ACCOUNTING FOR INCOME TAXES - CURRENT AND DEFERRED TAXES

November 2025

OVERVIEW

This Financial Reporting Insights is intended to be used as a resource in understanding and analyzing the accounting for current taxes payable or refundable, deferred tax assets (DTAs), and deferred tax liabilities (DTLs), which form the basis for the income tax amounts recorded on an entity's financial statements. The amounts recorded in the income statement are generally the differences between the income tax amounts on the current year and prior year balance sheets. This publication also discusses the effective tax rate reconciliation disclosure requirements.

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.

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 that 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 or benefit reflected 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 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).

Current taxes payable (refundable) may also be impacted by available tax credits, adjustments to prior year tax liabilities that become known in the current year (i.e., return to provision adjustments), and income tax payments made, or refunds received during the year. The current taxes payable or refundable amount appearing on an entity's balance sheet at the end of the year represents the gross income tax payable or refundable, as adjusted for any payments made or refunds received during the year. The deferred tax asset or liability amounts appearing on an entity's balance sheet at the end of the year represent the future tax consequences of temporary differences and carryforwards.

1.1 Measuring income taxes payable

ASC 740-10-30-2

The following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

a. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

b. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

ASC 740-10-30-3

Total income tax expense (or benefit) for the year is the sum of deferred tax expense (or benefit) and income taxes currently payable or refundable.

The measurement and recognition of total income taxes requires an understanding of a few concepts, including identification of permanent and temporary differences, operating losses and tax credit carryforwards, and determining the applicable tax rate. These concepts can be complex and have specific rules to consider as outlined under ASC 740. Refer to our publications, Accounting for income taxes: Book vs. tax basis differences and Accounting for income taxes: Determining the applicable tax rate for further discussion.

Most revenue and expense transactions that are included in pretax 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 deducted 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.

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

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 but have been reflected in the income tax return based on provisions of the tax law.

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. 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.

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 income taxes previously paid. These tax laws vary by jurisdiction and may be complex. ASC 740 requires that entities consider the tax laws and any related limitations on use of net operating loss (NOL) and tax credit carryforwards.

The following example illustrates the process for identifying temporary differences and operating loss and tax credit carryforwards.

Example 1-1: Identify temporary and permanent differences and operating loss and tax credit carryforwards

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 is 50% was deemed deductible but only $25,000 is included as expenses for tax purposes.

ABC Company's book income will exceed its taxable (or tax return) income by $75,000 ($100,000-$25,000) because of the permanent differences identified above.

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 book balance of the inventory reserve was $7,250,000 at the end of 20X2 as compared to $6,750,000 at the end of 20X1.
- The accrued compensation (book) balance was $3,500,000 as of December 31, 20X2 (of which $0 was deemed deductible), as compared to a book balance of $1,000,000 as of December 31, 20X1 (of which $0 was deemed deductible). The tax balance of accrued compensation as of December 31, 20X2, and 20X1 was $0.
- The accrued bonus (book) balance was $4,250,000 as of December 20X2 (of which $0 was deemed deductible), as compared to a book balance of $2,750,000 as of December 31, 20X1 (of which $0 was deemed deductible). The tax balance of accrued bonus as of December 31, 20X2, and 20X1 was $0.
- The cumulative accumulated depreciation for tax purposes at the end of 20X2 was $19,000,000 as compared to $16,000,000 at the end of 20X1.The cumulative accumulated depreciation for book purposes at the end of 20X2 was $9,000,000 as compared to $8,000,000 at the end of 20X1.

- ABC Company has a NOL carryforward of $2,000,000, which was fully used in 2022.

Below is a summary of ABC Company's cumulative deductible (taxable) temporary differences as of December 31, 20X2, and 20X1 and the related change in such temporary differences:

	December 31, 20X2	December 31, 20X1	Year to year Change
Allowance for expected credit losses	$1,450,000	$1,000,000	$450,000
Inventory reserve	7,250,000	6,750,000	500,000
Accrued compensation	3,500,000	1,000,000	2,500,000
Accrued bonuses	4,250,000	2,750,000	1,500,000
Accumulated depreciation-Tax	(19,000,000)	(16,000,000)	(3,000,000)
Accumulated depreciation-Book	9,000,000	8,000,000	1,000,000
Net operating loss carryforward	-	2,000,000	(2,000,000)
Total temporary differences	**$6,450,000**	**$5,500,000**	**$950,000**

The above items are temporary differences, as these amounts will be deductible or taxable for ABC Company in the future.

An entity considers the jurisdictions where it conducts business in order to determine its applicable tax rate. Entities may be subject to income taxes in multiple tax jurisdictions and at different tax rates. State or foreign taxes may be deducted when calculating the U.S. federal income tax rate; therefore, there is a federal income tax benefit for amounts paid to state or foreign jurisdictions.

Entities may use only enacted tax rates to determine the total income tax expense (benefit). Enacted tax rates are defined as tax rates for each applicable jurisdiction that have been signed into law. ASC 740 requires an entity to recognize changes in tax law once the enactment date has occurred. The effective date of the tax law may sometimes occur after the date of the enactment. In such cases, different rates may be applicable to the current and deferred tax calculations as of a reporting date. Refer to "Accounting for income taxes: Determining the applicable tax rate" for further discussion of changes in tax rates.

2. Current taxes payable or refundable

ASC 740-10-25-18

Income taxes currently payable for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year.

ASC 740-10-25-2

Other than the exceptions identified in the following paragraph, the following basic requirements are applied in accounting for income taxes at the date of the financial statements:

a. A tax liability or asset shall be recognized based on the provisions of this Subtopic applicable to tax positions, in paragraphs 740-10-25-5 through 25-17, for the estimated taxes payable or refundable on tax returns for the current and prior years.

b. A deferred tax liability or asset shall be recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

ASC 740-10-25-2 states that the current income tax payable or refundable is determined by applying the provisions of the enacted tax law to the taxable income or loss for the year. An entity would also consider tax positions it has taken or expects to take and whether such a position is more likely than not to be sustained upon examination or based on its technical merits. The more likely than not recognition criteria is not covered in this white paper; see ASC 740-10-25-5 to ASC 740-10-25-14 for further information related to uncertain tax positions.

See Section 1.1 for a discussion of enacted tax rates.

Current taxes payable (refundable) is a balance sheet amount which is calculated as follows:

- Applying the enacted tax rate to the entity's taxable income (loss) for the year
- Adding the prior year current tax payable (refundable)
- Subtracting payments (refunds) during the year

Current taxes payable (refundable) also includes adjustments which are generally referred to as return-to-provision (RTP) adjustments. See Chapter 4 for further discussion of RTP adjustments.

