
13 An Introduction to State Income Taxes

Understanding how state income taxes are accounted for in a tax provision can be very tricky, particularly because related figures don't appear to consistently tie out in the workpapers and in the financial statements. The purpose of this chapter is to review state income taxes in a provision where there are no permanent or temporary differences. This will make it easier to see how state income tax figures are calculated, accounted for, and presented in the financial statements. The next chapter will then layer in the state tax-related impact of permanent and temporary differences.

13.1 First complete the state tax provision (1100)

It may seem natural to complete the federal tax provision prior to the state tax provision for a number of reasons. First, federal income taxes are almost always more material than state income taxes. Second, if you have experience with state tax compliance, you know that federal taxable income (or some derivation of it) is the starting point for many state income tax returns, meaning the federal income tax return is prepared prior to the state tax returns.

However, it's important to remember that ASC 740 is an *accounting* concept and not a tax compliance concept. The tax rules allow companies to deduct state income taxes from their federal taxable income.¹²⁰ Thus, the state tax provision must be computed *first* to estimate this deduction on the federal tax provision.

What follows is an example of how this works in the form of an abbreviated or simplified state tax provision. As noted at the beginning of the chapter, there are no temporary or permanent differences in this example. Thus, the provision for state income taxes (\$6,250) is simply pretax book income (\$125,000) multiplied by the state tax rate (5%).

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¹²⁰ See Internal Revenue Code Section 164.

1100 - State Tax Provision Summary

State Tax Provision Calculation	Tax Provision	Notes/Explanations
	Current Year	
Pretax Book Income	\$125,000	From 1600
Permanent Differences		
Permanent Difference - GL-related Items - Revenue	\$0	From 1200 - Sch M Summary worksheet ↓
Permanent Difference - GL-related Items - Expenses	\$0	
Permanent Difference - Special Tax Calculation	\$0	
Temporary Differences		
Temporary Difference - GL-related Items	\$0	
Temporary Difference - Depreciation	\$0	
Tax Return Calculations		
Subtotal: Pre-NOL State Taxable Income	\$125,000	
Times: State Tax Rate	5.00%	From 80 - Tax Rates Summary
Subtotal: State Tax Before Credits	\$6,250	
Less: State Tax Credits	\$0	From 1200 - Sch M Summary worksheet
Subtotal: State Tax Return Prov. - Current Tax Exp/(Ben)	\$6,250	Tax expense/(benefit) on a tax return (cash) basis
Other Adjustments & True-ups	\$0	
Subtotal: Other Adjustments & True-ups	\$0	
Equals: Total State Taxes - Current	\$6,250	Carries to the summary below

13.2 The next step is to complete the federal tax provision (1000)

Having estimated state income taxes (\$6,250) as part of preparing the state tax provision, you're now prepared to compute the federal tax provision. Like the state tax provision, there are no temporary or permanent differences in the calculation. A key item to note in the example that follows is that while the pretax book income (\$125,000) *starting point* for the state and federal tax provisions is the same, federal taxable income (\$118,750) is \$6,250 *less* than state taxable income (\$125,000) because of the deduction for state income taxes.

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1000 - Federal-only Tax Provision*					
* See worksheet 1100 for the state tax provision.					
Calculation of Current Federal Taxes	Tax Provision	Dollar Amt.	ETR	Notes/Explanations	
	Current Year	Current Year	Current Year		
Pretax Book Income	\$125,000	\$26,250	21.00%	From 1600 The expected tax expense/rate of PTBI at the statutory tax rate	
State Taxes					
(Deduction)/Benefit for State Taxes - Current Exp/(Ben)	(\$6,250)	(\$1,313)	-1.05%	From 1100 - State Tax Provision	
Tax Return Calculations					
Subtotal: Pre-NOL Federal Taxable Income	\$118,750				
Times: Federal Tax Rate	21.00%			From 80 - Tax Rates Summary	
Subtotal: Federal Tax Before Credits	\$24,938				
Less: Federal Tax Credits	\$0	\$0	0.00%	From 1200 - Sch M Summary worksheet	
Subtotal: Fed Tax Return Prov. - Current Tax Exp/(Ben)	\$24,938	\$24,938	19.95%	Tax expense/(benefit) on a tax return (cash) basis	
Other Adjustments & True-ups	\$0				
Subtotal: Other Adjustments & True-ups	\$0				
Total Current Taxes - Federal-only // Federal ETR	\$24,938	\$24,938	19.95%	Carries to the "Summary of Current and Deferred Taxes" below	
Summary of Current and Deferred Federal Taxes					
Current Tax Expense/(Benefit) - Federal	\$24,938			Carries to 5 - Financial Statements	
Deferred Tax Expense/(Benefit) - Federal	\$0			From 1310 - USP Deferreds - Fed; carries to 50 - Tax JE	
total Tax Provision - Federal	\$24,938				

13.3 State income taxes in the financial statement footnotes (5)

The following table shows how state (and federal) income taxes are presented in the financial statement footnotes.

Notes to Consolidated Financial Statements ("The Footnotes")			
Income Taxes			
The income tax provision/(benefit) for the year consisted of the following:			
<u>Current Income Taxes</u>			
Current Taxes - Federal	\$24,938	From 1000 - Federal Tax Provision	
Current Taxes - State	\$6,250	From 1100 - State Tax Provision	
<u>Deferred Income Taxes</u>			
Deferred Taxes - Federal	\$0	From 1000 - Federal Tax Provision	
Deferred Taxes - State	\$0	From 1100 - State Tax Provision	
Total Tax Provision or Expense/(Benefit)	\$31,188		

As one would intuitively expect, current income taxes as presented above for both federal and state purposes tie directly to their respective tax provision calculations. And, as previously noted, we are not presently considering the impact of deferred taxes.

13.4 State income taxes in the effective tax rate reconciliation (5)

The presentation of income taxes in the ETR reconciliation

Up to this point, I believe it can be said that accounting for state income taxes and presenting them in the financial statements has followed a logical progression. However, things take a turn when it comes to the effective tax rate ("ETR") reconciliation.

Effective Tax Rate Reconciliation		
The differences between the effective tax rate reflected in the tax provision and the federal statutory rates are as follows:		
Description	Dollar	Rate
Expected Tax Provision/(Benefit) at the Statutory Tax Rate	\$26,250	21.00%
State Taxes Net of Federal Benefit	\$4,938	3.95%
Other Adjustments	\$0	0.00%
Income Tax Provision/(Benefit) / Effective Tax Rate (ETR)	\$31,188	24.95%

Note that neither federal nor state income taxes in the above reconciliation tie to any of the figures we have reviewed so far. How can that be? Up to this point in this book, the first line of the ETR has been calculated using the simplified method of multiplying

pretax book income times a *blended* federal and state tax rate. But in practice, meaning in the actual financial statements of a company, the first line of the ETR reconciliation (\$26,250) is computed by multiplying pretax book income (\$125,000) times the *federal* tax rate (21%).

Thus, one of the main purposes of the ETR reconciliation, and what makes it so valuable and insightful for financial statement readers, is that it answers this question: how much income tax (\$26,250) would the company owe if pretax book income (\$125,000) was taxed at the *federal statutory tax rate* (21%)? From that point, the ETR reconciliation compares the “expected tax” (\$26,250) with actual income taxes per the tax provision (\$31,188) and shows all reconciling items in between (such as state taxes of \$4,938).

Understanding the difference between income taxes in the ETR reconciliation and elsewhere in the financial statements

So, let’s come back to our original question, why do federal and state taxes presented in the ETR reconciliation not tie to income taxes as presented in the financial statement footnotes? As noted above, the first line of the ETR reconciliation is NOT federal income taxes per the federal tax provision (\$24,938), but the EXPECTED tax of the company (\$26,250) if pretax book income (\$125,000) was taxed at the federal statutory rate (21%). The difference between these figures, what they represent, and where they’re located in the federal tax provision workpapers is shown in the following illustration.

