Deferred Taxes and 2017 Tax Law Changes: A Teaching Case

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This paper presents a teaching case for use in either intermediate financial accounting or one or more different tax classes. The case deals with the impact of the 2017 tax law changes (Tax Cuts and Jobs Act) on deferred tax calculations for financial reporting. It includes the change in how net operating losses (NOLs) will affect deferred taxes. Students are given the opportunity to think critically about the tax law changes and how they affect financial reporting for taxes for 2017 and years beyond.

INTRODUCTION

In many traditional accounting programs, different accounting classes are often taught with a silo approach—each accounting class is taught as an independent class without a definitive attempt to integrate the principles across the different areas of accounting. For example, many financial accounting topics are taught with little or no discussion of the implications tax laws have on financial reporting. Financial and managerial accounting topics are often discussed without considering the implications or limitations of the accounting information systems providing the information to managers.

Some programs have attempted to bridge this gap by integrating topics across the accounting curriculum. However, integration may involve multiple faculty teaching each class or using faculty to teach in areas in which they may not have expertise or may not feel comfortable teaching. Other programs may teach specific classes independently but attempt to include appropriate sidebars which connect an accounting topic in one class with the implications from topics that may be discussed in other classes.

While it is common for financial accounting textbooks to create chapter illustrations and end-of-chapter problems without implicit or explicit tax implications, one topic in intermediate financial accounting requires the integration of financial accounting and taxation topics. The chapter on deferred taxes requires the implicit recognition of tax laws and the explicit understanding of specific tax laws. This chapter provides a great opportunity for these two areas of accounting to be integrated (Spiceland, Nelson, & Thomas, 2020). Of course, depending on the specific curriculum, not all students will necessarily have taken their first tax class by the time they encounter deferred taxes in the financial accounting sequence. If students have already had an introduction to taxes in a separate class, they will be better prepared to understand the implications of deferred tax concepts and calculations.

This teaching case focuses on the impact of the recent tax law changes (Public Law 15-97, 2017) on the concepts and calculations of deferred taxes for financial reporting. Students are asked to respond to implications of the tax law changes at the end of 2017 (KPMG, 2018; Owsley & McKinley, 2018;

Reinstein & Ahlers, 2018) on the deferred tax assets and liabilities for a specific company. They are also asked to discuss the impact of the tax law change relative to net operating losses (NOLs) on deferred taxes.

This case could fit very well in an intermediate financial accounting class after the deferred tax chapter is covered. Tax classes also cover material about the previous and current provisions for taking advantage of a net operating loss (NOL) (Rupert, Pope, & Anderson, 2018). The case could also be used in a tax class when NOLs are discussed. If less information were given to the students than is provided in the case material, it could also be used in a graduate tax research class where the students would be asked to research the provisions of the new tax law on NOLs and contrast the new provisions with the old provisions. They could also be asked to provide possible reasons for the tax law change. In addition, they could be asked to consider the implications if the recent tax law changes are reversed by politicians in the future.

CASE MATERIAL

Gordon Manufacturing, a calendar-year corporation started in 1956, is located in the U.S. Midwest. Because it is a manufacturing company, it has a heavy investment in fixed assets. Many of its revenues and expenses are recognized in the same period for both GAAP and tax purposes. Gordon uses different accounting methods for GAAP reporting and tax compliance for depreciation, warranties, and operating leases. Gordon uses straight-line depreciation and chooses the useful lives of assets for its financial statements and uses tax deprecation and statutory asset lives for its tax returns. Gordon provides warranties with most of its manufactured products, with the estimated warranty costs being expensed in the financial statements when the products are sold. The actual warranty costs are not deductible for tax purposes until they are paid. The last book-tax difference that Gordon has routinely is prepaid lease expenses for operating leases, which are tax-deductible when paid. The operating lease amounts are expensed evenly over the life of each right-of-use asset.

