ACCOUNTING FOR INCOME TAXES - BOOK VS. TAX BASIS DIFFERENCES

November 2025

Overview

This Financial Reporting Insights is intended to be used as a resource in understanding how to identify temporary and permanent differences and net operating loss and tax credit carryforwards, which together are one of the many aspects of accounting for income taxes.

This publication does not address every aspect of accounting for income taxes and should therefore be read in conjunction with the FASB Accounting Standards Codification (ASC) 740, *Income Taxes*.

TABLE OF CONTENTS

1 Background

ASC 740-10-05-1

The Income Taxes Topic addresses financial accounting and reporting for the effects of income taxes that result from an entity's activities during the current and preceding years. Specifically, this Topic establishes standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of all of the following:

a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income

b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting

c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years

ASC 740-10-10-1

There are two primary objectives related to accounting for income taxes:

a. To recognize the amount of taxes payable or refundable for the current year

b. To recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns.

As it relates to the second objective, some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In some tax jurisdictions, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

ASC 740-10-10-2

Ideally, the second objective might be stated more specifically to recognize the expected future tax consequences of events that have been recognized in the financial statements or tax returns. However, that objective is realistically constrained because:

a. The tax payment or refund that results from a particular tax return is a joint result of all the items included in that return.

b. Taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years.

c. Information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

ASC 740 covers the accounting and financial reporting of taxes which are based on income and provides guidance for the recognition and measurement of tax positions in an entity's income tax return that would directly or indirectly affect amounts reported in the financial statements.

Entities must determine their income tax provision (income tax expense within the financial statements) through a two-step process:

1. Recognize the amount of estimated taxes payable or refundable for the current year (i.e., the amount expected to be reflected on its income tax returns for the current year)
2. Recognize deferred taxes for the estimated future tax effects of events that have been recognized in either the financial statements or tax returns, but not both (to ensure that the recorded income tax expense includes the current and future tax effects of all items reflected in the financial statements).

Most revenue and expense transactions included in pretax financial statement income are also included in taxable income in the same year. However, as discussed in ASC 740-10-25-19, taxable income may differ from financial statement income when revenue and expense transactions are recognized under tax laws in a different period than they are recognized under U.S. Generally Accepted Accounting Principles (U.S. GAAP). Additionally, some revenues are tax exempt and some expenses may not be deductible on a tax return. Differences between revenues and expenses recognized for financial statement purposes and tax return purposes are commonly referred to as book to tax differences and are either permanent or temporary differences. Tax consequences of operating loss or tax credit carrybacks or carryforwards also need to be reflected within the current year financial statements.

The following example illustrates book to tax differences and the resulting impact on income (expense) recorded within the financial statements.

Example 1-1: Identifying book to tax differences

ABC Company is a U.S. taxpayer with an effective tax rate of 25%. ABC Company reviewed its trial balances and noted the following items that were treated differently for financial statement ("book") and tax return ("tax") purposes as of December 31, 20X2:

Permanent Differences:

- U.S. Federal Government bond interest revenue of $100,000–reflected as income for book purposes but not for tax purposes
- Meal expense of $50,000, of which 50% is deemed deductible–only $25,000 is included as expenses for tax purposes

ABC Company's book income will exceed taxable (or tax return) income by $75,000 ($100,000-$25,000) because of the permanent differences identified above. Since taxable income is lower than book income, this permanent difference will result in a reduction in income tax expense of $18,750 ($75,000 x 25%).

Temporary Differences:

- The book balance of the allowance for expected credit losses was $1,450,000 as of December 31, 20X2, as compared to $1,000,000 as of December 31, 20X1. The tax balance of the allowance for expected credit losses as of December 31, 20X2, and 20X1 was $0.
- The accrued bonus (book) balance was $4,250,000 as of December 31, 20X2, as compared to a book balance of $1,750,000 as of December 31, 20X1. The tax balance of accrued bonus as of December 31, 20X2, and 20X1 was $0.

ABC Company has cumulative deductible temporary differences of $5,700,000 ($1,450,000+$4,250,000) as of December 31, 20X2, as compared to cumulative deductible temporary differences of $2,750,000 ($1,000,000 +$1,750,000) as of December 31, 20X1. The change in cumulative temporary differences during 20X2 is $2,950,000. The income tax effect of this change of $737,500 ($2,950,000 x 25%) would result in an increase in current taxes payable with an offsetting deferred tax asset. The net effect of a change in cumulative temporary differences on income tax expense would be zero, unless a valuation allowance would be required on the deferred tax asset. Valuation allowances are beyond the scope of this publication.

The concept of temporary differences is the basis of deferred tax accounting (or the liability method) under ASC 740. ASC 740 and the FASB Codification Master Glossary define a "temporary difference" as 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. Temporary differences also result from events that have not been recognized in the financial statements and will result in taxable or deductible amounts in future years based on provisions of the tax law.