	Tax Provision	Dollar Amt.	ETR
Calculation of Current Federal Taxes	Current Year	Current Year	Current Year
Pretax Book Income	\$125,000	\$26,250	21.00%
State Taxes			
(Deduction)/Benefit for State Taxes - Current Exp/(Ben)	(\$6,250)	(\$1,313)	-1.05%
Tax Return Calculations			
Subtotal: Pre-NOL Federal Taxable Income	\$118,750		
Times: Federal Tax Rate	21.00%		
Subtotal: Federal Tax Before Credits	\$24,938		
Less: Federal Tax Credits	\$0	\$0	0.00%
Subtotal: Fed Tax Return Prov. - Current Tax Exp/(Ben)	\$24,938	\$24,938	19.95%
Other Adjustments & True-ups	\$0		
Subtotal: Other Adjustments & True-ups	\$0		
Total Current Taxes - Federal-only / Federal ETR	\$24,938	\$24,938	19.95%

A second item to note is that, while the *individual* federal and state figures in the “Income Taxes” footnote are different than the ETR reconciliation amounts, the *combined* tax

provision in both tables is the same (\$31,188). Thus, by definition, if federal taxes in the ETR reconciliation are \$26,250 then, mathematically, state taxes MUST be \$4,938 for the total to come to \$31,188. The question is how is that \$4,938 computed, and what's the reasoning behind it? The answer is that in the ETR reconciliation, state taxes are reported "net of the federal benefit" (sometimes abbreviated "NOFB"). The illustration that follows shows how state taxes NOFB is calculated in our example.

State Taxes Net of the Federal Benefit		
Calculation of State Taxes "NOFB"		
Total Provision for State Taxes	\$6,250	From the summary above
Less: Federal Benefit of State Taxes	(\$1,313)	Calculated below
Equals: State Taxes Net of the Federal Benefit	\$4,938	Ties to 10 - Financial Statement Tie-out
Federal Benefit of State Taxes		
The Federal Deduction for State Taxes	(\$6,250)	From 1000 - Federal Tax Provision
Time: Federal Tax Rate	21.00%	From 80 - Tax Rates Summary
Equals: The Federal Benefit of State Taxes	(\$1,313)	Carries 10 - Financial Statement Tie-out
Summary of Current and Deferred State Taxes		
Current Tax Expense/(Benefit) - State	\$6,250	From above - Carries to 1000 - Federal Tax Provision
Deferred Tax Expense/(Benefit) - State	\$0	There are no state deferred taxes in this example
Total Provision for State Taxes	\$6,250	Carries to 1000 - Federal Tax Provision

"State taxes net of the federal benefit"

What exactly are "state taxes net of the federal benefit?" Conceptually, they represent "gross" state taxes (\$6,250) less the benefit (or subsidy) received by the company (\$1,313) for state taxes deducted on the federal tax return. Thus, state taxes "NOFB" are a "net" (\$4,938) vs. a "gross" concept. In summary, state taxes are reported as a "gross" concept in the financial statements and footnotes EXCEPT as part of the ETR reconciliation where they're reported on a "net" concept.

13.5 State taxes and the taxes payable on the balance sheet (5 and 60)

According to the balance sheet on the face of the financial statements, the taxes payable of the company is \$31,188 (see the illustration that follows).

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Consolidated Balance Sheet	Amounts
Other Assets (this includes all non-tax-related assets)	\$1,125,000
Deferred Tax Asset - Federal or State	\$0
Total Assets	\$1,125,000
Liability - Taxes Payable	\$31,188

Because this example is based on simplified assumptions, it's easy to think the support for the \$31,188 payable is from the tax provision calculation we have been reviewing so far. It is not. Below, we see that the \$31,188 is the sum of the federal (\$24,938) and state (\$6,250) taxes payable as shown on workpaper 60 (the "Tax Payable Rollforward").

Taxes (Payable)/Rec. Rollforward	Federal	State	Totals
Beginning of Year ("BOY") Tax Receivable/(Payable)	\$0	\$0	\$0
Tax (Expense)/Benefit - Q1 through Q3	\$0	\$0	\$0
Subtotal - Tax Expense/(Benefit) through Q1 - Q3	\$0	\$0	\$0
<u>Summary of Cash Taxes Paid/(Received)</u>			
Tax Payments/(Refunds) - Q1 Estimated Tax	\$0	\$0	\$0
Tax Payments/(Refunds) - Q2 Estimated Tax	\$0	\$0	\$0
Tax Payments/(Refunds) - Q3 Estimated Tax	\$0	\$0	\$0
Subtotal - Tax Payments/(Refunds) - Q1 - Q3	\$0	\$0	\$0
Subtotal: Net Receivable/(Payable) - Q1 - Q3	\$0	\$0	\$0
Current Tax (Expense)/Benefit - Current Period (Q4)	(\$24,938)	(\$6,250)	(\$31,188)
Other Adjustments	\$0	\$0	\$0
End of Year ("EOY") Tax Receivable/(Payable)	(\$24,938)	(\$6,250)	(\$31,188)

13.6 The use of blended tax rates

In general

The company in our simplified example operates in a single state. In practice, even a modest-sized company can be required to file tax returns in multiple states. By default, ASC 740 guidelines require a company to prepare a separate tax provision calculation for

each jurisdiction (i.e., each state in this case) in which it has a filing requirement. However, the ASC 740 rules are also sufficiently pragmatic to allow a combined state tax calculation through the use of a blended tax rate.¹²¹

It should be noted, however, that the use of a combined or blended state tax rate should *not* be taken for granted. Regardless of the approach, a company is expected to be materially correct in its separate computations of federal *and* state income taxes. Therefore, if a you desire to use a blended state tax rate in the preparation of the provision, you need to prepare a sufficient amount of analysis and support to show that it will result in a state tax expense that's reasonably close to what it would be if state taxes were computed separately for each jurisdiction.

Balancing volume, the related complexity, and materiality

An individual state tax provision isn't typically very difficult to understand, compute, and track. However, if a company files in all fifty states then, even if the income tax in any given state isn't material (except for, perhaps, one or two states), the volume of tax provision workpapers can quickly explode. That kind of volume adds complexity, and complexity increases the risk of a material tax-related misstatement.

It's for this reason that many companies combine, or "blend," their state tax provision calculations in some form or another, computing state taxes in the aggregate rather than on a state by state basis. It's also possible for companies to take a hybrid approach. For example, assume that a company files in ten states. Nine of those states have a similar approach for taxing the income of a corporation, but one has a very different approach. It should be acceptable to develop a methodology for applying a blended approach to the nine states and preparing a separate state tax provision for the "outlier" state (for a total of two state tax provisions).

¹²¹ See ASC 740-10-55-25.

14 State Taxes – Permanent and Temporary Differences

In the previous chapter you gained an understanding of how state income taxes are calculated for tax provision purposes, as well as the difference for how they are presented in the effective tax rate reconciliation and income tax table sections of the financial statement footnotes. In this chapter, we will layer in permanent and temporary differences and evaluate not only how they impact state income taxes, but other aspects of the tax provision calculation, as well as the financial statements and accompanying footnote disclosures.

14.1 An example of a permanent difference and state taxes

Current tax provision – State taxes (1100)

Permanent Differences - GL-related - Expenses	
Expense - Permanent Item	\$20,000
Times: Sch M Statutory Disallowance %	50%
Perm. Difference - GL-related Item - (Fav)/Unfav. Sch M	\$10,000

In this first example, there is a GAAP expense of \$20,000 that is only 50% deductible for tax purposes, meaning the tax deduction is \$10,000 (see the illustration above).