Gordon is a mid-sized firm. In recent years, Gordon has had a 35% marginal and effective corporate tax rate. At the beginning of 2017, Gordon had the following cumulative differences between its taxable income and its financial statement income and the resulting deferred tax assets/liabilities:

	Cumulative Difference	Deferred Tax Asset/(Liability)
Excess tax depreciation	$5,700,000	($1,995,000)
Warranty expenses accrued but not paid	$450,000	$157,500
Prepaid operating lease costs	$124,000	($43,400)

In early December of 2017, Alan Schultz, an employee in the Gordon corporate finance and accounting office, began analyzing the temporary differences in preparation for the year-end financial statements. Alan also began determining what journal entry would be required at the end of the year with respect to deferred taxes.

For 2017, the anticipated tax return and financial statement amounts for depreciation, warranties, and operating leases are as follows:

	GAAP	Tax
Depreciation	$6,500,000	$7,200,000
Warranties	$730,000	$675,000
Operating Leases	$286,000	$310,000

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law. It reduced the corporate tax rate to 21% for all years starting after 2017. The TCJA also changed the treatment of tax net operating losses (NOLs). Prior to the change, companies had two options with respect to an NOL: (1)

carry it back two years and carry forward any unused amount for up to 20 years, or (2) carry the NOL forward for up to 20 years until used. The TCJA eliminated the carryback option and extended the carryforward option indefinitely but limited the carryforward offset each year to 80% of taxable income.

CASE REQUIREMENTS FOR STUDENTS

Any appropriate combination of the following requirements could be assigned to the students as they prepare for the case discussion. It may also be appropriate for the students to prepare a written response to the requirements to facilitate a more robust class discussion.

1. Assume you were helping Alan in early December. Determine the anticipated deferred tax asset and liability account balances at the end of 2017. Show the anticipated journal entry for the year if Gordon expects a taxable income of $25,000,000.
2. After the TCJA was signed on December 22, 2017, Alan asks you to again help by determining the anticipated deferred tax asset and liability account balances at the end of 2017. Show the new anticipated journal entry for the year if Gordon expects a taxable income of $25,000,000.
3. Comment on the differences you calculated in the prior two requirements. What was the effect of the tax rate reduction for Gordon? What would the effect have been for a company that has more deferred tax assets than liabilities at the end of 2017?
4. Consider the TCJA change in the treatment of tax NOLs. How will this change affect companies that have NOLs? Give some reasons why you think the carryback option was eliminated. What might the effect of the new indefinite NOL carryforward have on any allowance to reduce the deferred tax assets related to an NOL carryforward?
5. What tax planning strategies might companies have undertaken right at the end of 2017 in response to passage of the TCJA?

TEACHERS' NOTE

This case is not very long, but it does require considerable thought and some calculations. The students could be given the case in advance and asked to read it. Either on their own or in groups, they could consider the case requirements. Then they could discuss their conclusions in a classroom setting. The case discussion in class should easily fit within one class period. It is important to allow the students to think critically about the tax law changes and implications before leading them in a specific direction. The concepts covered in this case are not very difficult, but it is important for students to have a specific opportunity to consider the impact of the tax law changes.

The deferred tax chapter in intermediate accounting textbooks will need to be rewritten to reflect the changes in tax law. The change in future enacted tax rates will not change the concept presented in applying those rates, but perhaps this specific tax law change can be used as a specific example in the textbooks to illustrate a change in future rates. Of course, the textbook discussion of NOLs and how they can be handled will need to be updated. Students could also consider the temporal nature of tax law changes, depending on which political party is in power, whether the tax law changes have the desired effects, and what might happen when tax laws are again changed in the future.

Specific calculations and journal entries are provided below for the specific case requirements. Ideas for the discussion requirements are also presented.

Early December Calculations

The beginning-of-2017 deferred tax amounts were simply the cumulative temporary differences at that date multiplied by the 35% enacted tax rate. To calculate the anticipated deferred tax amounts for the 2017 balance sheet (from the perspective of the beginning of December), Alan simply needs to look at the 2017 GAAP-tax differences for each of the items and calculate the cumulative difference expected at the

end of 2017. Then the expected cumulative differences can be multiplied by the 35% enacted tax rate to determine the balances in each of the specific deferred tax assets and liabilities, as illustrated below:

	GAAP	Tax	2017 Difference
Depreciation	$6,500,000	$7,200,000	$700,000
Warranties	$730,000	$675,000	$55,000
Prepaid Leases	$286,000	$310,000	$24,000

