



Dbriefs U presents:

Book/Tax Differences — Fundamentals Every Accounting Major Should Know

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Agenda

Overview

Common permanent differences

- Meals and entertainment
- Tax exempt interest

Common temporary differences

- Fixed asset depreciation
- Accruals and reserves
- Prepaid expenses

Key takeaways

Common terminology

“Permanent” vs. “Temporary”

- Permanent: will not reverse in the future (i.e., book and tax will never cumulatively be equal)
- Temporary: will reverse in the future (i.e., book and tax will cumulatively become equal). These are sometimes referred to as “timing” items because this reversal exists.

“Favorable” vs. “Unfavorable”

- Favorable: net taxable income is less than net book income
- Unfavorable: net taxable income exceeds net book income

Effect on tax return

Schedule M-1 or M-3

- Schedule included with the tax return which reconciles differences from book income to taxable income
- Types of “book/tax” adjustments
 - Income subject to tax not recorded on books
 - Expenses recorded on books not deducted on tax return
 - Income recorded on books not included on tax return
 - Deductions on return not charged against book income

Poll question #1

A book/tax difference which results in taxable income greater than book income is a(n) _____ book/tax difference.

- Favorable
- Unfavorable
- Temporary
- Permanent

Common permanent book/tax differences

Fines & Penalties (IRC § 162(f))

Meals & Entertainment (IRC § 274(n))

Political Contributions (IRC § 162(e))

Officers Life Insurance (IRC § 264 and 101(a))

Tax Exempt Interest (IRC § 103(a))

Leased Auto Inclusion (IRC § 280F(a))

Federal Income Tax (IRC § 275)

Manufacturing Deduction (IRC § 199)

Meals and entertainment

- IRC §274(n) states that for certain meal and entertainment expenses only 50% of the total US GAAP book expense is allowed as a tax deduction.
- An analysis of the book expense should be done as the following types of M&E are fully deductible:
 - Holiday parties
 - Recreational or social employee activities
 - Overtime meal allowances

Schedule M-1/M-3 computation:

Meals and entertainment expense on books	\$100,000
Disallowance %	50%
Schedule M-1/M-3 Adj. (Unfavorable)	\$50,000

Tax-exempt interest

- Generally, for US GAAP purposes (book accounting) there is no distinction between taxable and tax-exempt interest — i.e., all is included in income.
- For federal tax purposes, interest derived from bonds insured by state and local governments is generally not included in gross taxable income.
- In order to determine the appropriate tax treatment, you will need to inquire as to the nature of the interest income amounts on the financial statements and reverse amounts from book income as appropriate (favorable M-1/M-3).

Poll question #2

Which of the following is NOT a permanent book/tax difference?

- Meals & entertainment expense
- Fines & penalty expense
- Advertising expense
- Tax exempt interest

Common temporary book/tax differences (timing)

Fixed Asset Depreciation

Gain or Loss on Sale of Fixed Assets

Amortization of Intangibles

UNICAP Adjustments-Inventory

Accruals and Reserves

Prepaid Expenses

Fixed asset depreciation — In general

- For US GAAP (book) purposes, depreciation is usually computed under the straight-line method over the company's determined life of the asset.
- Tax depreciation is the annual deduction allowed to recover the cost or other basis of tangible property used in a trade or business, or for the production of income.
- This expense is intended to allow for the obsolescence, as well as the wear and tear on eligible property.
- Generally, tax depreciation rules allow the cost of the asset to be recovered through depreciation deductions on an accelerated basis as compared to US GAAP rules.

Fixed asset depreciation — Methods, conventions, and special rules

- MACRS (Modified Accelerated Cost Recovery System) is the current depreciation method prescribed for tax purposes and applies to depreciable property placed in service after 1987.
- Generally, a half-year convention is utilized for property other than residential and nonresidential real estate (for these, a mid-month convention is utilized). However, in some circumstances a mid-quarter convention is required.
- Special provisions have been introduced in the past several years to allow increased depreciation expensing for tax purposes in order to encourage investments.