State Tax Provision Calculation	Tax Provision
	Current Year
Pretax Book Income	\$105,000
Permanent Differences	
Permanent Difference - GL-related Items - Revenue	\$0
Permanent Difference - GL-related Items - Expenses	\$10,000
Permanent Difference - Special Tax Calculation	\$0
Temporary Differences	
Temporary Difference - GL-related Items	\$0
Temporary Difference - Depreciation	\$0
Tax Return Calculations	
Subtotal: Pre-NOL State Taxable Income	\$115,000
Times: State Tax Rate	5.00%
Subtotal: State Tax Before Credits	\$5,750
Less: State Tax Credits	\$0
Subtotal: State Tax Return Prov. - Current Tax Exp/(Ben)	\$5,750
Other Adjustments & True-ups	\$0
Subtotal: Other Adjustments & True-ups	\$0
Equals: Total State Taxes - Current	\$5,750

As explained in the previous chapter, you complete the state tax provision prior to the federal tax provision. A screenshot of workpaper 1100 ("State Tax Provision") with the permanent difference of \$10,000 is shown to the left.

A key observation – and this is something that can even be missed by experienced tax professionals – is that part of the impact of permanent items is *embedded* in the state tax expense (this will be covered in more detail later in the chapter).

Current tax provision – Federal taxes (1000)

With the state tax provision completed, you now know the amount of state income taxes (\$5,750) that can be deducted in the federal tax provision. Taking that into account, along with the permanent difference (\$10,000), the federal tax provision computation looks like this:

Calculation of Current Federal Taxes	Current Year
Pretax Book Income	\$105,000
State Taxes	
(Deduction)/Benefit for State Taxes - Current Exp/(Ben)	(\$5,750)
Permanent Differences	
Permanent Difference - GL-related Items - Revenue	\$0
Permanent Difference - GL-related Items - Expenses	\$10,000
Permanent Difference - Special Tax Calculation	\$0
Temporary Differences	
Temporary Difference - GL-related Items	\$0
Temporary Difference - Depreciation	\$0
Tax Return Calculations	
Subtotal: Pre-NOL Federal Taxable Income	\$109,250
Times: Federal Tax Rate	21.00%
Subtotal: Federal Tax Before Credits	\$22,943
Less: Federal Tax Credits	\$0
Subtotal: Fed Tax Return Prov. - Current Tax Exp/(Ben)	\$22,943
Other Adjustments & True-ups	\$0
Subtotal: Other Adjustments & True-ups	\$0
Total Current Taxes - Federal-only / Federal ETR	\$22,943

So far in this book we have assumed that the current tax expense is an estimate at the time the provision is prepared (e.g., January and February) of the taxes that will be due when the tax returns are filed (e.g., September or October). Ignoring the impact of extension and estimated tax payments, this means we expect we will owe \$5,750 with our state income tax return and \$22,943 with our federal income tax return.

Taxes payable rollforward (60)

With current tax concepts in mind, it's helpful to look at the taxes payable rollforward (workpaper 60):

Taxes (Payable)/Rec. Rollforward	Federal	State	Totals
Beginning of Year ("BOY") Tax Receivable/(Payable)	\$0	\$0	\$0
Tax (Expense)/Benefit - Q1 through Q3	\$0	\$0	\$0
Subtotal - Tax Expense/(Benefit) through Q1 - Q3	\$0	\$0	\$0
<u>Summary of Cash Taxes Paid/(Received)</u>			
Tax Payments/(Refunds) - Q1 Estimated Tax	\$0	\$0	\$0
Tax Payments/(Refunds) - Q2 Estimated Tax	\$0	\$0	\$0
Tax Payments/(Refunds) - Q3 Estimated Tax	\$0	\$0	\$0
Subtotal - Tax Payments/(Refunds) - Q1 - Q3	\$0	\$0	\$0
Subtotal: Net Receivable/(Payable) - Q1 - Q3	\$0	\$0	\$0
Current Tax (Expense)/Benefit - Current Period (Q4)	(\$22,943)	(\$5,750)	(\$28,693)
Other Adjustments	\$0	\$0	\$0
End of Year ("EOY") Tax Receivable/(Payable)	(\$22,943)	(\$5,750)	(\$28,693)

Notice here that the payable balances for federal (\$22,943) and state (\$5,750) taxes correspond to the current federal and state tax provision calculations, respectively. Thus, in the context of this example, the taxes payable rollforward is equal to actual (or cash) taxes that are expected to be payable to tax authorities based on the tax returns that will be filed.

The financial statement balance sheet (5)

The taxes payable on the balance sheet (\$28,693) ties back to the combined amount in the taxes payable rollforward (see the illustration in the previous subsection above).

Consolidated Balance Sheet	Amounts
Other Assets (this includes all non-tax-related assets)	\$1,105,000
Deferred Tax Asset - Federal & State	\$0
Total Assets	\$1,105,000
Liability - Taxes Payable	\$28,693
Deferred Tax Liability - Federal or State	\$0
Other Liabilities (this includes all non-tax-related liabilities)	\$0
Equity - Common Stock & APIC	\$1,000,000
Equity - Retained Earnings	\$76,308
Total Liabilities & Stockholders' Equity	\$1,105,000

The income tax table in the financial statement footnotes (5)

The table for income taxes in the financial statement footnotes is presented as follows:

Income Taxes			
The income tax provision/(benefit) for the year consisted of the following:			
<u>Current Income Taxes</u>			
Current Taxes - Federal	\$22,943	From 1000 - Federal Tax Provision	
Current Taxes - State	\$5,750	From 1100 - State Tax Provision	
<u>Deferred Income Taxes</u>			
Deferred Taxes - Federal	\$0	From 1000 and 1310 - Federal Tax Prov. and Fed. Tax Deferred RF	
Deferred Taxes - State	\$0	From 1100 and 1320 - State Tax Prov. and State Tax Deferred RF	
Total Tax Provision or Expense/(Benefit)	\$28,693	Ties to the income statement on page 1 of 2	

Important observations are as follows:

- The “Current Income Taxes” section of the footnote ties to the federal and state tax provision calculations, respectively.
 - It’s possible to look at the total tax provision amount of \$28,693 and conclude that it relates to the taxes payable rollforward since the totals are the same.
 - While that’s the case in this example, it’s only because of simplified assumptions (it’s year 1 and there were no extension or estimated tax payments).
 - In summary, while there is a *relationship* between current taxes (an income statement concept) and taxes payable (a balance sheet concept), the totals for each are rarely the same in an actual tax provision.
- There are no temporary differences in this example, and thus no deferred taxes.

14.2 State taxes and the effective tax rate reconciliation

The ETR reconciliation – In general (5)

Thus far, state income taxes in the tax provision have followed a logical pattern in the sense that each computation is what we would (theoretically) expect to tie to a past or future tax return. However, as explained in the previous chapter, the presentation of the effective tax rate (“ETR”) reconciliation follows a different approach.

Effective Tax Rate Reconciliation			
The differences between the effective tax rate reflected in the tax provision and the federal statutory rates are as follows:			
Description	Dollar	Rate	
Expected Tax Provision/(Benefit) at the Statutory Tax Rate	\$22,050	21.00%	From 1000 - Federal Tax Provision
State Taxes Net of Federal Benefit	\$4,543	4.33%	From 1100 - State Tax Provision
Nondeductible Expenses	\$2,100	2.00%	From 1000 - Federal Tax Provision
Income Tax Provision/(Benefit) / Effective Tax Rate (ETR)	\$28,693	27.33%	Ties to the financial statements and the footnote above

The following observations are similarities and differences between the income tax table (pictured at the top of the previous page) and the ETR reconciliation.

- The total taxes in both tables are the same (\$28,693).
- The first line of the ETR reconciliation, or the “expected tax” of the company (\$22,050), is equal to pretax book income (\$105,000) times the federal statutory tax rate (21%).
 - By definition, this means the federal taxes per the income tax table (\$22,943) will *rarely* (if ever) tie to the expected federal taxes per the ETR (\$22,050).
- Related to the previous point, it’s important to recognize that, from a theoretical perspective, the company should “only” have federal income taxes equal to \$22,050. If the actual income tax provision is a different amount (\$28,693), such differences are itemized in the ETR reconciliation.