The tax effects of these differences are referred to as deferred tax assets or liabilities. Such temporary differences originate in one accounting period and reverse in another and ultimately result in the same amount of expense (benefit) for book and tax purposes over the reversal period of these differences. Under ASC 740, these differences are recorded within the financial statements by computing the impact on income tax expense (benefit) as if all the entity’s assets and liabilities were settled for amounts equal to the reported financial statement amounts. This approach ensures that income tax expense (benefit) reflected on the financial statements relates to income and expenses recognized within the financial statements rather than income and expenses recognized on the income tax return. It also helps prevent large fluctuations between years in income tax expense (benefit), as the impact of both the current income taxes payable (refundable) and deferred income taxes (i.e., those that will be paid (deducted) in the future) are included in the current period income tax expense (benefit).

Permanent differences, which is not a defined term within ASC 740, are events that do not have tax consequences in future periods. An entity would, therefore, not record deferred tax assets or liabilities related to permanent differences.

Permanent differences and temporary differences are together referred to as book to tax differences and represent the differences between financial statement income and taxable income in a particular year. The cumulative temporary differences between the tax basis and book basis of assets and liabilities will also be tax-effected and recorded as deferred tax assets or liabilities on an entity’s year-end balance sheet. Thus, identification and classification of temporary and permanent differences is an important and necessary building block for income tax calculations under ASC 740.

Without the guidance in ASC 740, an entity could assert that the amount of income tax expense (benefit) reported on the entity’s tax returns would be the same amount as income tax expense (benefit) in the financial statements. As illustrated above, this method of recording income taxes would not properly recognize the tax effects related to all income and expenses within the financial statements. The tax consequences of these tax return adjustments would not be recognized within the current year financial statements if the entity merely recorded the income tax expense amount computed from the income tax returns. ASC 740 requires entities to account for income taxes as if all assets were recovered and all liabilities were settled at amounts equal to the amounts reported in the financial statements.

The remaining sections of this publication will discuss permanent differences, temporary differences, and operating loss and tax credit carryforwards in further detail.

The differences between income tax expense calculated based on what appears on the tax return and income tax expense (benefit) calculated based on the guidance in ASC 740 may result in significant differences, even in the simple example above. Therefore, to properly apply ASC 740, it is important to understand the sources and types of temporary and permanent differences.

2 Permanent differences

ASC 740-10-25-30

Certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized. One example, depending on the provisions of the tax law, could be the excess of cash surrender value of life insurance over premiums paid. That excess is a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy but is not a temporary difference if the asset is expected to be recovered without tax consequence upon the death of the insured (if under provisions of the tax law there will be no taxable amount if the insurance policy is held until the death of the insured).

ASC 740-10-25-31

Tax-to-tax differences are not temporary differences. Recognition of a deferred tax asset for tax-to-tax differences is prohibited as tax-to-tax differences are not one of the exceptions identified in paragraph 740-10-25-3. An example of a tax-to-tax difference is an excess of the parent entity's tax basis of the stock of an acquired entity over the tax basis of the net assets of the acquired entity.

As noted in Section 1, ASC 740 notes that some basis differences may not become taxable or deductible in the future. These differences are generally referred to as “permanent differences.” The term “permanent” is used because these differences will not have future tax consequences either because such revenues are tax-exempt or the expenses are not deductible. Permanent differences also include tax-to-tax differences and other specific exceptions to the model for recording deferred taxes discussed in ASC 740-10-25-3.

Some common examples of permanent differences between amounts recognized within the financial statements and amounts recognized for U.S. federal income tax purposes include the following:

- Tax-exempt interest income is recognized within the financial statements, but such income will never be taxable. The related interest expense, if any, on debt incurred to purchase tax-exempt securities is never deductible, though it is expensed for financial reporting purposes.
- Meals and entertainment expenses are recognized as expenses in financial statements, but, generally, 50% of meals and all entertainment expenses are not deductible for income tax purposes.
- Political contributions or other lobbying related expenses will be recorded as expenses in financial statements but are not deductible for U.S. income tax purposes.
- Fines and penalties imposed by regulatory authorities are generally not tax deductible, while they are recognized as expenses in financial statements.
- Compensation expense is included as an expense within the financial statements. For public entities, compensation to certain highly compensated employees that amounts to more than $1 million annually may be subject to limitations on its deductibility for tax purposes due to a U.S. tax code provision known as section 162(m).
- Tax credits within the scope of ASC 740 may reduce the amount of tax owed but would not impact pretax income in the financial statements. If the related expenses that reduced pretax income are disallowed for tax purposes due to the claimed credit, a permanent difference arises related to those disallowed expenses. Expenses for which an entity will claim a credit (e.g., foreign tax credit or investment tax credit) will be recorded in the financial statements but are not deductible, as the entity is claiming a credit.