Example 2-1: Calculating current taxes payable (refundable)

As noted in Example 1-1 and Example 1-2, for the year ended December 31, 20X2, ABC Company has permanent differences of $75,000 that decrease taxable income, temporary differences of $950,000 that increase taxable income and a blended U.S. federal and state effective rate of 25%. In addition, ABC Company has pretax book income of $50,000,000 and had current taxes payable of $5,000,000 as of December 31, 20X1. ABC Company made income tax payments of $10,000,000 during 20X2.

The following table computes ABC Company's current taxes payable (refundable) as of December 31, 20X2:

	Amount
Pretax book income-year ended December 31,20X2	$50,000,000
Permanent differences- year ended December 31,20X2	(75,000)
Temporary differences- year ended December 31,20X2	950,000
Taxable income- year ended December 31, 20X2	50,875,000
Blended federal and state tax rate- year ended December 31, 20X2	25%
Current tax expense- year ended December 31, 20X2	12,718,750
Add: Current taxes payable- beginning of year	5,000,000
Less: Income tax payments made during the year	(10,000,000)
Current taxes payable (refundable)- end of year	**$7,718,750**

As demonstrated above, the end of the year current taxes payable is the sum of the balance at the beginning of the year and the current year activity, which is comprised of the current tax expense reported on ABC Company's tax return and any payments made during the year.

3. Deferred tax assets and liabilities

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 740-10-30-5

Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify the types and amounts of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.

b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (see paragraph 740-10-30-8).

c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.

d. Measure deferred tax assets for each type of tax credit carryforward.

e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

ASC 740-10-30-8

Paragraph 740-10-10-3 establishes that the objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Deferred taxes shall not be accounted for on a discounted basis.

ASC 740 requires a balance sheet approach to income tax accounting and assumes that assets and liabilities on the balance sheet will eventually be recovered and settled, respectively, at their reported amounts. The deferred tax expense (benefit) is the change in the deferred tax balances from the beginning to end of the year. ASC 740-10-30-5 outlines a five-step approach to determine the deferred tax asset and liability balances:

1. Identify the types and amounts of existing temporary differences, the nature and amount of each type of operating loss and tax credit carryforward, and the remaining length of the carryforward period.

2. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate.

3. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.

4. Measure deferred tax assets for each type of tax credit carryforward.

5. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

A temporary difference is created when an item is treated differently for financial statement and tax return purposes in the same period, provided that the difference is expected to reverse in a future period. A deferred tax asset or liability is computed by multiplying the applicable tax rates by the difference between the book basis and the tax basis of the asset or liability. Because of this assumption, a difference between the tax basis of an asset or a liability and its reported amount in the financial statements will eventually result in a taxable or deductible amount in future years.It may appear logical that deferred tax accounting would give some consideration to the time value of money, because a deduction today may be worth more than a deduction in the future; however, present valuing or discounting when measuring deferred taxes is prohibited by ASC 740.

Applicable tax rates for deferred taxes, as noted in ASC 740-10-55-23, are the enacted tax rates expected to be applied to taxable income in the periods and jurisdictions in which the deferred tax assets or liabilities are expected to be realized or settled, respectively. Refer to our publication, Accounting for income taxes: Determining the applicable tax rate for further discussion on enacted tax rates.

Deferred tax liabilities are measured as the total taxable temporary difference multiplied by the tax rate expected to apply to the taxable income in the periods in which the deferred tax liability is expected to be settled.

Deferred tax assets are similarly measured as the total deductible temporary difference and any NOL carryforwards multiplied by the tax rate expected to apply to the taxable income in the periods in which the deferred tax asset or NOL carryforward is expected to be realized. Deferred tax assets also include tax credit carryforwards which are not multiplied by an applicable tax rate as they are already tax-affected.

In certain cases, an entity may need to schedule or assess when temporary differences may reverse. Scheduling future taxable income is generally relevant when assessing the need for a valuation allowance. This topic is outside of the scope of this publication, See Accounting for income taxes: Valuation allowance for further information regarding assessing the need for valuation allowances.

ASC 740-10-10-3 discusses other situations which may also require scheduling, specifically when changes to tax rates have been enacted but will only become effective in the future. In this case, entities would need to prepare an analysis that projects the periods where the temporary difference will reverse, as the applicable rate for deferred taxes may fluctuate depending on when the temporary difference is expected to reverse. Scheduling may also be required in years where graduated tax rates are applied, since the rates applied to the temporary differences will vary based on the estimated timing of the reversal of such differences.

3.1 Phased-in Changes in Tax Rates

The following example illustrates the impact of changes to enacted tax rates on deferred tax assets and liabilities.

Example 3-1: Phased-in Changes in Tax Rates (ASC 740-10-55-129 to 55-130)

Example 14: Phased-In Change in Tax Rates

This Example illustrates the guidance in paragraph 740-10-55-23 for determination of the tax rate for measurement of a deferred tax liability for taxable temporary differences when there is a phased-in change in tax rates. At the end of Year 3 (the current year), an entity has $2,400 of taxable temporary differences, which are expected to result in taxable amounts of approximately $800 on the future tax returns for each of Years 4-6. Enacted tax rates are 35 percent for Years 1-3, 40 percent for Years 4-6, and 45 percent for Year 7 and thereafter.

The tax rate that is used to measure the deferred tax liability for the $2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of those temporary differences is on taxes payable for Years 1-3, Years 4-6, or Year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in Years 4-6. If tax losses are expected in Years 4-6, however, the tax rate is:

- 35 percent if realization of a tax benefit for those tax losses in Years 4-6 will be by loss carryback to Years 1-3
- 45 percent if realization of a tax benefit for those tax losses in Years 4-6 will be by loss carryforward to Year 7 and thereafter.

RSM COMMENTARY:

This example demonstrates how to apply the enacted tax rate that is expected in the years that the taxable temporary differences are expected to reverse when calculating deferred tax liabilities. It also illustrates additional considerations when future taxable losses are expected.

In this example:

- If the entity expects income in years 4 through 6, then it applies the 40% applicable rate to the cumulative temporary differences, resulting in a deferred tax liability of $960.
- If the entity expects losses in years 4 through 6 but may carry back these losses to years 1 through 3 (which is no longer available under U.S. Federal Tax Law), the entity applies the 35% applicable tax rate from years 1 through 3 to the cumulative temporary differences, resulting in a deferred tax liability of $840.
- If the entity predicts losses in years 4 through 6 but does not have the ability to carryback such losses, then it applies the 45% applicable rate to the cumulative taxable temporary differences, resulting in a deferred tax liability of $1,080.

3.2 Measuring the net deferred tax asset (liability)

The following example illustrates the calculation of deferred tax assets and liabilities.