There are other important observations to make, but these will be pointed out separately in the following subsection on state taxes and the ETR reconciliation.

State taxes and the effective tax rate reconciliation

You’ll notice from the ETR table on the previous page that one of the key reconciling differences between the expected tax at the federal statutory tax rate (\$22,050) and the total income tax provision (\$28,693) is state taxes (\$4,543).¹²² However, recall from the state tax provision calculation, the total states taxes were calculated to be \$5,750 (see the illustration to the right).

What accounts for the \$1,208 difference between the current tax provision amount of \$5,750 and the state taxes per the ETR reconciliation of \$4,543? The answer is that state taxes in the ETR reconciliation are shown *net* of the federal benefit (or “NOFB”), and the impact of

State Tax Provision Calculation		Tax Provision
		Current Year
Pretax Book Income		\$105,000
Permanent Differences		
Permanent Difference - GL-related Items - Revenue		\$0
Permanent Difference - GL-related Items - Expenses		\$10,000
Permanent Difference - Special Tax Calculation		\$0
Temporary Differences		
Temporary Difference - GL-related Items		\$0
Temporary Difference - Depreciation		\$0
Tax Return Calculations		
Subtotal: Pre-NOL State Taxable Income		\$115,000
Times: State Tax Rate		5.00%
Subtotal: State Tax Before Credits		\$5,750
Less: State Tax Credits		\$0
Subtotal: State Tax Return Prov. - Current Tax Exp/(Ben)		\$5,750
Other Adjustments & True-ups		\$0
Subtotal: Other Adjustments & True-ups		\$0
Equals: Total State Taxes - Current		\$5,750

¹²² The other difference in this example is a permanent difference of \$2,100, which we will address shortly.

permanent differences explains the rest. These concepts are illustrated in the calculations that follow, with a focus on the reconciliation bracketed in red.

State Taxes Net of the Federal Benefit	PTBI	Perm	Totals
Taxable Income	\$105,000	\$10,000	\$115,000
Times: Rate	5.00%	5.00%	5.00%
State Taxes	\$5,250	\$500	\$5,750
Less: Fed. Benefit of State Taxes	(\$1,103)	(\$105)	(\$1,208)
Equals: State Taxes Net of Fed. Benefit	\$4,148	\$395	\$4,543
Federal Benefit of State Taxes			
State Taxes	(\$5,250)	(\$500)	(\$5,750)
Times: Federal Rate	21.00%	21.00%	21.00%
Equals: Fed. Benefit of State Taxes	(\$1,103)	(\$105)	(\$1,208)
Total Permanent Differences			
Federal Tax Rate	21.00%		
Add: State Tax Rate Net of Fed. Benefit	3.95%		
Subtotal: Total Blended Tax Rate	24.95%		
Times: Total Permanent Differences	\$10,000		
Equals: Total Blended Tax on Perms	\$2,495		
Permanent Item Impact on State Taxes			
Total Blended Tax on Perms	\$2,495		
State Tax NOFB from the Financial Stmt. Rate Reconciliation	(\$2,100)		
Equals: Perm. Item Impact on State Taxes	\$395		

- As previously noted, state taxes in the ETR reconciliation are presented net of the federal benefit for the deduction of state taxes.
- Focusing solely on the PTBI amount that's driving taxable income, \$105,000 times 5% equals state taxes of \$5,250, and the federal deduction for this amount is \$1,103 (see the calculations above).
- There is a permanent difference impact on state taxes NOFB as well (\$105), as shown in the "Perm" column of the calculation in the top section.
- Some have the erroneous understanding that the state tax expense is *only* comprised of "state taxes." However, the calculations above clearly show that a portion of the company's overall permanent differences are embedded in both current state taxes (\$5,750) and state taxes NOFB (\$4,543).
 - See the calculations with the headings "Total Permanent Differences" and "Permanent Item Impact on State Taxes" to further illustrate this point.
 - Based on a blended federal and state tax rate concept (24.95%), we would expect the total impact of the permanent difference of \$10,000 to equal \$2,495.

- However, when referring to the ETR reconciliation, the tax impact of permanent differences is only \$2,100. Thus, the separate line item for permanent differences only shows the *federal* impact (\$10,000 times 21%).
- The \$395 state impact of the permanent difference of \$10,000 is embedded in the calculation of current state taxes. It's equal to \$10,000 times the state tax rate of 5% (\$500) less the \$105 federal benefit of state taxes (state taxes of \$500 times the 21% federal tax rate).

In summary, state taxes are computed at “gross” amounts throughout the tax provision calculation, and conceptually these gross amounts can be thought of as tax return concepts. However, for purposes of the ETR:

- State taxes are reported *net* of the federal benefit (NOFB) of the state tax deduction on the federal return and
- Permanent difference in the ETR reconciliation (\$2,100 in the ETR table) only include the federal tax impact (or the \$10,000 permanent difference times 21%).

The rationale for the presentation of state taxes in the financial statements

So, why have all of the complexity in the presentation of state taxes in the financial statements? Why isn't there consistency between state income taxes in the income tax table (\$5,750) and the ETR reconciliation (\$4,543)? While I confess not to know the full history of how this standard evolved as part of SEC reporting, I will attempt an educated guess.

I believe it mostly comes down to making the financial statements useful to those who read and analyze them. Even sophisticated and experienced finance and accounting (and tax!) professionals can have difficulty following and understanding all the income tax-related aspects of the financial statements. And some even bypass an in-depth analysis of income taxes altogether, focusing instead on metrics such as pretax book income, EBITDA, various non-GAAP figures and summaries, and other measures that exclude income taxes.

Still, taxes are a significant and material item for many companies, and it's important for “non-tax” financial statement readers to have a straightforward way to assess a company's tax profile. That's where the ETR reconciliation comes in. The first line of the ETR reconciliation is intuitive and answers the question, “What's the expected federal tax of the company solely based on pretax book income?” It also answers the questions:

- “If the company's actual income tax provision isn't that number, why not?” and
- “What factors are driving the differences between the expected tax based on pretax book income and actual taxes per the total income tax provision?”

However, in order to have simplicity in this one area (i.e., the ETR reconciliation), the computational mechanics are such that it creates complexity with rationalizing and reconciling the figures in the ETR reconciliation with other aspects of the tax provision. That said, I personally believe that after understanding the reasoning behind these differences, the tradeoff of complexity for additional insight provided by the ETR reconciliation is worth it.

14.3 A simple example of a temporary difference and deferred taxes that includes state taxes

A progressive introduction to temporary differences and state taxes

In this section, we'll walk through a simple example that involves accounting for temporary differences and the related deferred taxes that includes state income taxes. What makes this example "simple?"

- There are no permanent differences.
- There is a single unfavorable temporary difference in the form of an accrued expense of \$20,000 that's an expense for book but not deductible for tax until it's paid.
- Revenue (\$20,000) is set to be an exact offset to accrued expenses (also \$20,000), so pretax book income is equal to zero (\$0).

These simplifications should enable you to more easily isolate and see the state-related impacts caused by temporary differences. In the next section, we'll layer in additional revenue and expenses so that pretax book income is positive, but there will still be no permanent differences in the tax provision calculation.

Finally, while I have separated the presentation and analysis of the state tax impacts of permanent and temporary differences in this chapter, Appendix 5 is a comprehensive example that *combines* permanent differences, temporary differences, deferred taxes, and state income taxes in a single tax provision calculation so you can see how all of these concepts come together.

Pretax book income (5 and 1600)

As noted in the introduction to this section, in this simplified example revenue and expenses offset, meaning pretax book income is zero.

Revenue	\$20,000
Expenses (Pretax)	(\$20,000)
Income/(Loss) Before Income Tax Provision	\$0

The current state income tax expense (1100)

Remember, just because pretax book income is zero, it doesn't automatically follow that *taxable* income is zero. In this example, the accrued expenses of \$20,000 are a GAAP expense, but they are an unfavorable temporary difference for tax purposes. This is reflected in the computation of the current (as opposed to deferred) state income taxes in the illustration that follows.

