

Using Deferred Income Taxes As A Link Between Intermediate Accounting And Corporate Income Tax Courses

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ABSTRACT

The accounting curriculum (in fact business colleges in general) often is accused of operating in silos. As a result, it is claimed that students fail to see the connections among the assignments in their separate course work and the necessity to have an integrated understanding to function effectively in the real-world. As a response to the criticism, we use deferred income taxes as a means to help students bridge the gap between their Intermediate Accounting classes and their Corporate Income Tax course. As a bonus, students also: 1.) better understand the difficult topic of deferred income taxes, 2.) better understand Schedule M-1 on the corporate tax return, and 3.) gain experience in documentation via the preparation of accounting work papers.

Keywords: Deferred Income Tax; Intermediate Accounting; Corporate Income Tax Course

INTRODUCTION

To help overcome the tendency of students to view each course in isolation, the following illustration shows how the topic of deferred income taxes can help students integrate Intermediate Accounting and Corporate Income Tax courses. Students also should better understand the difficult topic of deferred income taxes, better understand Schedule M-1 on the corporate tax return, and gain experience in documentation via the preparation of accounting work papers.

DATA FOR THE ILLUSTRATION

The information below is limited to three temporary differences and one permanent difference. The list of differences easily can be expanded by the instructor to include as many as deemed appropriate.

Net Book Value at 12/31/20X9		Tax Basis at 12/31/20X9	
1) Accounts Receivable, less Allowance	\$225,000	Accts. Rec. (no Allowance)	\$340,000
2) Trading Securities, market	46,000	Trading Securities, cost	28,000
3) Trucks less Accumulated Depreciation using Straight-Line	85,000	Trucks less Accumulated Depreciation using MACRS	61,000
Other Information:	<u>20X9 Income Statement</u>	<u>20X9 Tax Return</u>	
Bad Debts Expense	\$90,000	\$50,000	
Unrealized Gain on Trading Securities	10,000	-0-	
Depreciation Expense	48,000	53,000	
Dividends from Trading Securities	3,000	900	
Book Income Before Taxes for 20X9	900,000		

ACCOUNTING WORK PAPERS

Students frequently present their answers to accounting and tax assignments in the form of a typed word document, a spreadsheet, or hand-written on a piece of notebook paper. Requiring students to present their answers

using accounting work paper format similar to that shown in Tables 1 and 2 should be more acceptable in the workplace and will help the students understand some of the complexities of accounting for income taxes.

The Deferred Income Tax Work paper (Table 1) uses the “balance sheet approach” to determine in the last column to the right the \$10,500 to be debited to the Deferred Income Tax—Current Asset account and the \$1,750 to be credited to the Deferred Income Tax—Long-Term Liability account as part of the income tax journal entry for 20X9. Note the “Book vs. Tax Difference at 12/31/X9” column on the Deferred Income Tax Work paper is designed to tie into the deferred tax account balances on the 20X9 balance sheet.

Table 1: Deferred Income Tax Work paper

Balance Sheet Accounts	12/31/X9 Book Value	12/31/X9 Tax Basis	Book vs. Tax Difference at 12/31/X9	Assumed Book vs. Tax Difference at 12/31/X8	Change in Difference During 20X9	Change Needed to DIT account (Change times 35% tax rate)
Current:						
Accounts Rec.	\$225,000	\$340,000	(\$115,000)	(\$75,000)	(40,000)*	(\$14,000)
Trading Portfolio	46,000	28,000	18,000	8,000	10,000	3,500
			(97,000)		30,000	(\$10,500)**
			x 35%			
		20X9 Bal. Sheet	\$33,950			
Long-Term:						
Truck	85,000	61,000	24,000	19,000	5,000	\$1,750***
			x 35%			
		20X9 Bal. Sheet	\$8,400			
* \$40,000 amount in parentheses indicates taxable income will be higher than book income for 20X9						
** \$10,500 amount in parentheses indicates debit to the Deferred Income Tax—Current Asset account						
*** \$ 1,750 amount should be credited to the Deferred Income Tax—Long-Term Liability account						

The instructor has the option to supplement Table 1 with an illustration of the “income statement approach” to determine the 20X9 entries to the deferred income tax accounts. The income statement approach would multiply the temporary differences shown above between the 20X9 income statement amount and the 20X9 tax return amount by the statutory income tax rate to get the 20X9 entries to the deferred income tax accounts.

The Tax Accrual Work paper (Table 2) provides the calculation supporting the \$323,015 credit to Income Tax Payable in the 20X9 income tax journal entry. The design of this work paper also allows a direct calculation of the \$314,265 debit to Income Tax Expense. (With a permanent difference existing for 20X9, simply multiplying the \$900,000 book income before tax times the 35% income tax rate would yield an incorrect amount for Income Tax Expense).

