning and ending amount of liabilities associated with uncertain tax positions is as follows:

<i>(Stated in millions)</i>	
Balance at January 1, 2007	\$730
Additions based on tax positions related to the current year	187
Additions for tax positions of prior years	16
Impact of changes in exchange rates	21
Settlements with tax authorities	(8)
Reductions for tax positions of prior years	(55)
Reductions due to the lapse of the applicable statute of limitations	(33)
Balance at December 31, 2007	\$858

Included in the Schlumberger *Consolidated Balance Sheet* at December 31, 2007 is approximately \$858 million of liabilities associated with uncertain tax positions in the over 100 jurisdictions in which Schlumberger conducts business, a number of which have tax laws that are not fully defined and are evolving. This amount excludes \$130 million of accrued interest and penalties. All but \$25 million of the unrecognized tax benefits, if recognized, would impact the Schlumberger effective tax rate.

Schlumberger classifies interest and penalties relating to uncertain tax positions within *Taxes on income* in the *Consolidated Statement of Income*. During 2007, Schlumberger recognized approximately \$36 million in interest and penalties.

The following table summarizes the tax years that are either currently under audit or remain open and subject to examination by the tax authorities in the most significant jurisdictions in which Schlumberger operates:

<i>(Stated in millions)</i>	
Canada	2002-2007
Mexico	2002-2007
Russia	2004-2007
Saudi Arabia	2001-2007
United Kingdom	2004-2007
United States	2003-2007

In certain of the jurisdictions noted above, Schlumberger operates through more than one legal entity, each of which has different open years subject to examination. The table above presents the open years subject to examination for the most material of the legal entities in each jurisdiction. Additionally, it is important to note that tax years are technically not closed until the statute of limitations in each jurisdiction expires. In the jurisdictions noted above, the statute of limitations can extend beyond the open years subject to examination.

Due to the geographic breadth of the Schlumberger operations, numerous tax audits may be ongoing throughout the world at any point in time. Tax liabilities are recorded based on estimates of additional taxes which will be due upon the conclusion of these audits. Estimates of these tax liabilities are made based upon prior experience and are updated in light of changes in facts and circumstances. However, due to the uncertain and complex application of tax regulations, it is possible that the ultimate resolution of audits may result in liabilities which could be materially different from these estimates. In such an event, Schlumberger will record additional tax expense or tax benefit in the period in which such resolution occurs.

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13. Income Taxes

Income taxes are based on pretax earnings, which were distributed geographically as follows:

	<i>2007</i>	<i>2006</i>	<i>2005</i>
Domestic	\$102,849	90,835	140,762
Foreign	829,314	678,212	613,898
Total	\$932,163	769,047	754,660

Reconciliation of the provision for income taxes computed at the U.S. federal statutory rate of 35% to the reported provision for income taxes is as follows:

	<i>2007</i>	<i>2006</i>	<i>2005</i>
Provision at U.S. federal statutory rate	\$326,257	269,166	264,131
State taxes—net	2,404	2,272	4,134
Foreign tax rates	(72,552)	(51,893)	(35,767)
Foreign earnings remitted to parent	49,188	33,801	10,761
Tax credits	(3,200)	(3,500)	(3,590)
Other—net	(1,939)	(10,176)	(2,261)
Total	\$300,158	239,670	237,408

Foreign earnings remitted to parent includes estimated taxes provided on foreign sourced earnings remitted or expected to be remitted, net, to the parent company after considering financial and operational requirements of the parent and foreign affiliate.

The Other—net in 2005 includes the incremental income tax expense of \$5,500 due to the repatriation of foreign earnings.

The components of the provisions for income taxes were:

	<i>Current</i>	<i>Deferred</i>	<i>Total</i>
2007			
Federal	\$ 12,302	35,292	47,594
Foreign	253,460	(7,766)	245,694
State	5,890	980	6,870
Total	\$271,652	28,506	300,158
2006			
Federal	\$ 14,871	5,305	20,176
Foreign	217,650	(4,927)	212,723
State	6,630	141	6,771
Total	\$239,151	519	239,670
2005			
Federal	\$ 16,469	7,570	24,039

Foreign	207,451	(1,275)	206,176
State	7,392	(199)	7,193
Total	\$231,312	6,096	237,408

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. With certain exceptions, the Company is no longer subject to U.S. federal, state and local or non-U.S. income tax examinations by tax authorities for years prior to 2004. The Company adopted the provisions of FIN 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109" on January 1, 2007 with no material impact to the financial statements. A reconciliation of the beginning and ending balance of unrecognized tax benefits is as follows:

	2007
Balance at January 1	\$37,054
Additions based on tax positions related to the current year	13,938
Additions for tax positions of prior years	641
Reduction for tax positions of prior years	(2,397)
Settlements	(6,119)
Foreign currency translation	1,867
Balance at December 31	\$44,984

Approximately \$30,700 of the total amount of unrecognized tax benefits at December 31, 2007 would affect the annual effective tax rate, if recognized. See Note 3 discussion of SFAS No. 141(R) for pending accounting rule changes. Further, the Company is unaware of any positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next twelve months.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in income tax expense. The total amount of accrued interest and penalties at December 31, 2007 and 2006 was approximately \$2,900.

The following table summarizes components of deferred tax assets and (liabilities) at December 31:

	2007	2006
Accrued compensation, pension and post-retirement benefits	\$127,448	\$121,438
Depreciation	(37,352)	(24,625)
Goodwill and intangibles	(75,727)	(46,586)
Accrued liabilities and other items—net	(1,365)	12,701
Net deferred tax asset (liability)	\$ 13,004	\$ 62,928

The following table summarizes the balance sheet classification of deferred tax assets and (liabilities) at December 31:

	2007	2006
Deferred Tax Asset		
Current	\$ 33,446	40,661
Noncurrent	25,526	36,480
Deferred Tax Liability		
Current	(2,017)	(1,511)
Noncurrent	(43,951)	(12,702)
Net deferred tax asset (liability)	\$ 13,004	62,928

Applicable U.S. income and foreign withholding taxes have not been provided on approximately \$958,600 of undistributed earnings of international associated companies at December 31, 2007. These earnings are considered to be permanently invested and, under certain tax laws, are not subject to taxes until distributed as dividends. Tax on such potential distributions would be substantially offset by foreign tax credits. If the earnings were not considered permanently invested, approximately \$210,500 of deferred income taxes would need to be provided.

Review Question Answers

Section 1

1. ASC 740 establishes standards of financial accounting and reporting for income taxes that are currently payable and for

- A. Correct. The scope of ASC 740 extends to the tax consequences of (1) revenues, expenses, gains, and losses included in taxable income of a year other than the year when they are recognized in income for financial reporting purposes; (2) other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting purposes; and (3) operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years.
- B. Incorrect. This issue is excluded from the scope of ASC 740.
- C. Incorrect. This issue is not covered under ASC 740.
- D. Incorrect. With certain exceptions, ASC 740 does not address accounting for income taxes in interim periods.

2. Under current generally accepted accounting principles, which approach is used to determine income tax expense?

- A. Correct. The asset and liability method accrues liabilities or assets (taxes payable or refundable) for the current year. It also recognizes deferred tax amounts for the future tax consequences of events previously recognized in the financial statements or tax returns. These liabilities and assets recognize the effects of temporary differences measured using the tax rate(s) expected to apply when the liabilities and assets are expected to be settled or realized. Accordingly, deferred tax expense (benefit) is determined by the change during the period in the deferred tax assets and liabilities. Income tax expense (benefit) is the sum of current tax expense (benefit), that is, the amount paid or payable, and the deferred tax expense (benefit).
- B. Incorrect. The "with and without" approach was an element of the deferred approach. This guidance stated that the tax effect of a timing difference should "be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income."
- C. Incorrect. The net-of-tax approach accounts for the effects of taxability or deductibility on assets and liabilities as reductions in their reported amounts.

- D. Incorrect. The deferred method determined income tax expense by multiplying pretax financial income by the current tax rate, with the difference between taxes payable (refundable) and income tax expense (benefit) being recorded as a deferred credit or charge.

3. The provisions of ASC 740, *Income Taxes: Overall*, are applicable to

- A. Incorrect. The provisions are applicable to domestic federal income taxes and foreign, federal, state, and local taxes that are based on income.
- B. Correct. ASC 740 applies not only to domestic federal income taxes but also foreign, state, and local taxes based on income.
- C. Incorrect. The provisions are applicable only to an enterprise's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method.
- D. Incorrect. Foreign enterprises are affected only if they report based on U.S. GAAP.

4. Rein, Inc. reported deferred tax assets and deferred tax liabilities at the end of both 2X11 and 2X12. For the year ended in 2X12, Rein should report deferred income tax expense or benefit equal to the

- A. Correct. The deferred tax expense or benefit recognized is the sum of the net changes in the deferred tax assets and deferred tax liabilities. The deferred income tax expense or benefit is aggregated with the income taxes currently payable or refundable to determine the amount of income tax expense or benefit for the year to be recorded in the income statement.
- B. Incorrect. The deferred income tax expense or benefit is equal to the sum of the net changes in the deferred tax assets and deferred tax liabilities.
- C. Incorrect. The deferred income tax expense or benefit is not just the net change in deferred tax liabilities.
- D. Incorrect. This calculation determines the income tax expense or benefit for the year.