State Tax Provision Calculation	Tax Provision	
	Current Year	Notes/Explanations
Pretax Book Income	\$0	From 1600
Permanent Differences		
Permanent Difference - GL-related Items - Revenue	\$0	From 1200 - Sch M Summary worksheet
Permanent Difference - GL-related Items - Expenses	\$0	
Permanent Difference - Special Tax Calculation	\$0	
Temporary Differences		
Temporary Difference - GL-related Items	\$20,000	
Temporary Difference - Depreciation	\$0	
Tax Return Calculations		
Subtotal: Pre-NOL State Taxable Income	\$20,000	
Times: State Tax Rate	5.00%	From 80 - Tax Rates Summary
Subtotal: State Tax Before Credits	\$1,000	
Less: State Tax Credits	\$0	From 1200 - Sch M Summary worksheet
Subtotal: State Tax Return Prov. - Current Tax Exp/(Ben)	\$1,000	Tax expense/(benefit) on a tax return (cash) basis
Other Adjustments & True-ups	\$0	
Subtotal: Other Adjustments & True-ups	\$0	
Equals: Total State Taxes - Current	\$1,000	Carries to the summary below

This example is interesting in the sense that the company is projected to have a current state (cash) tax liability when it files its tax return even though its pretax book income is *zero*. However, the total tax provision (meaning the sum of current and deferred taxes) of the company in this example of the company will also be zero. Why and how that's the case is addressed in the subsection that follows.

The deferred tax calculations for state income taxes (1320)

Recall from previous chapters that temporary differences between book (GAAP) and tax are by their very nature *temporary*. In other words, they will reverse over time. In our example, this means the \$20,000 unfavorable temporary difference that's increasing

taxable income in the current year will, in theory, be a \$20,000 *deduction* in a future year.¹²³

What the combination of the concepts above mean is the *net* state tax for provision purposes in this example will be zero. One way to see what may seem like a counterintuitive outcome is by reviewing the journal entries to record state taxes. Referring to the state tax provision calculation in the previous subsection, the current state income tax is \$1,000, and the journal entry is as follows:

State Income Tax Expense – Current	\$1,000	
Taxes Payable – State Income Taxes		\$1,000

The entry for the deferred state tax benefit is as follows, with the support in the table that follows (workpaper 1320).¹²⁴

Deferred Tax Asset – State Income Tax	\$1,000	
State Income Tax <u>Benefit</u> – Deferred ¹²⁵		\$1,000 ¹²⁶

[This space was intentionally left blank].

¹²³ There are a lot of assumptions built into this simplified statement. First, the \$20,000 deduction may or may not all occur in a single future tax period. Second, the state tax rate applicable to the current year's tax deduction (5% in this example) may increase or decrease in the future. And, finally, the company must have sufficient taxable income in the future to be able to use the deduction. The considerations and analysis related to this last point will fall under the topic of valuation allowances, which I do not address in this book. In summary, for purposes of the present example, we will assume that all deferred tax assets will be realizable in the future and that future taxable income will be taxed at a rate that's the same as Year 1.

¹²⁴ If you need a review of temporary differences and deferred taxes then see the applicable chapters from earlier in the material. But, in brief, the table shows that the \$20,000 disallowed in the current year will result in a state tax benefit of \$1,000 in a future period (the \$20,000 deduction times the 5% tax rate). This is recognized in the current year as a deferred tax benefit (a \$1,000 credit to tax expense) and as an offsetting deferred tax asset (\$1,000).

¹²⁵ This line of the journal entry hits the P&L, and it's a tax benefit in the sense that it's a negative tax expense (or a credit to deferred taxes).

¹²⁶ Unless you're relying on tax provision software, I recommend separating the journal entries for current and deferred taxes because it makes it far easier to rationalize, document, and support.

Deferred Tax Asset/Liability Computation								
Description	Gross Beg. Balance	Adjustments BOY Balance	Adjusted Beg. Balance	Current Activity	Times: State Tax Rate	Unadjusted Deferred Tax Asset/(Liability)	Adjustments	Adjusted Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$0	\$0	\$20,000	5.00%	\$1,000	\$0	\$1,000
Other Temporary Differences	\$0	\$0	\$0	\$0	5.00%	\$0	\$0	\$0
Total Deferred Tax Assets/(Liabilities) - State	\$0	\$0	\$0	\$20,000		\$1,000	\$0	\$1,000
	From tab 1300							
	Pretax Deferreds							
Deferred Tax Expense/Benefit Calculation								
BOY Deferred Tax Assets/(Liabilities) - State	\$0							
Less: EOY Deferred Tax Assets/(Liabilities) - State	(\$1,000)							
Equals: Deferred Tax Expense/(Benefit)	(\$1,000)							

Notice from the journal entries that the current tax expense is \$1,000, but, unlike for a permanent difference, there is an equal and offsetting deferred tax benefit (a credit entry) of \$1,000. Thus, when you net these two items together, the net income tax expense of the company is zero. This is a concept that we will revisit in more detail shortly, but let's first look at federal income taxes.

The current federal income tax expense (1000)

The current federal income tax expense is calculated as follows:

	Tax Provision
Calculation of Current Federal Taxes	Current Year
Pretax Book Income	\$0
State Taxes	
(Deduction)/Benefit for State Taxes - Current Exp/(Ben)	(\$1,000)
Permanent Differences	
Permanent Difference - GL-related Items - Revenue	\$0
Permanent Difference - GL-related Items - Expenses	\$0
Permanent Difference - Special Tax Calculation	\$0
Temporary Differences	
Temporary Difference - GL-related Items	\$20,000
Temporary Difference - Depreciation	\$0
Tax Return Calculations	
Subtotal: Pre-NOL Federal Taxable Income	\$19,000
Times: Federal Tax Rate	21.00%
Subtotal: Federal Tax Before Credits	\$3,990
Less: Federal Tax Credits	\$0
Subtotal: Fed Tax Return Prov. - Current Tax Exp/(Ben)	\$3,990
Other Adjustments & True-ups	\$0
Subtotal: Other Adjustments & True-ups	\$0
Total Current Taxes - Federal-only // Federal ETR	\$3,990

As a review from previous sections, the deduction for state taxes (\$1,000) is factored into the computation of federal taxable income (\$19,000). Thus, the current federal tax expense of the company is \$3,990, and the journal entry to record this result is:

Federal Income Tax Expense – Current	\$3,990
Taxes Payable – Federal Income Taxes	\$3,990

The deferred tax calculations for federal income taxes (1310)

The computation of the deferred tax asset and benefit for federal income taxes is computed in a manner that's analogous to state income taxes with one key difference. Like the computation of federal current taxes, the deferred federal tax computation must take the deduction for state taxes income account. Here is the computation of the deferred tax asset in what I'll refer to as "Method #1:"

Deferred Tax Assets/Liabilities - Method #1				Fed. Tax Rate			
	Gross	Current Year		Less the Fed.	Unadjusted		Adjusted
Description	Beg. Balance	Gross Temp. Differences	Adjusted Balance	Benefit of State Taxes	Deferred Tax Asset/(Liability)	Other Adjustments	Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$20,000	\$20,000	19.95%	\$3,990	\$0	\$3,990
Other Temporary Differences	\$0	\$0	\$0	19.95%	\$0	\$0	\$0
				See the rate			
Total Deferred Tax Assets/(Liabilities) - Federal	\$0	\$20,000	\$20,000	calculation	\$3,990	\$0	\$3,990

In the table above, notice that the deferred tax asset of \$3,990 (a debit), which is a *balance sheet* representation of the future value of federal tax deductions, is exactly equal to the current federal tax expense for Year 1 (see the previous subsection). Similarly, the computation of the deferred federal tax benefit (a credit), a *P&L* concept, is as follows:

Deferred Tax Expense/Benefit Calculation (Methods #1 and #2)

BOY Deferred Tax Assets/(Liabilities) - Federal	\$0
Less: EOY Deferred Tax Assets/(Liabilities) - Federal	(\$3,990)
Equals: Deferred Tax Expense/(Benefit) (P&L impact)	(\$3,990)

Thus, the journal entry to record deferred taxes is as follows:

Deferred Tax Asset – Federal Income Tax	\$3,990
Federal Income Tax <u>Benefit</u> – Deferred	\$3,990

Similar to state taxes, since the *current* federal tax expense (a debit of \$3,990) and the *deferred* federal tax benefit (a credit of \$3,990) are equal, the net federal income tax expense of the company is zero. In other words, because of the nature of temporary differences, the federal tax owed by the company for Year 1 as a current tax expense (\$3,990) will be offset by a deferred tax benefit (\$3,990) when the temporary difference of \$20,000 is deducted in a future federal tax return.

