

Valuation Allowance

- **Deferred Tax Assets** represent future tax savings; i.e. a reduction in future cash outflows
- **But, companies can only realize tax savings if they are profitable**
 - DTA reduces taxes paid, but will not produce a refund if the company does not have to pay taxes
 - Companies do not have to pay taxes when they have negative taxable income
 - Must have positive taxable income and positive income tax payable
- **Companies can only report a Deferred Tax Asset if it is “more likely than not” the firm will be profitable enough in the future to take advantage of the tax savings**
- **If it is not “more likely than not”, companies must reduce the DTA using a Valuation Allowance (XA)**
 - Works just like Allowance for Doubtful Accounts

Net Operating Losses (NOLs)

- A net operating loss occurs in a year when taxable income is negative
- Federal tax law permits taxpayers to use an NOL to offset the profits of prior and future years
- First, carry the NOL back 2 years and receive refunds for income taxes that have already been paid in those years
- Any loss remaining after the 2-year carryback can be carried forward up to 20 years to offset future taxable income
- Create a Deferred Tax Asset for the amount of tax savings due to NOL Carryforwards

Example: NOLs

- In 2011, Noll International Inc. experienced an \$80,000 net operating loss (i.e. negative taxable income) in its US subsidiary, and a \$150,000 net operating loss in its Liechtenstein subsidiary
- Noll did not pay taxes in 2009-2010 in either jurisdiction, so it cannot carry the loss back to get a refund
- Noll expects it is “more likely than not” to be able to use NOL carryforwards in 2014 in both countries
 - US tax rate is expected to be 35%. The US DTA is $\$80,000 \times .35 = \$28,000$
 - Liechtenstein tax rate is expected to be 15%. The LI DTA is $\$150,000 \times .15 = \$22,500$

- Journal entry:

Dr. Deferred Tax Asset (+A)	50,500	
Cr. Income Tax Expense (-E)		50,500

Example: NOL Carryforwards and Valuation Allowance

- In June 2012, Noll is preparing its quarterly reports and has serious doubts about the future profitability of its Liechtenstein subsidiary
- Noll decides that it is not “more likely than not” to be able to use NOL carryforwards in Liechtenstein before they expire
 - Recall, the LI DTA is $\$150,000 \times .15 = \$22,500$

- Journal entry:

Dr. Income Tax Expense (+E)	22,500
Cr. Valuation Allowance (+XA)	22,500

- Disclosure presentation:

Deferred Tax Assets

DTA: NOL Carryforwards	50,500
Less Valuation Allowance	<u>(22,500)</u>
Net Deferred Tax Assets	28,000

Example: NOL Carryforwards and Valuation Allowance

- In December 2012, Noll is preparing its annual report and is now very optimistic about the future profitability of its Liechtenstein subsidiary
- Noll decides that it is “more likely than not” to be able to use NOL carryforwards in Liechtenstein by 2014
 - Recall, the LI DTA is $\$150,000 \times .15 = \$22,500$
- Journal entry:

Dr. Valuation Allowance (-XA)	22,500
Cr. Income Tax Expense (-E)	22,500
- Note that this entry will increase Net Income by \$22,500
 - Such valuation allowance reductions could be used for “last chance” earnings manipulation