	1/1/2017 Cumulative Difference	2017 Difference	12/31/2017 Cumulative Difference	12/31/2017 Deferred Tax Asset/(Liability)
Depreciation	$5,700,000	$700,000	$6,400,000	($2,240,000)
Warranties	$450,000	$55,000	$505,000	$176,750
Prepaid Leases	$124,000	$24,000	$148,000	($51,800)

For the journal entry, the deferred tax asset and liabilities would be adjusted to their correct balances at the end of 2017, the taxes payable on the $25,000,000 of taxable income would be recorded, and the net debit needed to make the journal entry balance would be the 2017 income tax expense as illustrated:

	1/1/2017 Deferred Tax Asset/(Liability)	12/31/2017 Deferred Tax Asset/(Liability)	Adjustment
Depreciation	($1,995,000)	($2,240,000)	($245,000)
Warranties	$157,500	$176,750	$19,250
Prepaid Leases	($43,400)	($51,800)	($8,400)

Deferred Tax Asset	19,250		(from above)
Income Tax Expense	8,984,150		(plug figure)
Deferred Tax Liability		253,400	($245,000 + $8,400)
Taxes Payable		8,750,000	($25,000,000 x 35%)

Late December Calculations

After the TCJA is passed and the corporate tax rate for 2018 and future years is reduced to 21%, the deferred tax calculations would differ significantly as follows, as deferred tax asset and liability balances would now be calculated using the 21% future enacted tax rate:

	1/1/2017 Cumulative Difference	2017 Difference	12/31/2017 Cumulative Difference	12/31/2017 Deferred Tax Asset/(Liability)
Depreciation	$5,700,000	$700,000	$6,400,000	($1,344,000)
Warranties	$450,000	$55,000	$505,000	$106,050
Prepaid Leases	$124,000	$24,000	$148,000	($31,080)

With the updated deferred tax calculations, the adjustments to the deferred tax accounts would be much different, leading to the following amounts and journal entry:

	1/1/2017 Deferred Tax Asset/(Liability)	12/31/2017 Deferred Tax Asset/(Liability)	Adjustment
Depreciation	($1,995,000)	($1,344,000)	$651,000
Warranties	$157,500	$106,050	($51,450)
Prepaid Leases	($43,400)	($31,080)	$12,320

Deferred Tax Liability	663,320		($651,000 + $12,320))
Income Tax Expense	8,138,130		(plug figure)
Deferred Tax Asset		51,450	(from above)
Taxes Payable		8,750,000	($25,000,000 x 35%)

Notice that taxes payable for 2017 is still calculated using the 2017 tax rate of 35%, but the deferred tax assets and liabilities are all reduced, even though the cumulative temporary differences increased, because of the large decrease in the future enacted tax rate.

Comparison of Deferred Tax Calculations

Because Gordon has significantly more deferred tax liabilities than assets, the effect of the tax rate decrease is to reduce the net amount expected to be paid in extra taxes in the future when the temporary differences reverse. The effect of this rate decrease was to reduce the 2017 income tax expense significantly. Of course, if a company had more deferred tax assets than deferred tax liabilities, the opposite effect would occur—the 2017 income tax expense would increase due to the expectation of saving less on future tax bills when the temporary differences reverse.

Change to NOL Rules

When the TCJA rules apply to NOLs, all NOLs will lead to deferred tax assets, as no carryback will be allowed. The old carryback rules allowed for an immediate claim for a refund of prior taxes paid, but now NOLs can only be used to reduce future taxable income. In addition, since the corporate tax rate was changed to 21%, any deferred tax asset from an NOL carryforward will only be valued at 21% rather than a different, perhaps higher, rate that was applicable previously. Besides the elimination of the carryback option, the carryforward option can now only be used to offset 80% of a year's taxable income, so NOLs, in general, will not provide as quick of a potential benefit.