While the concept of future tax benefits offsetting current taxes may seem intuitive, it's not so easy to see where the 19.95% tax rate comes from in the deferred tax asset table that makes the math come out right, or a tax rate that results in a deferred federal tax asset and deferred tax benefit of \$3,990. After all, the federal statutory rate is 21%. So, again, where does the 19.95% come from? The answer is this percentage (19.95%) is equal to the federal tax rate (21%) less the rate for the federal benefit of the state tax deduction (1.05%), as illustrated in the calculation to the right.

Federal Statutory Rate - Current Year	21.00%
Less: Federal Benefit of the State Tax Deduction	-1.05%
Equal: Federal Tax Rate for Deferred Taxes	19.95%

This leads to another question: how is the federal benefit of the state tax deduction of 1.05% calculated? The answer is as follows:

The Federal Benefit of the State Tax Deduction Percentage

Gross Blended State Tax Rate	5.00%
Times: Federal Statutory Rate	21.00%
Equals: Federal Benefit of the State Tax Deduction	1.05%

If you find the “Method #1” percentage approach to be a difficult way to visualize the state effects on the federal computation of deferred taxes, consider this “Method #2” approach that, I believe, more clearly illustrates the effect of the state tax deduction:

Deferred Tax Assets/Liabilities - Method #2							
	Gross	Adjusted Beg.	Gross	(Ded.)/Benefit	Temp. Diff.	Times:	
Description	Beg. Balance	Balance	Temporary Differences	for State Tax Expense ¹	Net of State Tax (Ded.)/Ben.	Federal	Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$0	\$20,000	(\$1,000)	\$19,000	21.00%	\$3,990
Other Temporary Differences	\$0	\$0	\$0			21.00%	\$0
Total Deferred Tax Assets/(Liabilities) - Federal	\$0	\$0	\$20,000				\$3,990

Observations for this “Method #2” approach are as follows:

- Similar to the current tax provision, the tax benefit of state income taxes (\$1,000) is deducted from the gross temporary difference (\$20,000), which results in a federal temporary difference of \$19,000.
- This federal temporary difference (\$19,000) is then multiplied by the federal *statutory* rate of 21% to compute the deferred tax asset (\$3,990).
- The deferred tax benefit (a credit of \$3,990) associated with the deferred tax asset (a debit of \$3,990) is computed as shown in Method #1.

The financial statements and the footnotes (5)

I've repeatedly emphasized that for this example the net income tax expense is zero. Let's see what that looks like in the various elements of the financial statements and the related footnotes. First, the income statement:

Consolidated Statement of Comprehensive Income/(Loss)

Revenue	\$20,000
Expenses (Pretax)	(\$20,000)
Income/(Loss) Before Income Tax Provision	\$0
Income Tax (Provision)/Benefit	\$0
Net Income	\$0

- Revenue (\$20,000) is equal to accrued expenses (also \$20,000), so pretax book income is zero.
- Also, the income tax provision is equal to zero because the federal and state current tax expenses associated with the unfavorable temporary difference are offset by corresponding deferred tax benefits.

Now, let's look at the rate reconciliation:

Description	Dollar
Expected Tax Provision/(Benefit) at the Statutory Tax Rate	\$0
State Taxes Net of Federal Benefit	\$0
Nondeductible Expenses	\$0
Income Tax Provision/(Benefit) / Effective Tax Rate (ETR)	\$0

- The expected tax provision on line one is equal to pretax book income (\$0) times the federal statutory rate (21%), which is equal to zero.
- Following this logic, the income tax provision per the ETR table is also equal to zero, and there are no reconciling items between book and tax income.

Finally, let's look at the income tax table in the footnotes, the illustration that provides the most insight for understanding this example.

Income Taxes	
The income tax provision/(benefit) for the year consisted of the following:	
<u>Current Income Taxes</u>	
Current Taxes - Federal	\$3,990
Current Taxes - State	\$1,000
<u>Deferred Income Taxes</u>	
Deferred Taxes - Federal	(\$3,990)
Deferred Taxes - State	(\$1,000)
Total Tax Provision or Expense/(Benefit)	\$0

- Here we can see the net tax provision is zero, which is consistent with the income statement and the ETR reconciliation analysis above.

- However, with this presentation, it's far easier to see that, despite the fact that the net tax provision is zero, it's only because current year federal and state taxes are offset by deferred federal and state taxes.
 - Restating this point in a slightly different way, the table also shows that, despite owing taxes for the current year, the company expects to receive equal and offsetting tax benefits from future tax deductions based on the eventual reversal of the Year 1 temporary difference.

The mistake of netting the tax rate when computing deferred state income taxes

There may be times in practice where you may see the state tax rate net of the federal benefit used as a “shortcut” or as a “simplification” to compute state deferred taxes. Here is how that “shortcut” rate is computed:

The State Tax Rate Net of the Federal Benefit	
Gross Blended State Tax Rate	5.00%
Less: Fed. Benefit of the State Tax Deduction	-1.05%
Equals: State Tax Rate Net of the Federal Benefit	3.95%

Here is that same tax rate being used in the computation of deferred state taxes:

Description	Gross Beg. Balance	Adjustments BOY Balance	Adjusted Beg. Balance	Current Activity	Times: State Tax Rate	Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$0	\$0	\$20,000	3.95%	\$790
Other Temporary Differences	\$0	\$0	\$0	\$0	3.95%	\$0
Total Deferred Tax Assets/(Liabilities) - State	\$0	\$0	\$0	\$20,000		\$790
	From tab 1300					
	Pretax Deferreds					
Deferred Tax Expense/Benefit Calculation						
BOY Deferred Tax Assets/(Liabilities) - State	\$0					
Less: EOY Deferred Tax Assets/(Liabilities) - State	(\$790)					
Equals: Deferred Tax Expense/(Benefit)	(\$790)					

Following this logic, the federal *statutory rate* is used to compute federal deferred taxes:

Description	Gross Beg. Balance	Gross Temp. Differences	Adjusted Balance	Benefit of State Taxes	Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$20,000	\$20,000	21.00%	\$4,200
Other Temporary Differences	\$0	\$0	\$0	21.00%	\$0
Total Deferred Tax Assets/(Liabilities) - Federal	\$0	\$20,000	\$20,000	See the rate calculation	\$4,200
	From 1300	From 1200		below	
Deferred Tax Expense/Benefit Calculation (Methods #1 and #2)					
BOY Deferred Tax Assets/(Liabilities) - Federal				\$0	
Less: EOY Deferred Tax Assets/(Liabilities) - Federal				(\$4,200)	
Equals: Deferred Tax Expense/(Benefit) (P&L impact)				(\$4,200)	

However, the problem with this method becomes clearer when we review the income tax table from the financial statement footnotes in the illustration that follows:

Income Taxes	
The income tax provision/(benefit) for the year consisted of the following:	
<u>Current Income Taxes</u>	
Current Taxes - Federal	\$3,990
Current Taxes - State	\$1,000
<u>Deferred Income Taxes</u>	
Deferred Taxes - Federal	(\$4,200)
Deferred Taxes - State	(\$790)
Total Tax Provision or Expense/(Benefit)	\$0

First, it's true that this "net method" gets us to the same place as the "gross method" in the computation of the total tax provision (\$0), because *total* federal and state current taxes are fully offset by *total* deferred taxes. But notice that this approach results in a mismatch between the current and deferred federal and state taxes. In other words, in the company's present fact pattern, federal and state taxes *should* individually net to zero. However, the current federal taxes (\$3,990) do not fully offset against the federal deferred benefit (\$4,200), and state taxes have the same issue (a \$1,000 current tax expense vs. a \$790 deferred tax benefit).