- Tax-to-tax differences are differences between the tax basis of the stock of a subsidiary or equity method investee and the tax basis of the underlying net assets of that entity. These differences arise since tax regulations may treat the stock and the underlying net assets differently for tax purposes.

ASC 740-10-25-3 lists specific differences that would also not result in taxable or deductible amounts in future years:

- Entities will record an asset equal to the cash surrender value of an officer's or director's life insurance policy if the entity is the beneficiary. Premiums paid for these policies are generally not deductible and any proceeds are not taxable, provided that such policy is held until the death of the policy owner. Therefore, a deferred tax liability (DTL) would generally not be recognized (and therefore no temporary difference would be identified) related to any differences between the cash surrender value and the premiums paid. It should be noted that if the entity has a history of cashing out these policies prior to the death of the officer or director, the answer may change.
- In many cases, there will be a difference between the parent's investment in a domestic subsidiary for book and tax purposes. Deferred taxes would be provided on this difference, except when the parent entity demonstrates that it is able to recover its investment on a tax-free basis. Under current U.S. federal tax law, in certain circumstances, a parent entity may be able to recover its investment in its subsidiary without paying taxes through a tax-free liquidation or merger. When an entity demonstrates that it may recover its investment without any tax effect, such entity would not record a DTL (and therefore not identify a temporary difference) on any excess of the book basis over the tax basis of its investment in the subsidiary.
- Certain non-taxable entities (e.g., S-Corporations, limited liability companies, partnerships) do not pay federal income tax, but rather their income is taxed at the individual-shareholder level. Such entities would generally not identify temporary differences or record deferred taxes related to any book to tax basis differences in their assets and liabilities. Note that certain circumstances, such as a change in tax status, may result in future recognition of temporary differences and deferred tax assets or liabilities. In addition, such entities may be subject to entity-level state and local income taxes.

Under ASC 740, entities recognize the income tax effects of permanent differences by adjusting the amount of taxes payable or refundable for the current year. This means that current income tax expense (benefit) is either increased or decreased to account for the permanent differences. Permanent differences also impact the entity's effective tax rate (ETR). An entity's effective tax rate is found by dividing income tax expense by pretax income. Permanent differences are generally included within the reconciliation between pretax income and taxable income and result in adjustments to current income tax expense (benefit). If a permanent difference is a financial statement expense that is non-deductible for tax purposes, the entity's ETR will be higher than its statutory tax rate. Conversely, if a permanent difference is income that is non-taxable, the entity's ETR will be lower than its statutory tax rate. However, this relationship is true only when pre-tax book income is positive. If pre-tax book income is negative, the ETR calculation becomes more complex, especially if there is no current tax expense.

3 Identification of taxable and deductible temporary differences

ASC 740-10-05-7

A temporary difference refers to a difference between the tax basis of an asset or liability, determined based on recognition and measurement requirements 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. Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. Deferred tax assets and liabilities are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money.

> **ASC 740-10-05-8**
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> As indicated in paragraph 740-10-25-23, temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to as taxable temporary differences. Likewise, temporary differences that will result in deductible amounts in future years are often referred to as deductible temporary differences. Business combinations and joint venture formations may give rise to both taxable and deductible temporary differences.

As noted in Section 1, temporary differences are differences between the book and tax bases of assets and liabilities. Therefore, the financial statement (or "book") basis and the tax return (or "tax") basis must first be identified for each asset and liability.

All temporary differences must be considered in terms of the expected future tax consequences when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. ASC 740-10-05-8 categorizes two types of temporary differences. Taxable temporary differences lead to taxable amounts in the future when the related asset is recovered or the liability is settled. Deductible temporary differences will result in deductible amounts in the future when the related asset is recovered or the liability is settled. A taxable temporary difference will result in a deferred tax liability while a deductible temporary difference will result in a deferred tax asset.

The table below summarizes the attributes of deductible and taxable temporary differences.

Deductible Temporary Difference	Taxable Temporary Difference
Asset's book balance is ***smaller*** than its tax balance.	Asset's book balance is ***larger*** than its tax balance.
Liability's book balance is ***larger*** than its tax balance.	Liability's book balance is ***smaller*** than its tax balance. (This is rare.)