Fixed asset depreciation — Example of book/tax adjustment for reserve

Schedule M-1/M-3 computation:

- Calculate the difference between book depreciation and tax depreciation and add/subtract that difference from book income (favorable or unfavorable M-1/M-3).

Book depreciation expense (SL 10 yr life)	\$10,000
\$100,000 / 10 years	
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Tax depreciation expense	(\$20,000)
\$100,000 x 0.2 (MACRS 5 yr life)	
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Excess tax depreciation over book (favorable book/tax adjustment)	(\$10,000)
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Accruals and reserves — In general

- For US GAAP purposes, accruals and reserves are expensed in the year in which the amount is probable and reasonably estimated.
- For tax purposes, three criteria must be met to deduct an accrued expense:
 1. All events have occurred that establish the fact of the liability — it is “Fixed”.
 2. The amount of the liability can be determined with reasonable accuracy — it is “Determinable”.
 3. Economic performance has occurred with respect to the liability.
- Accrual accounts must be analyzed to determine if these tests are met in order to determine the appropriate treatment on the tax return.
- Reserves will not meet these tax requirements and, therefore, can only be deducted in the year in which payment occurs.

Accruals and reserves — Schedule M-1/M-3 computations

Schedule M-1/M-3 computation of a reserve:

- Change in balance sheet reserve = book/tax adjustment
 - Increase in reserve account = unfavorable
 - Decrease in reserve account = favorable

Schedule M-1/M-3 computation of an accrual:

- Change in balance sheet accrual less any allowable expenses (utilizing specified criteria) = book/tax adjustment
 - Increase in accrual account = unfavorable
 - Decrease in accrual account = favorable

Accruals and reserves — Example of book/tax adjustment for reserve

Reserve balance @ 12/31/2009	\$100,000
Reserve balance @ 12/31/2010	\$350,000
Net increase in balance (unfavorable book/tax adjustment)	\$250,000

Accruals and reserves — Example of book/tax adjustment for accrual

Accrued expense @ 12/31/2009	\$25,000
Allowable expense on 2009 return	-\$10,000
Adjusted balance at beginning of year	\$15,000
Accrued expense @ 12/31/2010	\$32,000
Allowable expense on 2010 return	-\$8,000
Adjusted balance at end of year	\$24,000
Net increase in balance (unfavorable book/tax adjustment)	\$9,000

Prepaid expenses

- GAAP — capitalize expenses paid in the current year where there is a benefit derived in a future period
- Tax — typically, prepaid expenses are not deductible unless “all events” and economic performance requirements are met. Economic performance occurs when subject matter that gives rise to the expense (services, property, etc.) is provided to the taxpayer
- Exceptions:
 - 3.5 month rule
 - § 461 requirements are met and benefit does not extend beyond one year
- Examples — Insurance, advertising, services

Prepaid expenses – Example of book/tax adjustment

Schedule M-1/M-3 computation:

Facts – Company XYZ has entered into a one year insurance policy which began in June 2010 for a total annual cost of \$120,000. As of 12/31/2010, US GAAP has allowed XYZ to expense \$60,000 and \$60,000 remains on the balance sheet as “prepaid insurance.”

Book insurance expense	\$60,000
Tax insurance expense	\$120,000
Excess tax expense over book (favorable book/tax adjustment)	(\$60,000)

Poll question #3

Depreciation expense can result in the following types of book/tax differences:

- Favorable & Temporary
- Unfavorable & Temporary
- Unfavorable & Permanent
- Both first and second choices

Key takeaways

- Differences in book income and taxable income occur because the two systems have different objectives.
- Book/tax differences are either permanent or temporary.
- Unfavorable differences result in a greater tax liability while favorable differences reduce overall tax liability.
- Tax professionals must understand these differences in order to help companies and clients identify planning opportunities that may reduce their tax liability.

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