Table 2: Tax Accrual Work paper

Book Income Before Taxes for 20X9	\$900,000
Permanent Difference: Special Dividend Received Deduction—70% of \$3,000 Dividends	(2,100)
Basis for Calculating Income Tax Expense for 20X9 (35% x \$897,900 = \$314,265)	\$897,900
Temporary Differences:	
Excess of Estimated Bad Debts Expense vs. Accts. Receivable Direct Write-off for 20X9	40,000
Unrealized Gain on Marking to Market the Trading Portfolio on December 31, 20X9	(10,000)
Excess of MACRS Depreciation vs. Straight-Line Depreciation for 20X9	(5,000)
Taxable Income	\$922,900
Statutory Income Tax Rate	x .35
Income Tax Payable	\$323,015

JOURNAL ENTRY FOR INCOME TAXES

The Deferred Income Tax Work paper (Table 1) provides the dollar amounts for the Deferred Income Tax accounts in the 20X9 income tax journal entry. The Tax Accrual Work paper (Table 2) provides the dollar amount for Income Taxes Payable and proves the “plug” to Income Tax Expense is correct.

Income Tax Journal Entry for 20X9

	Debit	Credit
Income Tax Expense (“Plug”—also directly calculated in Table 2)	314,265	
Deferred Income Tax—Current Asset (from Table 1)	10,500	
Deferred Income Tax Payable—Long-Term Liability (from Table 1)		1,750
Income Tax Payable (from Table 2)		323,015

The \$10,500 debit is to a Current Deferred Income Tax Asset account because both Accounts Receivable and the Trading Portfolio are classified as current accounts on the Balance Sheet. The \$1,750 credit is to a Long-Term Deferred Income Tax Liability account because Trucks are classified as a non-current account on the Balance Sheet.

SCHEDULE M-1 ON CORPORATE TAX RETURN

Using the previously illustrated accounting work papers and income tax journal entry developed in the Intermediate Accounting course, students can see the integration of deferred income taxes into the Corporate Income Tax course by requiring students to complete Schedule M-1 (Table 3) of the Corporate Income Tax Form 1120. (For companies with more than \$10 million in assets, Schedule M-3 would be completed instead of Schedule M-1.)

Table 3: Schedule M-1

Schedule M-1		Reconciliation of Income (Loss) per Books With Income per Return	
Note: Schedule M-3 may be required instead of Schedule M-1—see instructions.			
1	Net income (loss) per books	585735	
2	Federal income tax per books	314265	
3	Excess of capital losses over capital gains		
4	Income subject to tax not recorded on books this year (itemize):		
		
		
5	Expenses recorded on books this year not deducted on this return (itemize):		
a	Depreciation \$ 48000		
b	Charitable contributions \$		
c	Travel and entertainment \$		
d	Other (itemize):		
	Bad Debt Expense 90000	138000	
6	Add lines 1 through 5	1038000	
7	Income recorded on books this year not included on this return (itemize):		
a	Tax-exempt interest \$		
b	Other (itemize):		
	Unrealized Gain on Trading Portfolio		10000
8	Deductions on this return not charged against book income this year (itemize):		
a	Depreciation \$ 53000		
b	Charitable contributions \$		
c	Other (itemize):		
	Write-off of Uncollectible Accounts	50000	103000
9	Add lines 7 and 8		113000
10	Income—line 6 less line 9		925000

The \$925,000 “Income” on line 10 of Schedule M-1 would be the Taxable Income before Special Deductions. Subtracting the \$2,100 (\$3,000 x 70%) permanent difference created by the Special Dividend Received Deduction for the Trading Portfolio Dividends from the \$925,000 would equal the \$922,900 Taxable Income shown on the Tax Accrual Work paper (Table 2).

CONCLUSION/EXTENSIONS

Deferred Income Taxes can provide more than just an example of a topic that helps students appreciate the integration between Intermediate Accounting and Corporate Income Tax courses. The illustration can be enhanced by requiring preparation of the complete Corporate 1120 Tax Return. The Auditing course could be added to the deferred income tax example by requiring students to turn the accountant's worksheets used in the illustration into audit work papers and/or requiring students to draft the Income Tax Note Disclosure—including determination of the effective tax rate for 20X9. Other extensions could include requiring students to research the topic of deferred income taxes in the accounting and tax literature. Requiring students to provide a written synopsis of their research findings adds communication to the skills list that can be enhanced.

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