5. With respect to deferred tax assets, future income can come from which of the following?

- A. Incorrect. Estimated future taxable income should exclude the reversal of temporary differences and carryforwards.
- B. Correct. Tax-planning strategies that a company would implement to utilize an expiring NOL is one example of future income. Switching from tax-exempt to taxable investments is one of those strategies.
- C. Incorrect. Reversal of existing taxable temporary differences is a source of future income but it is based on the assumption that taxable income is zero and not that taxable income is greater than book income.

- D. Incorrect. A current year tax loss does not create future income, but rather a loss in the current year.

6. GAAP states that a deferred tax asset shall be reduced by a valuation allowance if it is

- A. Incorrect. GAAP specifically rejected the term probable as used in SFAS 5, Accounting for Contingencies.
- B. Incorrect. GAAP believes that the appropriate criterion is the one that produces results that are closest to the expected outcome. A reasonable possibility does not meet that standard.
- C. Correct. A deferred tax asset shall be reduced by a valuation allowance if the weight of the available evidence, both positive and negative, indicates that it is more likely than not (that is, the probability is greater than 50%) that some portion will not be realized. The allowance should suffice to reduce the deferred tax asset to the amount that is more likely than not to be realized.
- D. Incorrect. GAAP specifically rejected the term likely as used in SFAS 5, Accounting for Contingencies.

7. Intrapersonal income tax allocation arises because

- A. Correct. To provide a fair presentation of the various components of the results of operations, GAAP requires that income tax expense for the period be allocated among income from continuing operations, discontinued operations, extraordinary items, other comprehensive income, and items debited or credited directly to equity.
- B. Incorrect. Allocation among periods is interperiod tax allocation.
- C. Incorrect. Differences in the timing of revenues and expenses for financial statement and tax return purposes create the need for interperiod income tax allocation.
- D. Incorrect. Permanent differences do not create a need for tax allocation.

8. In financial statements prepared on the income tax basis, how should the nondeductible portion of expenses such as meals and entertainment be reported?

- A. Correct. Even though financial statements are prepared on the income tax basis, permanent difference items, e.g., nondeductible expenses, are included as revenues or expenses in the income statement. They do not have to be presented in a special category of the income statement.
- B. Incorrect. There is no special requirement to report these expenses in a separate category of the income statement.
- C. Incorrect. Permanent tax difference items are reported in the income statement.
- D. Incorrect. Permanent tax difference items are reported in the income statement.

Section 2

9. On September 15, 2X12, the county in which Spirit Company operates enacted changes in the county's tax law. These changes are to become effective on January 1, 2X13. They will have a material effect on the deferred tax accounts that Spirit reported. In which of the following interim and annual financial statements issued by Spirit should the effect of the changes in tax law initially be reported?

- A. Correct. When a change in the tax law or rates occurs, the effect of the change on a deferred tax liability or asset is recognized as an adjustment in the period that includes the enactment date of the change. The adjustment is allocated income from continuing operations in the first financial statements issued for the period that includes the enactment date.
- B. Incorrect. The effect should initially be reported in the first statements issued for the period that includes the enactment date.
- C. Incorrect. The periods covered include the effective date, not the enactment date.
- D. Incorrect. The effective date should be covered, not the enactment date.

10. Enterprises for which graduated tax rates are a significant factor measure a deferred tax liability or asset using the

- A. Incorrect. The alternative minimum tax rate is only considered in the recognition of a deferred tax asset for an alternative minimum tax credit carryforward.
- B. Correct. Enterprises for which graduated tax rates are significant measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the enterprise estimates the deferred tax liability or asset will be settled or recovered.
- C. Incorrect. The average graduated tax rate is used.
- D. Incorrect. The flat tax rate is used by enterprises for which graduated tax rates are not a significant factor.

11. West Corp. leased a building and received the \$36,000 annual rental payment on June 15, Year 4. The beginning of the lease was July 1, Year 4. Rental income is taxable when received. West's tax rates are 30% for Year 4 and 40% thereafter. West had no other permanent or temporary differences. West determined that no valuation allowance was needed. What amount of deferred tax asset should West report in its December 31, Year 4, balance sheet?