Example 3-2: Measuring the net deferred tax asset (liability)

ABC Company is a U.S. taxpaying entity which conducts its business activities in a single state. The applicable federal and state tax rates are 21% and 5%, respectively. ABC Company also provides the following financial information:

- The balance in the allowance for expected credit losses was $1,450,000 at December 31, 20X2, as compared to $1,000,000 at December 31, 20X1.
- The balance in the inventory reserve was $7,250,000 at December 31, 20X2, as compared to $6,750,000 at December 31, 20X1.
- The balance in the compensation accrual was $3,500,000 at December 31, 20X2, as compared to $1,000,000 at December 31, 20X1. None of the accrued amounts were deductible as of either year end.

- The balance in the accrued bonus was $4,250,000 at December 31, 20X2, as compared to $2,750,000 at December 31, 20X1. No portion of the accrued bonus was paid timely to qualify for a tax deduction in the year of the accrual.
- The cumulative accumulated depreciation for tax purposes at December 31, 20X2, was $19,000,000 as compared to $16,000,000 at December 31, 20X1.
- The cumulative accumulated depreciation for book purposes at December 31, 20X2, was $9,000,000 as compared to $8,000,000 at December 31, 20X1.
- ABC Company has a pre-2017 NOL carryforward of $2,000,000 which will expire on December 31, 20X3, which was considered a temporary difference as of December 31, 20X1 and used in 20X2.

ABC Company calculates the deferred tax assets and liabilities as of December 31, 20X2, in the schedule below.

(Notes 1 & 2)	Cumulative (taxable) deductible temporary difference	Effective tax rate	Deferred tax asset (liability)
Accumulated depreciation (accelerated) for tax purposes	$(19,000,000)	25%	($4,750,000)
Accumulated depreciation for book purposes	9,000,000	25%	2,250,000
Allowance for expected credit losses	1,450,000	25%	362,500
Inventory reserve	7,250,000	25%	1,812,500
Accrued bonuses	4,250,000	25%	1,062,500
Accrued vacation	3,500,000	25%	875,000
Net operating loss carryforward	-	25%	-
Total	**$6,450,000**		**$1,612,500**

Note 1: This table does not include any realizability considerations related to the deferred tax asset (i.e., whether a valuation allowance is required). Such considerations are beyond the scope of this publication. Please see Accounting for income taxes: Valuation allowance for further discussion.

Note 2: ASC 740 requires net presentation of deferred tax liabilities and assets within a taxpaying jurisdiction on a single line as a long-term asset or liability. Deferred tax assets and liabilities arising from different jurisdictions should be shown separately (i.e., a deferred asset related to the U.S. should not be netted against a deferred tax liability related to a foreign jurisdiction).

3.3 Measuring deferred tax expense

Deferred tax expense is generally the change between the beginning and end of period deferred tax assets or liabilities balance. In some cases, notably in business combinations, there may be additional changes between the beginning and end of period deferred tax asset and liability balances that would not be reflected in deferred tax expense. The tax impact of business combinations is beyond the scope of this publication.

Example 3-3: Measuring deferred tax expense

ABC Company is a U.S. taxpaying entity which conducts its business activities in a single state. The applicable federal and state tax rates are 21% and 5%, respectively. ABC Company calculates its deferred tax expense using the December 31, 20X2, deferred tax assets and liabilities from Example 3-2 and the December 31, 20X1, deferred tax assets and liabilities from their prior year schedules.

(Note 1)	Deferred Tax Asset (Liability) -2022	Deferred Tax Asset (Liability) -2021	Deferred Tax Expense (Benefit) -2022
Allowance for credit losses	$362,500	$250,000	($112,500)
Inventory reserve	1,812,500	1,687,500	(125,000)
Accrued compensation	875,000	250,000	(625,000)
Accrued bonuses	1,062,500	687,500	(375,000)
Accumulated depreciation for tax purposes	(4,750,000)	(4,000,000)	750,000
Accumulated depreciation for book purposes	2,250,000	2,000,000	(250,000)
Net operating loss carryforward	-	500,000	500,000
Total	**$1,612,500**	**$1,375,000**	**($237,500)**

Note 1: This example assumes that there were no business combinations that occurred during the year.

3.4 Measuring total income tax expense

Income tax expense for the period includes the current tax payable (refundable) and the future tax consequences of items included in different periods in the financial statements and the income tax returns. Total income tax expense, therefore, reflects the tax effect of all items within book income, whether or not the tax effects are reported in the tax return in that period.

Example 3-4: Total income tax expense

ABC Company is a U.S. taxpaying entity which conducts its business activities in a single state. The applicable federal and state tax rates are 21% and 5%, respectively. ABC Company's total income tax expense is the sum of current tax expense (calculated in Example 2-1) and deferred tax benefit (calculated in Example 3-3). The following table calculates total income tax expense.

	Amount
Current tax expense	$12,718,750
Deferred tax expense (benefit)	(237,500)
Total income tax expense	**$12,481,250**

4. Changes in estimates or errors

Generally, financial statements are issued before the tax returns are prepared and filed. Therefore, there may be differences between the current tax amounts recorded within the financial statements and the amounts reported on the tax return. Such differences are known as return to provision adjustments or RTP adjustments. Entities must consider whether these adjustments are changes in accounting estimates or error corrections in accordance with ASC 250.

Entities may estimate certain amounts to close their books on a timely basis. Such estimates would be based on information available at the time. Under ASC 250, if the entity had a reasonable basis for its estimate, and any subsequent information was not readily available at the time the entity closed its books, the adjustment would typically be a change in estimate. An adjustment of a prior-period income tax payable due to new information or later identification of information that was not known or knowable prior to the issuance of the financial statements would generally be a change in estimate. These changes in estimate are accounted for either in the period of change or prospectively (ASC 250-10-45-17).

Example 4-1: RTP Adjustments

On February 5, 2023, ABC Company issued its financial statements for the year ended December 31, 20X2. Key tax amounts included within the financial statements are reflected in Example 3-2 and Example 3-3. ABC Company also prepared and filed its tax return on September 15, 20X3.

Subsequent to filing its tax return, ABC Company noted the following differences between the income tax amounts reflected within the financial statements and the tax return:

- On February 10, 2023, ABC Company's board of directors approved disbursing $500,000 of the accrued bonuses to the financial personnel on February 14, 2023. The remainder of the accrued bonuses were paid on March 31, 20X3. The payment of the accrued bonus on February 15, 2023, reduced the temporary difference since the amount became deductible in 20X2.
- The cumulative accumulated depreciation for tax purposes included in the tax return was $19,327,000 as compared to $19,000,000 included in the financial statements. This difference was primarily due to estimating the last month of additions by asset class when developing the amounts included in the financial statements. Actual additions were included in the tax return.