Temporary differences generally result from these broad categories of differences (as described in ASC 740-10-25-20):

- **Revenues that are taxable after being recognized in the financial statements**. An asset (and the related revenue) would be recorded on the financial statements, while the related revenues would be taxable in a future year when the asset is recovered or collected (taxable temporary differences).
- **Expenses that are deductible after being recognized in the financial statements.** A liability or a contra-asset account (and the related expense) would be recorded on the financial statements, while the related expense would be deductible in a future year when the liability is settled (deductible temporary differences).
- **Revenues or gains that are taxable before being recognized in the financial statements**. A liability would be recorded on the financial statements (rather than revenue recognized) to reflect cash collected in advance for goods or services to be provided in the future. Such cash collections may be included in taxable income in the year collected. The related revenue would be recorded in the financial statements in a future year when the goods and services are provided, and the liability is settled (deductible temporary differences).
- **Expenses or losses that are deductible before being recognized in the financial statements.** Assets may be depreciated or amortized for financial statement purposes at a slower rate than for tax purposes, resulting in less book expense and higher asset values in earlier years. In later years, the amounts will reverse and result in taxable amounts in a future year (taxable temporary differences).
- **Differences between the financial reporting and tax basis of identifiable assets acquired and liabilities assumed in a business combination.** Differences may occur between the financial statement values of identifiable assets acquired and liabilities assumed in a business combination

accounted under ASC 805, and the related tax basis of such assets acquired and liabilities assumed. Those differences (except for non-deductible goodwill and the other exceptions to comprehensive accounting for deferred taxes) will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively. These differences are more likely to occur when the business combinations are structured as stock (or non-taxable) acquisitions rather than when the business combinations are structured as asset (or taxable) acquisitions that result in a fair market value basis of the assets for tax purposes.

- **Transfers of assets other than inventory (between two different tax paying entities that are part of a consolidated group).** Differences between the tax basis of an asset and the financial statement basis of the asset may result when an asset other than inventory is transferred between two different tax-paying entities within the same consolidated group for financial reporting purposes. Such differences will result in taxable or deductible amounts when the asset is recovered.

Each temporary difference should be identified for the purpose of measuring deferred taxes (e.g., accumulated depreciation, allowances for expected credit losses).

ASC 740 provides the following guidance related to temporary differences that may not be identified with specific assets or liabilities within the financial statements:

ASC 740-10-25-24

Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting.

Temporary differences may also result from transactions that are recognized in the financial statements but have a different tax treatment than those used for financial statement purposes.

ASC 740-10-25-25 provides two examples:

1. An entity recognizes revenue over time for financial statement purposes while recognizing revenue when the contract is completed for tax purposes.
2. An entity recognizes organizational costs as expenses when incurred for financial statement purposes while deferring the expenses for tax purposes.

ASC 740-10-25-26 states that even though there is no specific asset or liability recorded in the financial statements, these differences are temporary differences because the recognition of income or expenses in the financial statements occurs in a different period or amount than the corresponding taxable or deductible amounts for tax purposes. The timing and amount of future taxable or deductible amounts would be determined based on the provisions of the applicable tax law.

4 Net operating loss and tax credit carryforwards

As discussed in Section 3, ASC 740 discusses certain temporary differences that may not be linked to a particular asset or liability on the financial statements. In those cases, there is a temporary difference that results from an event that has been recognized in the financial statements and, based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future or prior years. Net operating losses and tax credit carryforwards are examples of tax attributes that give rise to deferred tax assets under ASC 740.

4.1 Net Operating Loss (NOL) carryforwards or carrybacks

As discussed in ASC 740-10-55-34 to 55-35, a NOL carryforward or carryback arises when an entity incurs a taxable loss in a particular year and is permitted under the relevant tax laws to use that loss to reduce taxable income in a future or prior year. Certain jurisdictions have tax laws that permit losses to be carried forward to future years while other jurisdictions have tax laws that permit operating losses to be carried back to prior years, which may result in a refund of previously paid income taxes. These tax laws vary by jurisdiction and may be complex. ASC 740 requires that entities consider the tax laws and any related limitations on utilization of any NOL carryforwards.

U.S. federal NOL's generated in years beginning before January 1, 2018 expire after 20 years but may be used to offset 100% of the entity's taxable income in tax years prior to expiration. U.S. federal NOLs generated in years beginning after December 31, 2017 may be carried forward indefinitely but may only be applied against 80% of the entity's taxable income in any tax year. Certain state and foreign jurisdictions may permit carryback of these losses to prior periods, so entities should consult with their tax advisors on this area.

ASC 740-10-55-34 permits the recognition of income tax refunds receivable as part of the current income tax expense or benefit for operating losses that would be permitted to be carried back under the relevant tax regulations and permits the recognition of a deferred tax asset as part of deferred tax expense or benefit for an operating loss carryforward, which would be subject to appropriate considerations regarding the need for a valuation allowance (which is beyond the scope of this publication).

Example 4-1: Net Operating Loss Carryforward

ABC Company is a U.S. taxpayer and generated taxable income (loss) of $1,000,000 and ($1,000,000) in 20X1 and 20X2, respectively. ABC Company is not permitted under current tax law to carry back the 20X2 loss to prior periods. ABC Company is permitted to carry the loss forward indefinitely, though its usage of this loss is limited to 80% of its taxable income in a particular year.

