

## Tax Reporting vs. Financial Reporting

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- **Income Tax Expense on the income statement is based on pre-tax income computed using GAAP (or IFRS)**

Financial Statements (“Books”):

Pre-tax income (per GAAP rules)  
x Effective tax rate  
= Income Tax Expense

- **Income Tax Payable (or paid in cash) is based on Taxable Income using tax code rules**

Tax Return:

Taxable income (per IRS rules)  
x Statutory tax rate  
= Income Tax Payable

- **The two tax amounts can be DIFFERENT!**
  - Permanent differences
  - Temporary differences

## Tax Reporting vs. Financial Reporting

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<u>Examples</u>	<u>GAAP</u>	<u>Tax Code</u>
Interest income from municipal bonds	Interest revenue increases pre-tax income	Does not affect taxable income (tax-exempt)
Cash advances from customers (unearned revenue)	Revenue recognized when earned (in future)	Revenue recognized when cash collected (now)
Bad debt expense	Expense recognized when sale is made (now)	Expense when account is written-off (in future)
Depreciation	Depreciation method chosen by firm	Depreciation schedule from tax authority

## Example

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	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000

- EBITDA in this example is Earnings before depreciation, municipal bond interest revenue, and taxes

## Example: Permanent Differences

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	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0

- **Permanent Differences**

- Revenues that are never included in taxable income and expenses that are never deductible for tax purposes
  - Examples: Interest on tax-exempt municipal bonds, tax penalties and tax credits, state and foreign taxes
- Do not reverse over time
- Cause the Effective Tax Rate to not equal the Statutory Tax Rate

## Example: Temporary Differences

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	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
<b>Depreciation</b>	<b>(10,000)</b>	<b>(10,000)</b>	<b>Depreciation</b>	<b>(15,000)</b>	<b>(5,000)</b>

- **Temporary Differences**

- Revenues or expenses recognized in a different period for tax purposes than for financial reporting purposes
  - Examples: book vs. tax depreciation, bad debt expense, unearned revenue
- Reverse over time
- Stored up in Deferred Tax Assets and Liabilities

## Example: Pre-tax Income vs. Taxable Income

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	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
<b>Pre-tax Income</b>	<b>41,000</b>	<b>41,000</b>	<b>Taxable income</b>	<b>35,000</b>	<b>45,000</b>

- **Pre-Tax Income: Earnings before taxes under GAAP**
- **Taxable Income: Earnings before taxes under tax rules**
  - Differences between pre-tax income and taxable income arise from permanent and temporary differences

## Example: Income Tax Payable

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	<b>Taxable income</b>	<b>35,000</b>	<b>45,000</b>
			<b>X Statutory rate</b>	<b>0.35</b>	<b>0.35</b>
			<b>Income Tax Payable</b>	<b>12,250</b>	<b>15,750</b>

- **Statutory rate: Tax rate set by the government**
- **Income Tax Payable: Taxes owed to the government**
  - Taxable income x statutory rate

## Example: Adjusted Pre-Tax Income

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
<b>Muni Interest Revenue</b>	<b>1,000</b>	<b>1,000</b>	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
<b>Remove Perm Diff</b>	<b>(1,000)</b>	<b>(1,000)</b>	X Statutory rate	0.35	0.35
<b>Adj. Pre-tax Income</b>	<b>40,000</b>	<b>40,000</b>	Income Tax Payable	12,250	15,750

- **Adjusted Pre-Tax Income**

- Used to compute Income Tax Expense for financial reporting purposes
- Pre-tax income adjusted for permanent tax differences



## Example: Income Tax Expense

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
Remove Perm Diff	(1,000)	(1,000)	X Statutory rate	0.35	0.35
<b>Adj. Pre-tax Income</b>	<b>40,000</b>	<b>40,000</b>	Income Tax Payable	12,250	15,750
<b>X Statutory rate</b>	<b>0.35</b>	<b>0.35</b>			
<b>Income Tax Expense</b>	<b>14,000</b>	<b>14,000</b>			

- **Income Tax Expense**

- Number reported on the income statement
- Adjusted Pre-Tax Income x Statutory rate
- Differs from Income Tax Payable due to Temporary Differences