This example shows that employing a "net method" to state taxes in computing either current or deferred taxes is incorrect. Instead, the "gross method" of using the full state tax rate (5%) should be used in state income tax calculations, and the deduction for state taxes should be reflected in both federal current and deferred calculations. The exception is that a net state income tax concept should be employed in the ETR reconciliation, a concept that we've previously covered in detail.¹²⁷

Finally, what do you do in practice if you encounter a company that employs the "net method" for state tax computations?¹²⁸ First, you should recognize that it's not technically correct and inform the appropriate individuals that is the case.¹²⁹ However, as a purely practical matter, it's something you *may* be able to note but pass on if the overall impact on the financial statements and the accompanying footnotes is immaterial.¹³⁰

¹²⁷ For further support, see ASC 740-10-55-20 and ASC 740-10-45-6.

¹²⁸ This could happen if you're new to a company or if you're auditing a company's tax provision.

¹²⁹ Who those individuals are will vary based on the situation, as well as whether you are working for the company or auditing them.

¹³⁰ What if a company is audited and they have consistently used the "net method," but it's not an issue the auditors have ever raised? Does this mean the auditors have signed off on the approach? You should not assume that's the case. The auditors may uncover this and other findings during the course of the audit they don't agree with. However, if

14.4 A more realistic example of a temporary difference and deferred taxes that includes state taxes

The company has pretax book income and a tax expense

Now that we've covered the fundamentals of how state income taxes interact with temporary differences in a tax provision, we'll examine a more realistic example where the company has pretax book income and a tax expense (instead of both being zero), which is summarized in the income statement as follows:

Revenue	\$340,000
Expenses (Pretax)	(\$235,000)
Income/(Loss) Before Income Tax Provision	\$105,000
Income Tax (Provision)/Benefit	(\$26,198)
Net Income	\$78,803

The breakdown of the \$235,000 pretax expenses (that exclude the tax expense) is as follows:

- \$215,000 are “standard” expenses where GAAP (or “book”) and tax are the same.
- As with the previous simplified example, there is a \$20,000 amount that is an expense for GAAP but is a temporary difference for tax.
 - This \$20,000 amount is not deductible in Year 1, but it will be deductible in a future period when the amount is paid or settled.

The current state income tax expense (1100)

The current state tax expense, or the cash tax expense expected upon the filing of the Year 1 tax return, is \$6,250.¹³¹ It is computed as follows:

[This space was intentionally left blank].

such items are immaterial, they may document them in their audit workpapers without raising them with the client.

¹³¹ We are presently continuing with the assumption that current taxes are a proxy for cash taxes, but there are other factors to consider in practice.

State Tax Provision Calculation		Tax Provision
		Current Year
Pretax Book Income		\$105,000
Permanent Differences		
Permanent Difference - GL-related Items - Revenue		\$0
Permanent Difference - GL-related Items - Expenses		\$0
Permanent Difference - Special Tax Calculation		\$0
Temporary Differences		
Temporary Difference - GL-related Items		\$20,000
Temporary Difference - Depreciation		\$0
Tax Return Calculations		
Subtotal: Pre-NOL State Taxable Income		\$125,000
Times: State Tax Rate		5.00%
Subtotal: State Tax Before Credits		\$6,250
Less: State Tax Credits		\$0
Subtotal: State Tax Return Prov. - Current Tax Exp/(Ben)		\$6,250

It's worth noting in this example that pretax book income (\$105,000), not the unfavorable temporary difference (\$20,000), is the main driver of the current tax expense (\$6,250).

The current federal income tax expense (1000)

The current federal income tax expense is as follows:

Calculation of Current Federal Taxes		Current Year
Pretax Book Income		\$105,000
State Taxes		
(Deduction)/Benefit for State Taxes - Current Exp/(Ben)		(\$6,250)
Permanent Differences		
Permanent Difference - GL-related Items - Revenue		\$0
Permanent Difference - GL-related Items - Expenses		\$0
Permanent Difference - Special Tax Calculation		\$0
Temporary Differences		
Temporary Difference - GL-related Items		\$20,000
Temporary Difference - Depreciation		\$0
Tax Return Calculations		
Subtotal: Pre-NOL Federal Taxable Income		\$118,750
Times: Federal Tax Rate		21.00%
Subtotal: Federal Tax Before Credits		\$24,938
Less: Federal Tax Credits		\$0
Subtotal: Fed Tax Return Prov. - Current Tax Exp/(Ben)		\$24,938

Similar to the previous example, the deduction for state income taxes (\$6,250) has an impact on federal taxable income.

The deferred tax calculations for state income taxes (1320)

The computation and related commentary for state deferred tax assets (a debit of \$1,000) and the corresponding deferred tax benefit (a credit of \$1,000) is the same as in the previous section.

Deferred Tax Asset/Liability Computation								
	Gross	Adjustments	Adjusted Beg.	Current	Times:	Unadjusted		Adjusted
Description	Beg. Balance	BOY Balance	Balance	Activity	State Tax Rate	Deferred Tax Asset/(Liability)	Adjustments	Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$0	\$0	\$20,000	5.00%	\$1,000	\$0	\$1,000
Other Temporary Differences	\$0	\$0	\$0	\$0	5.00%	\$0	\$0	\$0
Total Deferred Tax Assets/(Liabilities) - State	\$0	\$0	\$0	\$20,000		\$1,000	\$0	\$1,000
	From tab 1300							
	Pretax Deferreds							
Deferred Tax Expense/Benefit Calculation								
BOY Deferred Tax Assets/(Liabilities) - State	\$0							
Less: EOY Deferred Tax Assets/(Liabilities) - State	(\$1,000)							
Equals: Deferred Tax Expense/(Benefit)	(\$1,000)							

The deferred tax calculations for federal income taxes (1310)

The computation and related commentary for federal deferred tax assets (a debit of \$3,990) is the same as in the previous section.

Deferred Tax Assets/Liabilities - Method #1				Fed. Tax Rate			
	Gross	Current Year		Less the Fed.	Unadjusted		Adjusted
Description	Beg. Balance	Gross Temp. Differences	Adjusted Balance	Benefit of State Taxes	Deferred Tax Asset/(Liability)	Other Adjustments	Deferred Tax Asset/(Liability)
Accrued Expenses	\$0	\$20,000	\$20,000	19.95%	\$3,990	\$0	\$3,990
Other Temporary Differences	\$0	\$0	\$0	19.95%	\$0	\$0	\$0
				See the rate			
Total Deferred Tax Assets/(Liabilities) - Federal	\$0	\$20,000	\$20,000	calculation	\$3,990	\$0	\$3,990

Similarly, the computation of the deferred federal tax benefit (a credit of \$3,990) is the same as well:

Deferred Tax Expense/Benefit Calculation (Methods #1 and #2)

BOY Deferred Tax Assets/(Liabilities) - Federal	\$0
Less: EOY Deferred Tax Assets/(Liabilities) - Federal	(\$3,990)
Equals: Deferred Tax Expense/(Benefit) (P&L impact)	(\$3,990)

The income tax table in the financial statements (5)

The presentation of the income tax table in the financial statements is insightful, especially when comparing it to the previous example where pretax book income was zero.