The net impact of these two RTP adjustments is illustrated below.

	Cumulative temporary differences - per income tax return	Cumulative temporary differences - per financial statements	Effect on deferred taxes Debit (credit)
Accumulated depreciation (tax)	($19,327,000)	($19,000,000)	($327,000)
Accumulated depreciation (book)	9,000,000	9,000,000	-
Accrued bonuses	3,750,000	4,250,000	(500,000)
Total	($6,577,000)	($5,750,000)	($827,000)
Effective tax rate	N/A	N/A	25%
Increase in DTL	N/A	NA	($206,750)

ABC Company considered both the timing of the board decision to accelerate the payment of the bonuses and the nature and amount of the accumulated depreciation difference. ABC Company concluded that when its financial statements were issued, it had a reasonable basis for its original accumulated depreciation estimates and it was unaware of the board decision to accelerate a portion of the bonus payment. Therefore, ABC Company considered these adjustments to be changes in estimates.

An adjustment of a prior period income tax payable due to information that was either known or knowable prior to the issuance of the financial statements may be considered an error. If material, error corrections are accounted for by restating the prior-period financial statements (ASC 250-10-45-23). Examples of errors may include:

- The entity's taxes payable included a calculation error; for example, a permanent difference was treated as a temporary difference or deducted twice from taxable income.
- Despite information being readily available, the entity estimated an amount, and that estimate was significantly different from the actual amount.
- The entity did not appropriately apply the provisions of ASC 740 to facts and circumstances that were known or knowable at the time of the issuance of the financial statements.

The above examples are not all-inclusive. Consideration of whether an RTP adjustment is a change in estimate, or an error requires significant judgment and careful consideration of all the relevant facts and circumstances.

5. Exceptions to the comprehensive model for recognizing deferred taxes

ASC 740-10-25-3 details exceptions to the comprehensive model for recognizing deferred taxes. The comprehensive model requires the recognition of deferred tax assets (DTAs) and deferred tax liabilities (DTLs) for temporary differences between the financial reporting and tax bases of assets and liabilities. Such exceptions include items for which the recognition of a DTA or DTL is prohibited.

5.1 Specific exemptions

As noted in section ASC 740-10-25-3(a), a deferred tax liability would not be recorded for the specific temporary differences listed in that section unless it becomes apparent that they will reverse in the foreseeable future. Therefore, a deferred tax liability is not recognized for temporary differences unless it becomes apparent that those temporary differences will reverse (i.e., be realized or settled) in the foreseeable future. Deferred tax liabilities which would not be recorded are:

- An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture that is essentially permanent in duration. (A corporate joint venture is a corporation owned and operated by a small group of investors for the mutual benefit of the venturers who have an interest or relationship other than passive investors. An entity that is a subsidiary of one of the venturers is not a corporate joint venture for this purpose. Further, the life of the joint venture may not be limited by the nature of the venture or other business activity.)
- Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in years beginning on or before December 15, 1992. (A last-in, first-out pattern determines whether reversals pertain to differences that arose in years beginning on or before December 15, 1992.)
- Bad debt reserves for tax purposes of thrifts (stock or mutual savings and loan associations and mutual savings banks) that arose in tax years beginning before December 31, 1987 (the base-year amount).

- Policyholders' surplus of stock life insurance companies that arose in years beginning on or before December 15, 1992.

The above exceptions are absolute and specific and may not be applied to other types of temporary differences. The most common item referenced in the section above relates to outside basis differences as discussed in Section 5.2.

Additionally, ASC 740-10-25-3 provides additional exceptions to recording deferred tax liabilities which include leveraged leases, nondeductible goodwill, intercompany profit on transfers of inventory and foreign currency fluctuations, which are discussed in Section 5.3 through Section 5.6.

5.2 Outside basis differences

ASC 740-30-25-7

Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference shall be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free, and the entity expects that it will ultimately use that means. For example, tax law may provide that:

a. An entity may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent entity's tax basis for the stock of that subsidiary.

b. An entity may execute a statutory merger whereby a subsidiary is merged into the parent entity, the noncontrolling shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business entity, and certain other requirements of the tax law are met.

ASC 740-30-25-8

Some elections for tax purposes are available only if the parent owns a specified percentage of the subsidiary's stock. The parent sometimes may own less than that specified percentage, and the price per share to acquire a noncontrolling interest may significantly exceed the per-share equivalent of the amount reported as noncontrolling interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the noncontrolling interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the noncontrolling interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

ASC 740-30-25-9

A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future.

The general rule in ASC 740 related to investments in domestic subsidiaries is that a deferred tax liability would be recognized for the excess of the basis for financial reporting purposes in a subsidiary over the tax basis of such investment in the subsidiary. However, the deferred tax liability does not have to be recognized if the tax law provides a means by which the basis difference can be recovered on a tax-free basis. For example, under the U.S. federal tax law, a basis difference in an 80% or more owned subsidiary can be recovered through a tax-free liquidation. If a taxpaying entity intends to recover its investment basis in this manner, then the deferred tax liability would not need to be recorded.

ASC 740-30-25-9 discusses the recognition of deferred taxes for outside tax-basis differences in investments in subsidiaries or corporate joint ventures. Outside tax basis differences are differences in the book basis and tax basis of an investment. For example, an entity may have an investment in a consolidated subsidiary, which is the book basis, while the subsidiary's stock basis is the tax basis. Differences between these two bases are considered outside tax basis differences. A deferred tax asset is recognized for the excess of the tax basis over the book basis for an investment that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. Entities would then need to assess whether a valuation allowance would be needed on the deferred tax asset.

5.2.1 Measuring outside basis of investments in partnerships

While partnerships are generally not subject to entity-level income taxes as described in ASC 740, a taxable entity with an investment in a partnership must account for the current and deferred tax obligations arising from its investment in the partnership. Accordingly, for deferred tax purposes, a deferred tax asset or liability would be recorded for the book and tax basis differences on the investment in partnership. Outside basis differences for partnerships are not addressed under ASC 740-30-25-7 through 25-9 and, accordingly, investors in partnerships would be subject to the general rules in ASC 740 regarding DTAs and DTLs for basis differences.

In practice, we believe there are two acceptable views on measuring effect of the basis difference when the book basis exceeds the tax basis of a taxable entity's investment in a partnership. The first approach would be to record a deferred tax liability for the entire outside basis difference (i.e., the book and tax basis difference). In this case, deferred taxes are measured based on the entire outside basis difference in the partnership investment, because an entity is generally unable to recover its investment in the partnership without incurring tax consequences.