In 20X3, ABC Company generates taxable income of $2,000,000. ABC Company is therefore able to use the full amount ($1,000,000) of its net operating loss carryforward to reduce its 20X3 taxable income, since the net operating loss amount is less than 80% of ABC Company's 20X3 taxable income.

4.2 Income tax credits and carryforwards

4.2.1 Scope

Entities may be eligible for certain corporate income tax credits based on enacted tax laws in their taxpaying jurisdictions. Certain income tax credits are accounted for under ASC 740, while others are covered by other GAAP. Tax credits are generally included within the scope of ASC 740 when they are neither refundable nor transferable and are realizable only as a reduction of an entity's income tax liabilities.

Credits that are not dependent on taxable income, such as refundable credits and certain transferable credits, are generally viewed as government assistance and are accounted for outside of the scope of ASC 740 regardless of whether these credits are used to offset a tax liability or claimed as a refund. Many tax credits that are available under the Inflation Reduction Act of 2022, as amended, that are refundable or transferable will be accounted for outside of the scope of ASC 740. Such income tax credits that are accounted for outside of ASC 740 are outside the scope of this publication.

4.2.2 Income tax credits within the scope of ASC 740

Corporate income tax credits are amounts that entities may subtract directly from income taxes payable, as compared to a deduction (or expense), which is subtracted from taxable income. An income tax deduction would, therefore, reduce income taxes only by the tax-effect of the deduction, while an income tax credit would reduce income taxes by the full amount of the income tax credit. For example, if an entity receives an income tax deduction of $10,000 and has an effective tax rate of 21%, the $10,000 income tax deduction would reduce the entity's income taxes by $2,100. If, however, the entity receives a $10,000 income tax credit, such credit would reduce the entity's income taxes by the full $10,000. Thus, it is in an entity's best interest to use any income tax credits to the extent they qualify for the income tax credit, even if using the credit causes the loss of an income tax deduction. It should be noted that in many cases, these income tax credits are enacted to encourage entities to engage in a particular activity (e.g., hiring certain employees, research, using renewable energy), and thus an entity may or may not qualify for these credits.

Common U.S. federal income tax credits include the foreign tax credit, the research and development credit, the orphan drug credit, employment credits, and general business credits. The category known as general business credits is an umbrella category which includes various types of credits. Each income tax credit has specific eligibility criteria. Entities should consult with their tax advisors regarding eligibility criteria for income tax credits, including the relevant carryback and carryforward rules in the jurisdictions where they conduct business.

ASC 740-10-55-34 to 55-35 permits the recognition of income tax refunds receivable for income tax credits that would be permitted to be carried back under the relevant tax regulations and the recognition of a deferred tax asset for a tax credit carryforward. Recognition of deferred tax assets is subject to consideration of whether a valuation allowance is needed. Such consideration is beyond the scope of this publication.

The following example illustrates how an entity would use an income tax credit carryforward:

Example 4-2: Income Tax Credit Carryforward

ABC Company generated taxable income (loss) of $1,000,000 and ($1,000,000) in 20X1 and 20X2, respectively. ABC Company had an effective tax rate of 21% and paid income taxes of $210,000 and zero in 20X1 and 20X2, respectively. ABC Company earned a research and development tax credit of $1,500,000 in 20X2, which it was unable to use that year since it did not pay income taxes due to its taxable loss. Such credit, under U.S. tax law, if not used in the year earned, may be carried back for one year and carried forward for 20 years. In 20X2, ABC Company carried back a portion of the credit (which was limited to 75% of the tax) and applied a total credit of $157,500 ($210,000 x 75%) to 20X1 income taxes paid and obtained a refund of previously paid income taxes.

In 20X3, ABC Company generated taxable income of $2,000,000. ABC Company first used the NOL carryforward of $1,000,000 from 20X2 to reduce its 20X3 taxable income to $1,000,000. ABC then reviewed its remaining unused research and development credit from 20X2 and concluded that it would:

- Apply a credit of $157,500 ($1,000,000 x 21% x 75%) to further reduce the calculated tax liability for 20X3.
- Carry the remaining credit of $1,185,000 ($1,500,000 -$157,500 - $157,500) forward to be used in 20X4 or future years.

4.3 Investment tax credits

While all income tax credits reduce the amount of income taxes paid, an investment tax credit (ITC) is a specific type of income tax credit. An entity earns an ITC when it purchases a qualifying depreciable asset (e.g., a piece of manufacturing equipment). Such credit is often calculated as a percentage of the cost of the asset. An ITC may also reduce the entity's tax basis in the asset. The ITC would be recorded within the entity's financial statements once an entity determines that it is eligible for the ITC under U.S. federal tax law. ASC 740-10-25-45 requires an ITC to be reflected in the financial statements when the ITC reduces income tax payable or qualifies as a deferred tax asset. ASC 740-10-25-46 further states that entities may make an accounting policy election to account for the ITC using either the deferral method or the flow-through method, though the deferral method is preferable for traditional ITCs. Upon adoption of ASU 2023-02, the flow-through method is required for investments on which the entity has elected to apply the proportional amortization method.