Income Taxes	
The income tax provision/(benefit) for the year consisted of the following:	
<u>Current Income Taxes</u>	
Current Taxes - Federal	\$24,938
Current Taxes - State	\$6,250
<u>Deferred Income Taxes</u>	
Deferred Taxes - Federal	(\$3,990)
Deferred Taxes - State	(\$1,000)
Total Tax Provision or Expense/(Benefit)	\$26,198

- Deferred taxes (benefits of \$3,990 and \$1,000) are exactly the same as in the previous example, because both examples reflect the impact of a \$20,000 unfavorable temporary differences (that will be a deductible tax benefit in the future).
- The current taxes section is different. This is because the federal and state current tax expenses include the impact of unfavorable temporary differences (\$20,000) and pretax book income (\$105,000).
 - These amounts tie back to the federal and state current tax provision calculations, respectively.

The taxes payable rollforward (60)

The taxes payable/receivable rollforward is as follows:

Taxes (Payable)/Rec. Rollforward	Federal	State	Totals
Beginning of Year ("BOY") Tax Receivable/(Payable)	\$0	\$0	\$0
Tax (Expense)/Benefit - Q1 through Q3	\$0	\$0	\$0
Subtotal - Tax Expense/(Benefit) through Q1 - Q3	\$0	\$0	\$0
<u>Summary of Cash Taxes Paid/(Received)</u>			
Tax Payments/(Refunds) - Q1 Estimated Tax	\$0	\$0	\$0
Tax Payments/(Refunds) - Q2 Estimated Tax	\$0	\$0	\$0
Tax Payments/(Refunds) - Q3 Estimated Tax	\$0	\$0	\$0
Subtotal - Tax Payments/(Refunds) - Q1 - Q3	\$0	\$0	\$0
Subtotal: Net Receivable/(Payable) - Q1 - Q3	\$0	\$0	\$0
Current Tax (Expense)/Benefit - Current Period (Q4)	(\$24,938)	(\$6,250)	(\$31,188)
Other Adjustments	\$0	\$0	\$0
End of Year ("EOY") Tax Receivable/(Payable)	(\$24,938)	(\$6,250)	(\$31,188)

- There was no need to show this table in the previous example because federal and state taxes were zero.
- Federal (\$24,398) and state (\$6,250) taxes payable correspond to the (cash) tax liability expected to be payable when federal and state tax returns are filed based on their respective current tax calculations.

The tax adjusting journal entry ("tax AJE") (50)

Assuming no previous journal entries were made to income tax accounts in Year 1, the tax AJE based on the facts of this example are as follows:

Account Description	Opening Balance From 1600 ¹	Calculated Balance "Plug" ²	Adjusting (Tax) Journal Entry Carries to 1600 ³
Deferred Tax Asset - Federal	\$0	\$3,990	\$3,990
Deferred Tax Asset - State	\$0	\$1,000	\$1,000
Liability - Tax Payable - Federal	\$0	(\$24,938)	(\$24,938)
Liability - Tax Payable - State	\$0	(\$6,250)	(\$6,250)
Liability - Deferred Tax Liability - Federal or State	\$0	\$0	\$0
Expense - Income Tax - Federal - Current Exp./ (Benefit)	\$0	\$24,938	\$24,938
Expense - Income Tax - State - Current Exp./ (Benefit)	\$0	\$6,250	\$6,250
Expense - Income Tax - Federal - Deferred Exp./ (Benefit)	\$0	(\$3,990)	(\$3,990)
Expense - Income Tax - State - Deferred Exp./ (Benefit)	\$0	(\$1,000)	(\$1,000)
Totals / Check Figure (should be zero)			\$0

- The sum of all adjusting journal entries foots to zero.
- When there are numerous entries it can be difficult (if not overwhelming) to think of them all together. However, the tax entries are far easier to conceptualize when you break them down into their individual components as follows:

Current – Federal

Federal Tax Expense – Current	\$24,398	
Taxes Payable – Federal		\$24,398

Current – State

State Tax Expense – Current	\$6,250	
Taxes Payable – State		\$6,250

Deferred – Federal

Deferred Tax Asset – Federal	\$3,990	
Deferred Tax Benefit – Federal		\$3,990

Deferred - State

Deferred Tax Asset – State	\$1,000	
Deferred Tax Benefit – State		\$1,000

The effective tax rate reconciliation (5)

Let's now take a look at the ETR reconciliation:

Effective Tax Rate Reconciliation		
The differences between the effective tax rate reflected in the tax provision and the federal statutory rates are as follows:		
Description	Dollar	Rate
Expected Tax Provision/(Benefit) at the Statutory Tax Rate	\$22,050	21.00%
State Taxes Net of Federal Benefit	\$4,148	3.95%
Nondeductible Expenses	\$0	0.00%
Income Tax Provision/(Benefit) / Effective Tax Rate (ETR)	\$26,198	24.95%

The first line of \$22,050 is equal to pretax book income (\$105,000) times the federal statutory tax rate (21%). Understanding the build-up of the second line, the state income taxes net of the federal benefit of \$4,148, is more complex. The first step is to determine the total provision for state income taxes, which is as follows:

Summary of Current and Deferred State Taxes

Current Tax Expense/(Benefit) - State	\$6,250
Deferred Tax Expense/(Benefit) - State	(\$1,000)
Total Provision for State Taxes	\$5,250

Now that you have the total provision for state taxes, you can compute state (income) taxes net of the federal benefit (\$4,148) as shown in the illustration to the right.

State Taxes Net of the Federal Benefit

Calculation of State Taxes "NOFB"	
Total Provision for State Taxes	\$5,250
Less: Federal Benefit of State Taxes	(\$1,103)
Equals: State Taxes Net of the Federal Benefit	\$4,148
Federal Benefit of State Taxes	
Total Provision for State Taxes	(\$5,250)
Time: Federal Tax Rate	21.00%
Equals: The Federal Benefit of State Taxes	(\$1,103)

Referring to the ETR reconciliation on the previous page, notice that the tax rate (3.95%) associated with the state taxes NOFB (\$4,148) in the ETR reconciliation table ties to the “Tax Rates Summary” worksheet (see the percentage bracketed in red).

Federal Statutory Rate	Current Year	Notes/Explanation
Federal Statutory Rate - Current Year	21.00%	
State Tax Rate		
Blended State Tax Rate		
Gross Blended State Tax Rate	5.00%	This is the average tax rate for all states in which the company operates
The State Tax Rate Net of the Federal Benefit		
Gross Blended State Tax Rate	5.00%	From above
Less: Fed. Benefit of the State Tax Deduction	-1.05%	Calculated below
Equals: State Tax Rate Net of the Federal Benefit	3.95%	
The % Federal Benefit of the State Tax Deduction		
Gross Blended State Tax Rate	5.00%	From above
Times: Federal Statutory Rate	21.00%	Same
Equals: Federal Benefit of the State Tax Deduction	1.05%	Carries above

Will this always be the case? The answer is no, because when permanent differences come into play the state rate in the ETR reconciliation will differ from that in the “Tax Rates Summary” above. However, because there are no permanent differences in this example, the ETR reconciliation shows that the federal tax rate (21%) and the state tax rate (3.95%) are in line with expectations. And here is one final way to think of these concepts in a way that ties back to the ETR reconciliation:

Pretax Book Income	\$105,000
Times: Combined Federal and State Tax Rate	24.95%
Equals: Total Tax Provision or Expense/(Benefit)	\$26,198

14.5 Appendix 5 – Combining permanent differences, temporary differences and state taxes

A significant milestone

You’ve now reached a significant milestone in your knowledge of tax provisions, which is that you now have the capability to combine the following concepts into a single tax provision calculation:

- Federal taxes
- State taxes
- Permanent differences
- Temporary differences

This means you're ready to review the example in Appendix 5 starting on page 221. In addition, you now have the foundational knowledge necessary to understand and apply more advanced tax accounting concepts. I wish you the very best on your continuing professional education journey! I would love to stay connected with you along the way, so feel free to sign on to my mailing list (www.nctaxdirector.com) and to connect with (or follow) me on LinkedIn.