The second approach, typically referred to as the "look-through" approach, allows a taxable entity to look through to the underlying partnership items and apply the exceptions under ASC 740-10-25-3 (discussed above) when measuring the amount of the deferred tax liability to record. Using this look-through method, an entity may exclude any deferred tax liabilities related to the portion of the outside basis difference attributable to a temporary difference that, under the exceptions in ASC 740, would not have been recognized (e.g., nondeductible goodwill and eligible investments in foreign or domestic subsidiaries). This method allows the entity to match its outside basis temporary difference with its share of the inside temporary differences solely for purposes of applying ASC 740's exceptions. For example, the amount of deferred tax liability recorded for the outside basis difference in the partnership would be reduced for any amount related to nondeductible goodwill.

For investments in partnerships where the tax basis exceeds its book basis, a question arises as to whether the foreseeable future criteria in ASC 740-30-25-9 for recording a DTA for other outside basis differences should be applied to investments in partnerships. We believe that it would be acceptable to apply these rules by analogy to investments in partnerships, but recording the DTA, which assumes that the foreseeable future criteria does not apply to investments in partnerships, would be equally acceptable. However, when a DTA is recorded for the outside basis difference, careful consideration should be given to whether the DTA will reverse and if the reversal will result in a capital loss. If this is the case, entities should evaluate whether there are sufficient available sources of future taxable income, such as reversing deferred tax liabilities, available tax planning strategies or projections of future taxable income that will generate similar character of income (e.g., capital gain).

5.2.2 Deferred tax considerations related to investments in partnerships

As outlined in Section 5.2.1, investors may use either of two approaches when measuring the deferred tax effects of outside basis differences in partnership investments. Regardless of the measurement method selected, investors may "look through" the partnership to determine whether the expected character of the outside basis difference is capital or operating. Investors may also develop schedules for reversing the individual inside basis differences of the partnership to ascertain the character (ordinary income or capital) and timing of the income upon reversal. Additionally, investors may also analyze the reversal patterns of the partnership's individual inside basis differences when reviewing the realizability of other deferred tax assets and determining the need for a valuation allowance. However, we believe that the aggregate amount of future taxable income considered in an investor's valuation allowance assessment should not exceed the actual outside basis difference.

Entities should choose an approach to measuring the amount of deferred taxes recorded related to the outside basis difference for the investment in a partnership and apply it consistently to all investments in partnerships reflected within the entity's consolidated financial statements. Further, we believe that an entity that uses the look-through approach to assess the realizability of deferred taxes related to its partnership investment should intend and be able to hold such investment as planned. If the entity lacks intent or ability to recover its investment through operations, such as planning to sell its partnership investment, it should not use the look-through approach for these determinations

5.3 Leveraged leases

ASC 740 does not change the accounting for leveraged leases required by ASC 842-50.

For all leveraged leases acquired under a business combination or by a not-for-profit entity under ASC 842-50, there would not be any recognition of a deferred tax credit. A leveraged lease acquired in a business combination is generally valued "based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows" (ASC 842-50-30-2). Differences between the book value and the tax basis would not be accounted for under deferred tax accounting and instead would be accounted for under ASC 842-50 as component parts.

5.4 Acquisition date accounting for goodwill

Goodwill arises in business combinations accounted for under ASC 805 when the transaction purchase price exceeds the fair value of the assets acquired net of liabilities assumed. Such goodwill may be fully tax deductible, partially tax deductible or not deductible depending on whether the business combination was structured as a nontaxable, taxable or partially taxable business combination. Generally, goodwill is tax-deductible when it arises from a taxable business combination, (i.e., when the buyer receives a step-up in tax basis for the acquired assets, including goodwill). In contrast, goodwill is generally not deductible in nontaxable business combinations and results in a permanent difference upon impairment or amortization of the goodwill for book purposes.

5.4.1 Tax-deductible goodwill

ASC 805-740-25-8 through 25-9 explain how to divide tax-deductible goodwill into components for proper deferred tax accounting as of the acquisition date. Component 1 is the lesser of goodwill for book purposes or tax-deductible goodwill. Component 2 is the remainder of either book goodwill over tax-deductible goodwill, or vice versa. Pursuant to ASC 805-740-25-9, an entity is prohibited from recognizing a deferred tax liability when tax-deductible goodwill is less than goodwill for book purposes at the acquisition date.

If tax-deductible goodwill is greater than goodwill for book purposes at the acquisition date, then a deductible temporary difference exists, and a deferred tax asset should be recognized. Determining the amount of the deferred tax asset to be recognized in this situation is not as simple as taking the deductible temporary difference and multiplying it by the applicable tax rate. This is because goodwill is a residual that is reduced by the amount of any deferred tax asset recognized for the difference between tax-deductible goodwill and goodwill for book purposes. Such reduction in goodwill for book purposes will then increase the temporary difference and so on and so forth. As such, a simultaneous equation, such as the one in ASC 805-740-55-10, may be used to calculate the deferred tax asset and, ultimately, the amount of goodwill for book purposes to be recognized: The following illustrates the application of the simultaneous equation:

- Preliminary temporary difference (PTD) = tax basis in goodwill - preliminary book goodwill
- Deferred tax asset (DTA) = (tax rate/(1 - tax rate)) x preliminary temporary difference
- Final book goodwill = preliminary book goodwill – DTA

The following example illustrates the application of the above simultaneous equation when tax-deductible goodwill exceeds the book goodwill at the acquisition date.

Example 5-1: Tax consequences of goodwill

ABC Company acquired DEF Company on April 1, 20X2, and is now preparing its financial statements for the year ended December 31, 20X2. Its assumptions are:

- The reported amount of goodwill for book purposes is $600,000 before taking into consideration the tax benefit associated with goodwill.
- The tax basis of goodwill is $900,000.
- The tax rate is 21% for all years.

ABC Company calculates the PTD before taking into consideration any tax benefit associated with goodwill. The PTD is the excess of tax goodwill over book goodwill, before taking into consideration the tax benefit associated with goodwill. The deferred tax asset represents the tax effected preliminary temporary difference.

As of April 1, 20X2, Component 1 goodwill has a book basis of $600,000 and a tax basis of $600,000. Component 2 goodwill has a book basis of $0 and a tax basis of $300,000. In this case, Component 2 goodwill is an excess of tax-deductible goodwill over book goodwill, and therefore a tax benefit for that excess is also a temporary difference which results in a deferred tax asset. As of April 1, 20X2, the goodwill for book purposes is adjusted for the tax benefit associated with goodwill by using the following simultaneous equation:

(Tax Rate ÷ (1-Tax Rate)) × PTD = DTA

The calculation of the PTD and the deferred tax asset follows:

	Amount
Tax basis-goodwill	$900,000
Less: Book basis-goodwill	(600,000)
PTD	$300,000
Tax rate ÷ (1-Tax rate) 21%/ (1-21%)	26.58%
Deferred tax asset	**$79,747**

Goodwill for book purposes would be established at the acquisition date at $520,253 ($600,000- $79,747 =$520,253).