- A. Incorrect. The amount of \$5,400 is based on a 30% tax rate.

- B. Correct. \$36,000 rental payment is taxable in full when received in Year 4, but only \$18,000 [$\$36,000 \times (6/12)$] should be recognized in financial accounting income for the year. The result is a deductible temporary difference (deferred tax asset) arising from the difference between the tax basis (\$0) of the liability for unearned rent and its reported amount in the year-end balance sheet ($\$36,000 - \$18,000 = \$18,000$). The income tax payable for Year 4 based on the rental payment is \$10,800 ($\$36,000 \times 30\%$ tax rate for Year 4), the deferred tax asset is \$7,200 ($\$18,000$ future deductible amount $\times 40\%$ enacted tax rate applicable after Year 4 when the asset will be realized), and the income tax expense is \$3,600 ($\$10,800$ current tax expense - $\$7,200$ deferred tax benefit). The deferred tax benefit equals the net change during the year in the entity's deferred tax liabilities and assets ($\$7,200$ deferred tax asset recognized in Year 4 - $\$0$).
- C. Incorrect. The income tax payable is \$10,800.
- D. Incorrect. The amount of \$14,400 would be the income tax payable if the 40% tax rate applied in Year 4.

12. Last year, before providing for taxes, Ajax Company had income from continuing operations of \$930,000 and an extraordinary gain of \$104,000. The current effective tax rate on continuing operations income was 40% and the total tax liability was \$398,000 ignoring any temporary differences. The amount of the extraordinary gain net of tax effect was

- A. Incorrect. The amount of \$41,600 results from multiplying the extraordinary gain times the effective tax rate.
- B. Incorrect. The amount of \$62,400 results from subtracting the extraordinary gain times the effective tax rate from the extraordinary gain.
- C. Correct. Given that the effective tax rate for continuing operations was 40%, the related tax expense was \$372,000 ($\$930,000 \times 40\%$). Because the total tax liability was \$398,000, \$26,000 ($\$398,000 - \$372,000$) was applicable to the extraordinary item. Accordingly, the extraordinary gain net of tax effect was \$78,000 ($\$104,000 - \$26,000$).
- D. Incorrect. The amount of \$104,000 results from not accounting for the tax effect.

Section 3

13. Because Jab Co. uses different methods to depreciate equipment for financial statement and income tax purposes, Jab has temporary differences that will reverse during the next year and add to taxable income. Deferred income taxes that are based on these temporary differences should be classified in Jab's balance sheet as a

- A. Incorrect. A liability is not shown as an offset to assets and it is not current.
- B. Incorrect. A liability is not shown as an offset to assets.
- C. Incorrect. The classification of a deferred tax liability should not be determined by the reversal date of the temporary differences unless it is not related to an asset or liability for financial reporting.
- D. Correct. These temporary differences arise from use of an accelerated depreciation method for tax purposes. Future taxable amounts reflecting the difference between the tax basis and the reported amount of the asset will result when the reported amount is recovered. Accordingly, Jab must recognize a deferred tax liability to record the tax consequences of these temporary differences. This liability is noncurrent because the related asset (equipment) is noncurrent.

14. In its first 4 years of operations, Alder, Inc.'s depreciation for income tax purposes exceeded its depreciation for financial statement purposes. This temporary difference was expected to reverse over the next 3 years. Alder had no other temporary differences. Alder's balance sheet for its fourth year of operation should include

- A. Incorrect. The effects of the difference are not treated as a contra asset.
- B. Incorrect. A deferred tax asset is recognized for deductible temporary differences.
- C. Incorrect. The deferred tax liability is related to noncurrent assets.
- D. Correct. Because of differences between the financial and tax reporting of depreciation, the financial reporting basis of Alder's depreciable assets exceeded their tax basis. The result is a temporary difference. Based on the assumption that amounts related to the future recovery of the depreciable assets recorded for financial reporting purposes will exceed their remaining tax basis, the excess will be taxable when the assets are recovered. Thus, the recovery of the reported amounts of these assets will give rise to taxable amounts. The deferred tax consequences of taxable amounts are recognized as deferred tax liabilities. Alder's deferred tax liability arising from the taxable temporary difference is classified as noncurrent because it is related to noncurrent assets.

15. In its Year 4 income statement, Cere Co. reported income before income taxes of \$300,000. Cere estimated that, because of permanent differences, taxable income for Year 4 would be \$280,000. During Year 4, Cere made estimated tax payments of \$50,000, which were debited to income tax expense. Cere is subject to a 30% tax rate. What amount should Cere report as income tax expense?