- **Deferral Method:** The ITC is recognized in the financial statements as a reduction to the carrying value of the related asset or recorded as a liability (i.e., treated as deferred income). The benefit of the ITC is then recognized over the life of the related asset either as a reduction to depreciation expense or as other income. The ITC is therefore not recognized directly as a reduction to income tax expense. Temporary differences may arise when the financial statement carrying amount of the acquired asset is reduced, when a deferred credit is recorded or if the ITC results in a statutory reduction in the tax basis of the related asset.
- **Flow-through Method:** The ITC is recognized as a reduction to income taxes payable (or an increase in income taxes receivable or a deferred tax asset if the credit is carried forward to future years, subject to any required valuation allowance) for the year in which the credit arises. At the same time, income tax expense is reduced for the same amount within the financial statements. Temporary differences generally occur under the flow-through method only if a statutory reduction in tax basis of the asset acquired occurs.

Entities may select one of two permitted accounting policies to record the deferred tax assets or liabilities resulting from ITCs. The selected accounting policy must be applied consistently to all ITCs. One accounting policy is an asset (liability) method, where the entity records the offset to the deferred tax asset (DTA) or DTL by adjusting the carrying value of the asset acquired or the deferred liability that was initially set up for the ITC. The entity uses an iterative formula to calculate the final carrying amount of the asset or the deferred liability. The second accounting policy is an income statement approach, where the entity records the offset to the DTA or DTL to income tax expense.

5 Additional guidance

5.1 Common temporary differences

5.1.1 Accounts Receivable/Allowances for expected credit losses

Taxable book to tax differences generally arise when the entity uses the accrual method for book purposes and the cash method for tax purposes. Deductible temporary differences would also arise when the entity uses the accrual method for both book and tax purposes, but allowances for expected credit losses are not deductible for tax purposes.

5.1.2 Inventory

Deductible temporary differences generally arise when the entity capitalizes certain costs for tax purposes pursuant to tax laws that are not permitted to be capitalized for financial statement purposes. Deductible temporary differences also arise when an entity records inventory valuation reserves for book purposes, such as lower of cost or market and obsolescence reserves, which are typically not allowed for tax purposes. While a lower of cost or market method does exist under tax law, it is rarely used in practice and differs significantly from the GAAP approach.

5.1.3 Fixed assets

Taxable or deductible temporary differences generally arise when the entity uses different depreciable lives or methods for book purposes and tax purposes (e.g., straight line method for book purposes and accelerated methods for tax purposes). Deductible temporary differences also arise since impairment losses for book purposes are not allowed for tax purposes. Taxable or deductible temporary differences may also result due to differences in costs capitalized for book purposes in accordance with GAAP and tax purposes, in accordance with tax regulations (e.g., differences in depreciation expense, investment tax credits, capitalized interest).

5.1.4 Compensation accruals

Deductible temporary differences (which result in deferred tax assets) may arise for accruals not allowed for tax purposes or, when accruals are allowed for tax purposes, such accruals may be different from the amount accrued for book purposes.

The following example illustrates certain common temporary differences.

Example 5-1: Common Temporary Differences

ABC Company (ABC) prepared its tax return prior to finalizing its financial statements and the balances below were obtained from ABC's general ledger and tax return as of and for the year ended December 31, 20X3.

ABC also provided the following information:

- ABC used the accrual method to record revenue for book and tax purposes. ABC also estimated expected credit losses on its accounts receivable for book purposes.
- ABC capitalized certain costs to inventory pursuant to tax regulations that it was not permitted to capitalize for book purposes. ABC also recorded inventory valuation reserves to reflect excess and slow-moving inventory for book purposes.
- ABC depreciated its assets over the same useful lives for book and tax purposes but used accelerated methods to depreciate for tax purposes and straight-line methods for book purposes.
- ABC accrued bonuses for book purposes which are generally not deductible for tax purposes until paid.

	Book Balance Debit (Credit)	Tax Return Balance Debit (Credit)	Temporary Difference Debit (Credit)	Deductible or Taxable
Accounts Receivable	$4,500,000	4,500,000	-	N/A
Allowance for expected credit losses	(500,000)	-	500,000	Deductible
Inventory	8,000,000	9,125,000	1,125,000	Deductible
Inventory reserve	(2,000,000)	-	2,000,000	Deductible
Property and equipment	7,000,000	7,000,000	-	N/A
Accumulated depreciation	(1,000,000)	(2,500,000)	(1,500,000)	Taxable
Accrued bonus	(1,100,000)	-	1,100,000	Deductible

Deductible temporary differences resulted from amounts that were recorded as book expense but were not deducted on the tax return. Taxable temporary differences resulted from amounts that were deducted on the tax return but were not recorded on the books.