5.5 Intra-entity / intercompany inventory transfers

Entities that file consolidated financial statements may have subsidiary entities that file separate tax returns. Generally, income taxes (both current and deferred) are recorded to reflect transactions between separate taxpaying entities, even when they are members of a consolidated group. However, the one exception is for inventory, where there will generally be no temporary differences recorded in either the seller entity's or the buyer entity's separate financial statements. Inventory is usually transferred between entities at a profit. To the extent intercompany profit is deferred in consolidation, a similar entry would be required to defer the taxes paid by the seller entity. Therefore, reporting entities should maintain records tracking inter-company transactions so that deferred taxes are not misstated. Further any current tax amounts related to intra-entity transfers of inventory would be treated as prepaid taxes and not a deferred tax asset.

5.6 Functional currency

When a foreign operation has the U.S. dollar as its functional currency, the carrying amounts of nonmonetary assets and liabilities (e.g., property and equipment) are based on U.S. dollar amounts derived by using historical exchange rates. The realization of the U.S. dollar carrying amount of a nonmonetary asset would result in taxable income in the foreign jurisdiction equal to the foreign-currency equivalent, measured at the current exchange rate, of the U.S. dollar carrying amount.

The foreign tax basis of the asset would have been initially established when the asset was acquired. That tax basis was the amount of foreign currency paid to acquire the asset, which was the amount translated at the exchange rate then in effect (the historical rate) to arrive at the U.S. dollar carrying amount before depreciation. The foreign tax basis, especially in hyperinflationary countries, may have been subject to indexing under the foreign tax law.

For any nonmonetary asset, the temporary difference for foreign tax purposes is made up of:

- The difference between the foreign tax basis before any adjustment for indexing and the carrying amount in the pre-remeasurement foreign-currency financial statements (i.e., after adjustment to U.S. accounting principles and before remeasurement into U.S. dollars)
- The changes in tax basis, if any, resulting from indexing provisions of the foreign tax law
- The difference arising in remeasurement (i.e., the difference between the historical-rate and current-rate translations of the U.S. dollar carrying amount).

In hyperinflationary countries, the second component would generally partially offset the impact of the third component.

ASC 740 precludes deferred taxes for the third component. Because no deferred taxes are recognized for the third component, the effect of indexing on the tax basis (the second component) is also eliminated when determining deferred taxes.

For property and equipment, deferred taxes should be computed in the foreign currency by comparing the historical book and tax basis in the foreign currency after the respective depreciation but before any indexing for either book or tax purposes. The foreign-currency deferred tax is then remeasured into U.S. dollars using the current exchange rate. Any additional tax depreciation on the current return that results from indexing will reduce the current tax provision.

The tax bases of assets and liabilities of entities located in countries with highly inflationary economies that prepare financial statements adjusted for general price-level changes in accordance with U.S. GAAP are often adjusted for the effects of inflation. For those entities, the accounting issues are how temporary differences should be determined as of the current reporting date and how the deferred tax expense or benefit for the period should be determined.

First, temporary differences should be determined based on the difference between the indexed tax bases of the assets and liabilities and the related price-level restated amounts reported in the financial statements. Second, the deferred tax expense or benefit for the period is based on the difference between the deferred tax assets and liabilities at the end of the current period and the deferred tax assets and liabilities at the end of the prior period after the amounts at the end of the prior period have been remeasured to units of general purchasing power at the end of the current year. The remeasurement of deferred tax assets and liabilities at the end of the prior year is reported as a restatement of beginning equity, like the remeasurement of all other assets and liabilities.

5.7 Cash value of life insurance

The excess of cash value of life insurance over the premiums paid is generally not a temporary difference if, under the provisions of the tax law, there would be no taxable amount if the insurance policy is held until the death of the insured. Therefore, deferred taxes are not recognized on basis differences related to cash surrender value amounts for life insurance when it is management's intent to maintain the policy until the death of the insured. However, if management intends to surrender the policy for its cash value, a deferred tax liability should be recognized for the excess of cash value over cumulative 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.

6. Effective tax rate reconciliation

Spotlight on change: FASB Accounting Standards Update 2023-09 – Improvements to Income Tax Disclosures

On December 14, 2023, the Financial Accounting Standards Board (FASB or Board) issued Accounting Standards Update (ASU) 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*. The amendments in this ASU address investor requests for more transparency about income tax information through improvements to income tax disclosures primarily related to an entity's effective tax rate reconciliation and income taxes paid information. However, ASU 2023-09 does not amend the recognition or measurement requirements of ASC 740.

For public business entities, the amendments in ASU 2023-09 became effective for annual periods beginning after December 15, 2024 (i.e., 2025 for public business entities with calendar year ends). For entities other than public business entities, the amendments are effective one year later.

6.1 Effective tax rate reconciliation before the adoption of ASU 2023-09

ASC 740-10-50-12

A public entity shall disclose a reconciliation using percentages or dollar amounts of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The statutory tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed.

ASC 740-10-50-13

A nonpublic entity shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

Public entities must provide a quantitative reconciliation of the income tax expense attributable to income from continuing operations to the amount of tax which would result from the application of the domestic federal statutory tax rate applicable to the highest level of taxable income to the pretax income from continuing operations. This reconciliation, which is required for each year for which an income statement is presented, may be performed in dollars or in percentages of pretax income from continuing operations, with each significant source of difference disclosed separately. Statutory income tax rates for this disclosure are the regular tax rates enacted in the entity's country of domicile, without considering rates from an alternative tax system. In accordance with Rule 4-08(h)(2) of Regulation S-X, if no individual reconciling item amounts to more than 5% of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate, and the total difference to be reconciled is less than 5% of such computed amount, no reconciliation need be provided unless it would be significant to understanding the trend of earnings. In other words, for U.S. entities reconciling to the U.S. federal statutory income tax rate of 21%, this would generally require disclosure of reconciling items that impact the rate by 1.05% or more (21% x 5%). Reconciling items that are individually less than 5% of the computed amount may be aggregated within the effective tax rate reconciliation. Nonpublic entities may forgo numerical reconciliation but must still provide a qualitative description of significant reconciling items.

Typical reconciling items between recorded income tax expense and the income tax expense that would be computed at an entity's statutory rate include, but are not limited to:

- State and local income taxes, net of federal effect
- Foreign tax effects
- Effect of cross-border tax laws
- Enactment of new tax laws
- Nontaxable or nondeductible items
- Tax credits
- Changes in valuation allowances
- Changes in unrecognized tax benefits

RSM COMMENTARY: Although not required for nonpublic entities, the numerical effective tax rate reconciliation is a useful disclosure. This reconciliation provides financial statement users with an understanding of the factors which cause an unusual relationship between the income tax provision and the income from continuing operations.