One of the most obvious reasons for eliminating the NOL carryback option is to avoid having companies use a NOL from 2018 or 2019, years in which the corporate tax rate is 21%, to get a tax benefit from 2016 or 2017 when the corporate tax rates could have been much higher. It is also possible that the carryback was eliminated as part of trying to reduce the cost of the TCJA as part of the means to justify its passage. Even though an NOL will now only be allowed to offset future taxable income—and only 80% of that each year—the indefinite carryforward period will allow some struggling corporations that thought they might lose the carryforward when it expired to now assume they will be able to use it at some point in the future. Therefore, these companies, some of which might have needed an allowance to reduce the deferred tax asset from the NOL carryforward to realizable value, might now be able to reduce or eliminate the related allowance. Of course, if these companies do anticipate liquidation before using the NOL carryforward, they may still need the allowance. However, in at least some of these cases, the "going concern" assumption might also be questioned.

End-of-2017 Tax Planning Strategies

For many corporations, the TCJA reduced the marginal and effective corporate tax rate substantially. After the new law was signed in late December of 2017, what tax planning strategies might corporations have considered? Typical tax planning strategies of shifting taxable revenues to the future and shifting deductible expenses to a current period would become even more valuable. For example, if a corporation like Gordon could legitimately shift taxable revenues from 2017 to 2018, these revenues would be taxed

at 21% rather than 35%. Likewise, if Gordon could shift deductible expenses from 2018 to 2017, a 35% benefit could be achieved rather than a 21% benefit.

If a corporation was close to a NOL for 2017, it might have determined how it could increase the 2017 writeoffs, leading to a 2017 NOL. This NOL would still be qualified for the carryback option, whereas, if the writeoffs led instead to a 2018 NOL, that NOL would not be eligible for the carryback option.

CLASSROOM VALIDATION AND FEEDBACK

This case was tested in a senior-level intermediate financial accounting class during the Summer Semester of 2018. The case was distributed about one week before the class discussion of the case. However, the students also had an exam the weekend before the case discussion in class, so although the students should have understood deferred tax concepts, they were somewhat pressed for time due to a double-speed summer class and their study for the exam.

Many of the students had read the case and thought about the concepts presented prior to the discussion in class, especially because they had a class assignment to provide a written response to the case requirements that was due at the end of the case discussion. The class participation was appropriate, with many of the class members openly participating in the case discussion.

Approximately 40 minutes was devoted to the class discussion. Students were then asked for anonymous feedback about their perspectives on the case and the case discussion experience through a survey instrument. The survey included several items rated on a Likert-type scale and two open-ended items for comments.

The Likert-type items were rated by the students from strongly agree (5) to strongly disagree (1). Average ratings for these items are provided in Table 1.

TABLE 1
STUDENT FEEDBACK ON CASE-STRONGLY AGREE (5) TO STRONGLY DISAGREE (1)

Item	n	Mean
This case helped me to learn new information.	20	4.50
This case caused me to think critically about the issues presented.	20	4.65
The case presented a topic that was worthwhile to discuss.	20	4.65
The case content was interesting to me.	20	4.05
The instructions and background information in the case were clear.	20	3.75
This case was a positive learning experience.	20	4.25
The case requirements were appropriate for the material presented in the case.	20	4.20
Class discussion of this case improved my understanding of the case content.	20	4.85
Class discussion of this case caused additional critical thinking.	20	4.80

Most of the means are between 4 and 5, indicating a general level of agreement with those statements. The highest means, along with comments from the open-ended questions, indicate that the actual class discussion was very beneficial to the students in helping them to understand the case material and think critically about it. One statement about the clarity of the instructions and background information had a mean of 3.75, still above the neutral point, but indicating the possibility that the case could still be improved.

FUTURE RESEARCH

This case, or a revised version of this case, could also be used in one or more tax classes where NOLs are discussed. A tax research class might be an appropriate venue for the students to discuss more of the tax planning strategies corporations may have undertaken in the last few days of 2017 after the TCJA was signed. To use the case in a tax class, the basic concepts of deferred taxes from a financial accounting perspective might first need to be covered or reviewed.

CONCLUSION

This case may be helpful to students as they learn about the intersection of financial reporting with tax law, especially with respect to the new tax law passed at the end of 2017. Since it will take time for intermediate financial accounting textbooks to be adjusted for the tax law change, this case may be a good way to bridge the current textbook material with up-to-date tax laws. This case may also be valuable in tax classes where the changes in the tax laws for 2018 and the implications of those changes are discussed. This case was successfully used in a classroom setting, and the objectives of the case were met. Student feedback was generally positive.

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