5.2 Business combinations

5.2.1 Taxable vs. nontaxable business combinations

Business combinations are considered either taxable or nontaxable business combinations for income taxes, which is determined at the entity level. Some business combinations may also be partially taxable; these are further discussed in Section 5.2.1.3.

5.2.1.1 Taxable business combinations

Taxable business combinations are taxable to the target because the assets, and often the liabilities, are sold and assigned to the buyer. The target pays income tax on the transaction and the buyer's tax basis in the assets and liabilities are stepped up, generally to fair value. These business combinations are often referred to as asset deals.

Purchases of partnership interests or limited liability company (LLC) interests also generally result in taxable business combinations. Additionally, under certain circumstances, the U.S. Internal Revenue Code allows companies to elect to treat certain business combinations that are structured as sales of entities (e.g., the sale of stock in an entity) as a purchase of assets by the buyer. One such election is a section 338 election (either a section 338(h)(10) election, which is a joint election between a buyer and seller, or a section 338(g) election, which is a unilateral election by a buyer). Consequently, the purchase of the stock of C Corporations or S Corporations, when combined with certain tax elections, could also result in a taxable business combination

Taxable business combinations will have few temporary differences because the book basis and tax basis of the acquired assets and liabilities will generally be the same amounts for most assets and liabilities. However, some differences may result in areas, such as revenue recognition and contingent consideration, where the treatment for book purposes differs from the tax treatment. Additionally, certain acquisitions include agreements between a buyer and seller of the allocation of the purchase price among the acquired assets and liabilities for tax purposes such that the allocation to individual assets and liabilities may differ for book and tax purposes.

5.2.1.2 Nontaxable business combinations

Nontaxable business combinations are generally not taxable to the target because the ownership interests (i.e., C corporation shares) are sold to the buyer. These business combinations are often referred to as stock deals.

Nontaxable business combinations will often result in many temporary differences because the tax basis of the assets and liabilities of the target will be the same after the acquisition as they were before the acquisition (i.e., carryover basis is used for tax purposes), while the book basis will be based predominantly on the acquisition-date fair values of the assets and liabilities of the target as required by ASC 805.

The major distinction between a taxable and nontaxable business combination is that a taxable business combination results in the buyer acquiring a tax basis in the acquired assets and liabilities that is equal to the consideration that is paid for those assets and liabilities, while a nontaxable business combination generally results in the buyer acquiring the historical tax basis in the acquired assets and liabilities.

5.2.1.3 Partially taxable business combinations

Business combinations may also be a combination of a taxable and nontaxable transaction. This is common when the seller receives a “roll-over” interest in an acquiring company, which is structured as a tax-deferred rollover. In such business combinations, there is a combination of carryover tax basis for the rollover interest and a new tax basis for the remainder of the business combination. Additionally, when the business combination involves entities in multiple jurisdictions, differences in tax legislation among jurisdictions may cause the same business combination to be taxable in some jurisdictions and nontaxable in others.

> **RSM COMMENTARY: Exceptions to recording temporary differences**
>
> There are certain exceptions to recording temporary differences for differences between the book basis and tax basis of acquired assets and liabilities; these exceptions relate to non-deductible goodwill. No deferred taxes are recorded for the portion of book goodwill for which amortization is not deductible for tax purposes, leveraged leases and certain outside basis differences that are beyond the scope of this publication.

5.2.1.4 Important considerations for pass-through entities

Partnerships, LLCs taxed as partnerships and entities that have elected S Corp status (collectively referred to as pass-through entities) do not pay U.S. federal income taxes but rather pass the tax liability to the owners. The term “taxable” in the context of business combinations does not refer to the taxpaying status of the buyer but rather the tax structure of the business combination.

Furthermore, when financial statements are prepared in conformity with U.S. GAAP, a pass-through entity must report income taxes related to any subsidiary included in its consolidated financial statements that is not a pass-through entity. Thus, deferred taxes may be recorded at the pass-through entity level as a result of basis differences existing at their consolidated subsidiaries after a business combination. Therefore, it is important to consider the full consolidated tax structure of both the buyer and the acquired entity when considering the impact of income taxes on the business combination.

In summary, the term “taxable” in business combinations involving pass-through entities relates to the tax implications of the business combination in itself rather than the tax status of the buyer and the acquired entities, because business combinations involving consolidated subsidiaries must be considered.

5.2.2 Illustration- Temporary differences in a nontaxable business combination

The following example illustrates temporary differences in a nontaxable business combination.