- A. Incorrect. The amount of \$34,000 equals the \$84,000 of income taxes payable minus the \$50,000 of income taxes paid.
- B. Incorrect. The amount of \$50,000 equals income taxes paid, not the total current income tax expense.
- C. Correct. A permanent difference does not result in a change in a deferred tax asset or liability, that is, in a deferred tax expense or benefit. Thus, income tax expense equals current income tax expense,

which is the amount of taxes paid or payable for the year. Income taxes payable for Year 4 equal \$84,000 (\$280,000 taxable income x 30%).

- D. Incorrect. The amount of \$90,000 is equal to the reported income of \$300,000 times the tax rate.

16. On its December 31, Year 2, balance sheet, Shin Co. had income taxes payable of \$13,000 and a current deferred tax asset of \$20,000 before determining the need for a valuation account. Shin had reported a current deferred tax asset of \$15,000 at December 31, Year 1. No estimated tax payments were made during Year 2. At December 31, Year 2, Shin determined that it was more likely than not that 10% of the deferred tax asset would not be realized. In its Year 2 income statement, what amount should Shin report as total income tax expense?

- A. Incorrect. The amount of \$8,000 ignores the balance in the valuation account.
- B. Incorrect. The amount of \$8,500 assumes the balance in the valuation account equals 10% of the Year 2 increase in the deferred tax asset.
- C. Correct. The deferred tax expense or benefit recognized is the sum of the net changes in the deferred tax assets and deferred tax liabilities. It is aggregated with the current tax expense or benefit to determine the income tax expense for the year. The amount of income taxes payable (current tax expense) is given as \$13,000. The deferred tax asset increased by \$5,000, but \$2,000 ($\$20,000 \times 10\%$) was determined to be an appropriate credit to an allowance account. Thus, income tax expense for Year 2 is \$10,000 [$\$13,000$ current tax expense - ($\$5,000$ increase in the deferred tax asset $\$2,000$ credit to an allowance account) deferred tax benefit].
- D. Incorrect. The amount of \$13,000 is the amount of current income taxes payable.

17. Under IFRSs, a deferred tax asset is

- A. Incorrect. Under GAAP, a deferred tax asset is reduced by a valuation allowance if necessary.
- B. Incorrect. Under GAAP, the gross amount of the deferred tax asset is measured by applying the enacted tax rate to the deferred tax consequences.
- C. Correct. Under IFRS, a deferred tax asset is recognized for most deductible temporary differences and for the carryforward of unused tax losses and credits, but only to the extent it is probable that taxable profit will be available to permit the use of those amounts. Probable means more likely than not. Thus, no valuation allowance is recognized.
- D. Incorrect. A deferred tax liability is recognized to reflect the deferred tax consequences of a taxable temporary difference.

18. According to U.S. GAAP, which of the following items should affect current income tax expense for Year 3?

- A. Incorrect. Interest on a Year 1 tax deficiency paid in Year 3 is applicable to Year 1.
- B. Incorrect. Penalty on a Year 1 tax deficiency paid in Year 3 is applicable to Year 1.
- C. Correct. Current tax expense is the amount of income taxes paid or payable for a year as determined by applying the provisions of the enacted tax law to the taxable income for that year.
- D. Incorrect. A change in income tax rate for Year 4 would affect the deferred tax expense or benefit for Year 3, assuming scheduled effects of a temporary difference will occur in Year 4.

19. A company is required to record a valuation account against a deferred income tax asset if it is _____ that some portion or all of the deferred tax asset will not be realized.

- A. Incorrect. The probable threshold is not used in determining whether a valuation account is required. Probable could be defined as a reasonable belief.
- B. Incorrect. The reasonably possible threshold is not used in determining whether a valuation account is required. Reasonably possible might not be a strong enough threshold when determining a potential outcome.
- C. Correct. GAAP uses the more-likely-than-not (more than 50 percent probability) threshold to determine whether a valuation account is required.
- D. Incorrect. GAAP does not use highly likely as a threshold for determining whether a valuation account is required. Highly likely might be too strong of a threshold.

20. Under existing GAAP, how should a deferred tax liability be classified on the balance sheet?

- A. Incorrect. The classification is not based on the estimated reversal date unless the deferred tax liability does not relate to an asset or liability.
- B. Correct. GAAP requires the classification of the deferred tax liability (or asset) follow the classification of the related asset or liability.
- C. Incorrect. GAAP does not provide for always classifying the deferred tax liability (or asset) as long-term.
- D. Incorrect. There is no GAAP requirement that a deferred tax liability or asset always be classified as current.