The following example illustrates a simple rate reconciliation for a public entity prior to the adoption of ASU 2023-09. Although the following example was prepared using both currency and percentages, it is important to note that ABC Company was only required under ASC 740 to present this reconciliation in either currency or percentages in its financial statements.

Example 6-1: Effective Tax Rate Reconciliation

ABC Company, a public entity, prepared its effective tax rate reconciliation for the year ended December 31, 20X2. ABC Company had pretax book income of $50,000,000 and permanent differences of $75,000 that decreased taxable income. ABC Company also had a blended tax rate of 25%, which consisted of a 21% U.S. federal tax rate and a 4% state tax rate (net of federal tax benefit). ABC Company also determined that its total income tax expense was $12,481,250, which consisted of current tax expense of $12,718,750 offset by a deferred tax benefit of ($237,500).

ABC Company prepared the effective tax rate reconciliation as follows:

	Currency	Percentages
Income taxes at U.S. Federal rate ($50,000,000 x 21%)	$10,500,000	21.0%
Effect of permanent differences ($75,000 x 25%)	(18,750)	0.0%
State income taxes net of federal benefit ($50,000,000 x 4%)	2,000,000	4.0%
Total income tax expense	**$12,481,250**	**25.0%**

6.2 Effective tax rate reconciliation after the adoption of ASU 2023-09

The following sections provide a high-level summary of the new requirements for the effective tax rate reconciliation pursuant to ASU 2023-09. Please see our publication, ASU 2023-09-Expanded Income Tax Disclosure Requirements, for a comprehensive discussion of implementation and interpretive guidance to assist with the adoption of ASU 2023-09.

6.2.1 Guidance for public business entities (PBE)

ASC 740-10-50-12 requires a PBE to disclose an annual reconciliation between the amount of reported income tax expense (or benefit) from continuing operations and the amount computed by multiplying the income (or loss) from continuing operations before income taxes[1] by the applicable statutory federal (national) income tax rate of the jurisdiction (country) of domicile. When the rate used by a PBE is other

[1] Although not defined in ASC 740, in practice, the term "income (or loss) from continuing operations before income taxes" is understood to include all pretax income and expenses items, except those related to discontinued operations (see ASC 205-20), other comprehensive income (see ASC 220-10) or the cumulative effect of a change in accounting principle through retrospective application of the new accounting principle to all prior periods (see ASC 250-10).

than the U.S. federal corporate income tax rate, the PBE is required to disclose the rate used and the basis for using that rate.

For each annual reporting period, ASC 740-10-50-12A(a) requires that a PBE disclose a tabular effective tax rate reconciliation using both reporting currency amounts and percentages, disaggregated by the following eight specific categories:

1. State and local income tax, net of federal (national) income tax effect
2. Foreign tax effects
3. Effect of cross-border tax laws
4. Effect of changes in tax laws or rates enacted in the current period
5. Nontaxable or nondeductible items
6. Tax credits
7. Changes in valuation allowances
8. Changes in unrecognized tax benefits

ASC 740-10-50-12A(c) specifies that categories 3 through 7 above consist solely of federal income taxes assessed by an entity's country of domicile. Category 1 reflects all taxes assessed by states and localities within the entity's country of domicile, while category 2 reflects income taxes assessed by jurisdictions outside the entity's country of domicile. Category 8 is the sole category where aggregated disclosure across all jurisdictions is permitted.

If it is not otherwise evident, ASC 740-10-50-12C requires a PBE to provide an explanation of the individual reconciling items required by ASC 740-10-50-12A(a), such as the nature, effect and underlying causes of the reconciling items and the judgment used in categorizing such reconciling items.

ASC 740-10-50-12A(b) requires further disaggregation of certain reconciling items (as summarized in the table below), based on a quantitative threshold equal to 5% or more of the amount determined by multiplying income (or loss) from continuing operations before income taxes by the applicable federal statutory tax rate ("the 5% threshold"). Entities reconciling to the U.S. federal statutory tax rate of 21% would generally need to disclose items affecting the effective tax rate by 1.05% (21% x 5%) or more. The 5% threshold aligns with the effective tax rate reconciliation disclosure threshold in U.S. SEC Regulation S-X, Title 17 CFR § 210.4-08(h)(2).

Effective Tax Rate Reconciliation Category	Further Required Disaggregated Information
State and local income tax, net of federal (national) income tax effect	Qualitative information only (ASC-740-10-50-12B)
Foreign tax effects	Quantitative, by nature [Note 1] and jurisdiction
Effect of cross-border tax laws	Quantitative, by nature
Enactment of new tax laws	None
Nontaxable or nondeductible items	Quantitative, by nature
Tax credits	Quantitative, by nature
Changes in valuation allowances	None
Changes in unrecognized tax benefits	None
Other adjustments [Note 2]	Quantitative, by nature

Note 1: When disaggregating reconciling items by nature, ASC 740-10-50-12A(b) explains that entities should consider the reconciling item's fundamental or essential characteristics, such as the event that caused the reconciling item and the activity that is associated with the reconciling item. For example, reconciling items within the "Tax credits" category may be disaggregated by type of credit, such as research and development or energy tax credits.

Note 2: The "Other adjustments" category is used for reconciling items that do not fit within the eight categories specified in ASC 740-10-50-12A(a).

All reconciling items are required to be presented on a gross basis within the annual effective tax rate reconciliation, except for the following items specified in ASC 740-10-50-12A(c):

- Taxes on cross border income imposed by the entity's country of domicile may be presented net of the related tax credits within the "Effect of cross-border tax laws" category if the taxes and credits relate to the same income during the same reporting period (e.g., Global Intangible Low-Taxed Income net of foreign tax credits).
- An unrecognized tax benefit recognized in the current annual period for a tax position taken or expected to be taken in the same reporting period may be presented on a net basis in the category where the tax position is presented. For example, current year research and development credits may be presented net with the current year unrecognized U.S. federal tax benefit in the "Tax credits" category.
- Reconciling items presented in the "Changes in unrecognized tax benefits category" may be presented on a combined basis for all jurisdictions.

RSM COMMENTARY: Materiality Considerations

Entities should view the disclosure requirements in ASC 740-10-50-12A through 50-12C through the lens of materiality. ASC 105-10-05-6 states that "the provisions of the Codification need not be applied to immaterial items." As a result, the amendments on the disclosure of reconciling items by specific categories with further disaggregation of reconciling items within those categories based on the application of a quantitative threshold do not apply to immaterial items. In other words, an entity does not need to separately disclose the specific categories or reconciling items if they are immaterial, even if the quantitative threshold specified in ASC 740-10-50-12A(b) is met (paragraph BC22 in ASU 2023-09).