## Example: Income Tax Expense vs. Income Tax Payable

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
Remove Perm Diff	(1,000)	(1,000)	X Statutory rate	0.35	0.35
Adj. Pre-tax Income	40,000	40,000	<b>Income Tax Payable</b>	<b>12,250</b>	<b>15,750</b>
X Statutory rate	0.35	0.35			
<b>Income Tax Expense</b>	<b>14,000</b>	<b>14,000</b>			
 <b>IncTaxExp–IncTaxPay</b>	 <b>1,750</b>	 <b>(1,750)</b>			

## Example: Income Tax Expense vs. Income Tax Payable

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
<b>Depreciation</b>	<b>(10,000)</b>	<b>(10,000)</b>	<b>Depreciation</b>	<b>(15,000)</b>	<b>(5,000)</b>
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
Remove Perm Diff	(1,000)	(1,000)	X Statutory rate	0.35	0.35
Adj. Pre-tax Income	40,000	40,000	Income Tax Payable	12,250	15,750
X Statutory rate	0.35	0.35			
Income Tax Expense	14,000	14,000			
			<b>Book Depr-Tax Depr</b>	<b>5000</b>	<b>(5000)</b>
IncTaxExp – IncTaxPay	1,750	(1,750)			

## Example: Income Tax Expense vs. Income Tax Payable

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
Remove Perm Diff	(1,000)	(1,000)	X Statutory rate	0.35	0.35
Adj. Pre-tax Income	40,000	40,000	Income Tax Payable	12,250	15,750
X Statutory rate	0.35	0.35			
Income Tax Expense	14,000	14,000			
			Book Depr-Tax Depr	5000	(5000)
IncTaxExp – IncTaxPay	1,750	(1,750)	<b>Tax Effect @ 35%</b>	<b>1,750</b>	<b>(1,750)</b>

- **Temporary Differences reverse over time!**

## Example: Effective Tax Rate

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
<b>Pre-tax Income</b>	<b>41,000</b>	<b>41,000</b>	Taxable income	35,000	45,000
Remove Perm Diff	(1,000)	(1,000)	X Statutory rate	0.35	0.35
Adj. Pre-tax Income	40,000	40,000	Income Tax Payable	12,250	15,750
X Statutory rate	0.35	0.35			
<b>Income Tax Expense</b>	<b>14,000</b>	<b>14,000</b>			
<b>Effective Tax Rate</b>	<b>34.1%</b>	<b>34.1%</b>			

- **Effective Tax Rate = Income Tax Expense / Pre-Tax Income**
  - Does not equal 35% (Statutory Rate) because of Permanent Differences
  - Does not reverse

## Tax Expense Calculation: Summary

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
Income Tax Expense	14,000	14,000	Income Tax Payable	12,250	15,750
Pre-Tax Income			41,000		<b><u>2011</u></b>
+/- Permanent Diff			- 1,000		
Adjusted Pre-Tax Inc			40,000		
X Statutory rate = Income Tax Expense				X 0.35 =	14,000
+/- Temporary Diff			<b>-5,000</b>		
Taxable Income			35,000		
X Statutory rate = Income Tax Payable				X 0.35 =	<b>12,250</b>

## Tax Expense Calculation: Summary

	<u>Books</u>			<u>Tax Return</u>	
	<u>2011</u>	<u>2012</u>		<u>2011</u>	<u>2012</u>
EBITDA	50,000	50,000	EBITDA	50,000	50,000
Muni Interest Revenue	1,000	1,000	Muni Interest Revenue	0	0
Depreciation	(10,000)	(10,000)	Depreciation	(15,000)	(5,000)
Pre-tax Income	41,000	41,000	Taxable income	35,000	45,000
Income Tax Expense	14,000	14,000	Income Tax Payable	12,250	15,750
Pre-Tax Income			41,000		<b><u>2012</u></b>
+/- Permanent Diff			- 1,000		
Adjusted Pre-Tax Inc			40,000		
X Statutory rate = Income Tax Expense				X 0.35 =	14,000
+/- Temporary Diff			<b>+5,000</b>		
Taxable Income			45,000		
X Statutory rate = Income Tax Payable				X 0.35 =	<b>15,750</b>