Example 5-2: Temporary Differences in a Non-Taxable Business Combination

ABC Company purchased XYZ Company (XYZ) on January 1, 20X3, and accounted for the business combination pursuant to ASC 805 and recorded the acquired assets and liabilities of XYZ Company at their fair values. The business combination was structured as a nontaxable transaction.

ABC Company provided the following additional information:

- XYZ Company's prior year (December 31, 20X2) tax return indicated an inventory value of $4,995,000, a property and equipment value of $7,000,000 and an intangible asset value of zero.
- ABC Company's third-party valuation of XYZ indicated an inventory value of $6,350,000, a property and equipment value of $15,000,000 and an intangible asset value of $12,000,000.

The following table illustrates the book and tax basis of the above acquired assets and the resulting temporary differences.

	Book Basis	Tax Basis	Temporary Difference	Deductible or Taxable
Inventory	$6,350,000	4,995,000	(1,355,000)	Taxable
Property and equipment	15,000,000	7,000,000	(8,000,000)	Taxable
Identified intangible assets	12,000,000	-	(12,000,000)	Taxable

In this case, ABC Company identified taxable temporary differences due to fair value adjustments that increased the book basis of inventory, property and equipment, and intangible assets but did not affect the historical tax basis of such assets.

5.2.3 Illustration- Temporary differences in a taxable business combination

The following example illustrates temporary differences in a taxable business combination.

Example 5-3 Temporary Differences in a Taxable Business Combination

ABC Company formed a new wholly owned subsidiary and acquired certain assets and liabilities of XYZ Company on January 1, 20X3. ABC Company accounted for the transaction pursuant to ASC 805 and thus recorded the acquired assets and liabilities of XYZ Company at their fair values. Such business combination was structured as a taxable business combination.

ABC Company provided the following additional information:

- The third-party valuation of XYZ Company's acquired assets and liabilities showed an inventory value of $6,350,000, a property and equipment value of $15,000,000 and an intangible asset value of $12,000,000.

The following table illustrates the book and tax basis of the above acquired assets and the resulting temporary differences.

	Book Basis	Tax Basis	Temporary Difference	Deductible or Taxable
Inventory	$6,350,000	6,350,000	-	N/A
Property and equipment	15,000,000	15,000,000	-	N/A
Identified intangible assets	12,000,000	12,000,000	-	N/A

In this case, ABC Company did not identify any temporary differences because both the book and tax basis of the acquired assets were adjusted to fair value.

RSM COMMENTARY: Temporary differences in taxable business combinations

In certain cases, even in taxable business combinations, the values assigned for tax purposes may differ from those assigned for book purposes. Two common examples are:

- Buyer and seller agree to an allocation of purchase price for tax purposes that is different than the fair values assigned for book purposes.
- Target's revenue recognition policies differ for book and tax purposes, resulting in either deferred or unbilled revenue for book purposes that differs from the amounts for tax purposes.

Entities should therefore carefully consider the facts and circumstances specific to the business combination rather than assume that there are no temporary differences resulting from taxable business combinations.

Appendix A: Acronyms

Acronym	Definition
ASC	Accounting Standards Codification
DTA	Deferred Tax Asset
DTL	Deferred Tax Liability
ETR	Effective Tax Rate
FASB	Financial Accounting Standards Board
ITC	Investment Tax Credits
LLC	Limited Liability Company
NOL	Net Operating Loss
U.S GAAP	U.S. Generally Accepted Accounting Principles

Appendix B: Definitions

Several terms with specific meaning are used throughout this publication. Those terms and the corresponding definitions based on the FASB's Master Glossary of the Codification are provided in the table that follows.

Term	Definition
Carrybacks	Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.
Carryforwards	Deductions or credits that cannot be utilized on the tax return during a yeahat may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.
Current Tax Expense (or 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 or excess of deductions over revenues for that year.

Term	Definition
Deductible Temporary Difference	Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference.
Deferred Tax Asset	The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.
Deferred Tax Liability	The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.
Event	A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity.
Income Tax Expense (or Benefit)	The sum of current tax expense (or benefit) and deferred tax expense (or benefit).
Income Taxes	Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.
Income Taxes Currently Payable (Refundable)	See Current Tax Expense (or Benefit).
Tax Consequences	The effects on income taxes—current or deferred—of an event.
Tax Position	A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to: a. A decision not to file a tax return b. An allocation or a shift of income between jurisdictions c. The characterization of income or a decision to exclude reporting taxable income in a tax return d. A decision to classify a transaction, entity, or other position in a tax return as tax exempt e. An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.
Taxable Income	The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.

Term	Definition
Taxable Temporary Difference	Temporary differences that result in taxable amounts in future years when the related asset is recovered or the related liability is settled. See Temporary Difference.
Temporary Difference	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. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 740-10-25-25), 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.
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.

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