The following example from ASC 740 illustrates an effective tax rate reconciliation, after the adoption of ASU 2023-09.

Example 6-2: Rate Reconciliation Between Income Tax Expense (or Benefit) and Statutory Expectations - Case A: Public Business Entity (ASC 740-10-55-231)

The following illustrates the specific categories and the reconciling items disclosed by a public business entity in its tabular rate reconciliation in accordance with paragraphs 740-10-50-12A through 50-12B. The entity is domiciled in the United States and presents comparative financial statements. For the disclosure of foreign tax effects in accordance with paragraph 740-10-50-12A(b)(2), it is assumed that the 5 percent threshold, computed by multiplying the income (or loss) from continuing operations before income taxes by the applicable statutory federal (national) income tax rate of the United States, is met:

a. For Ireland, both at the jurisdiction level and for certain individual reconciling items of the same nature within Ireland

b. For the United Kingdom, for certain individual reconciling items of the same nature within the United Kingdom, but not at the jurisdiction level

c. For Switzerland and Mexico, at the jurisdiction level, but not for any individual reconciling items of the same nature within each jurisdiction.

	Year Ended December 31, 20X2		Year Ended December 31, 20X1		Year Ended December 31, 20X0	
	Amount	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
U.S. Federal Statutory Tax Rate	$AA	aa%	$BB	bb%	$CC	cc%
State and Local Income Taxes, Net of Federal Income Tax Effect[(a)]	AA	aa	BB	bb	CC	cc
Foreign Tax Effects						
United Kingdom						
Statutory tax rate difference between United Kingdom and United States	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Share-based payment awards	AA	aa	BB	bb	CC	cc
Research and development tax credits	(AA)	(aa)	(BB)	(bb)	CC	cc
Other	(AA)	(aa)	BB	bb	(CC)	(cc)
Ireland						
Statutory tax rate difference between Ireland and United States	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Changes in valuation allowances	(AA)	(aa)	(BB)	(bb)	CC	cc
Enacted changes in tax laws or rates	-	-	BB	bb	-	-
Other	AA	aa	(BB)	(bb)	(CC)	(cc)
Switzerland	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Mexico	AA	aa	BB	bb	CC	cc
Other foreign jurisdictions	(AA)	(aa)	(BB)	(bb)	CC	cc
Effect of Changes in Tax Laws or Rates Enacted in the Current Period	-	-	-	-	(CC)	(cc)

	Year Ended December 31, 20X2		Year Ended December 31, 20X1		Year Ended December 31, 20X0	
	Amount	Percent	Amount	Percent	Amount	Percent
Effect of Cross-Border Tax Laws						
Global intangible low-taxed income	AA	aa	BB	bb	CC	cc
Foreign-derived intangible income	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Base erosion and anti-abuse tax	AA	aa	BB	bb	CC	cc
Other	AA	aa	-	-	-	-
Tax Credits						
Research and development tax credits	-	-	(BB)	(bb)	(CC)	(cc)
Energy-related tax credits	(AA)	(aa)	-	-	-	-
Other	-	-	(BB)	(bb)	-	-
Changes in Valuation Allowances	AA	aa	(BB)	(bb)	(CC)	(cc)
Nontaxable or Nondeductible Items						
Share-based payment awards	AA	aa	BB	bb	CC	cc
Goodwill impairment	AA	aa	BB	bb	-	-
Other	AA	aa	(BB)	(bb)	CC	Cc
Changes in Unrecognized Tax Benefits	(AA)	(aa)	BB	bb	(CC)	(cc)
Other Adjustments	AA	aa	(BB)	(bb)	(CC)	(cc)
Effective Tax Rate	$AA	aa%	$BB	bb%	$CC	cc%

(a) State taxes in California and New York made up the majority (greater than 50 percent) of the tax effect in this category.

6.2.2 Rate reconciliation guidance for all other entities

Entities other than PBEs are not required to provide the numerical tabular reconciliation of the effective tax rate discussed in Section 6.2.1, which is consistent with legacy disclosure requirements. Instead, ASC 740-10-50-13 requires that entities other than PBEs qualitatively disclose the nature and effect of specific categories of reconciling items (as outlined in Section 6.2.1) and individual jurisdictions that result in a significant difference between the statutory tax rate and the effective tax rate. Accordingly, if state or foreign income taxes significantly impact an entity's effective tax rate, the jurisdictions that contribute to the increase or decrease in the rate should be disclosed.

Example 6-3: Rate Reconciliation Between Income Tax Expense (or Benefit) and Statutory Expectations - Case B: Entity Other Than Public Business Entity (ASC 740-10-55-232 through 55-233)

The following illustrates significant reconciling items disclosed by an entity other than a public business entity in accordance with paragraph 740-10-50-13.

The difference between Entity W's effective tax rate and its statutory tax rate is primarily attributed to tax credits, state taxes, and foreign taxes. More specifically, the foreign tax effects of Entity W's operations in Ireland had a decreasing effect on its effective tax rate, while the foreign tax effects of Entity W's operations in France had an increasing effect on its effective tax rate. Entity W received federal research and development tax credits, which decreased its effective tax rate, while state taxes in California increased its effective tax rate.

RSM COMMENTARY: Effective tax rate reconciliation for entities other than public business entities

Although a numerical reconciliation table is not required, entities other than PBEs will likely need to prepare comprehensive supporting documentation similar in nature to that prepared by PBEs to support the qualitative disclosures required under ASC 740-10-50-13.

Appendix A: Acronyms

Acronym	Definition
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
DTA	Deferred Tax Asset
DTL	Deferred Tax Liability
FASB	Financial Accounting Standards Board
NOL	Net Operating Loss
PTD	Preliminary Temporary Difference
RTP	Return to Provision

Appendix B: Definitions

Several terms with specific meaning are used throughout this publication. Those terms and the corresponding definitions based on the Master Glossary of the FASB's Accounting Standards 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 year that 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 Consequences	The future effects on income taxes as measured by the applicable 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 (or Benefit)	The change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Income tax expense (or benefit) for the year is allocated among continuing operations, discontinued operations, and items charged or credited directly to shareholders' equity.
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).
Public Business Entity	A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity. a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

Term	Definition
	b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion. An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.
Public Entity	A business entity or a not-for-profit entity that meets any of the following conditions: a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets). b. It is required to file financial statements with the Securities and Exchange Commission (SEC). It provides financial statements for the purpose of issuing any class of securities in a public market.
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 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.

Term	Definition
	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.
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.
Unrecognized Tax Benefit	The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10.
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.

+1 800 274 3978
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