Deferred Tax Assets and the Valuation Allowance

A valuation allowance is a key factor in the income tax provision. Here's why you have to get it right.

By Howard Telson

CrossBorder Solutions

The World's AI Tax Expert

Everyone roots for a company built on a little bravery and a great idea. But the truth is, even businesses that seem impossible to live without can take a long time to turn a profit. Where would Corporate America be without FedEx, for example? Before email, faxes, and Venmo, the best a company could do for legal documents, payments, even airline tickets, was to overnight them. And while today 24 hours may seem like a long time to wait for an important package, FedEx waited a lot longer before delivering its first profit—four years.

Fast-forward to more modern times and businesses are having the same struggles. In fact, many wait a lot longer than FedEx to see gains. Born in 2009, the digital-payment company Square lost money every year until 2015. Let's not forget about Amazon, now a household name, which experienced years of explosive sales since launching in 1994—yet didn't turn a profit until 2003. Even Tesla had issues getting off the ground: Incorporated in 2003, the eco-friendly company had its first profitable quarter in 2013.

What's our point? Aside from dreamers and less-than-ideal income statements, corporate newborns often have something else in common: tax assets that can't be used because they're not operating in the black. So, they're deferred and deferred until companies become profitable and can actually apply them—or, until they expire. Recording the full value of vulnerable deferred tax assets, however, doesn't work for regulators and auditors. And so, if there's a good chance that a company won't ever be able to realize a full deferred tax asset, then it will need to reduce its value on the balance sheet, and this reduction is called a valuation allowance.

While the valuation allowance may seem like a simple accounting treatment, the truth is the calculations can have a huge effect on a company's tax expense, and overall profitability. This is why it's an important—and highly scrutinized—component of the income tax provision. How does the valuation allowance work? And how do companies know if they need one? That's what we're going to cover right here.

Deferreds: A Recap

It may sound like Accounting 101—and okay, it is—but to understand how a valuation allowance works, and how it impacts the income tax provision, you need to understand how tax assets and liabilities representing future tax expense or benefit stand to affect a company's earnings. In other words, you need to understand deferreds.

Three core calculations are required to complete a corporate income tax provision: the current tax provision, deferred provision, and rate reconciliation. While a current tax provision estimates a company's current tax liability or benefit for the year, a deferred provision projects future obligations or benefits—and it's the part of the provision that could require a valuation allowance. The deferred provision calculates how assets and liabilities accrued now will affect a company's tax position later on, or to put it in simple terms, how a company's tax bill will be impacted in future years by items incurred in past years.

The deferred provision is made up of three main components: timing differences, net operating losses, and tax credits. Deferred tax assets and liabilities can generally arise from differences in the treatment of income and expense items between tax and accounting rules, the carryover of unused net operating losses, and the carryover of unused tax credits. Within financial statements (e.g. Form 10-K for public companies), deferred tax assets and liabilities appear on companies' balance sheets as line items, and are listed in tax footnotes, broken down into material items and categories, so investors and other interested parties get a sense of the composition of the deferreds.

Deferred tax assets and liabilities are tracked via a deferred roll-forward, which provides the beginning of the year balances of such items, the current year activity, and the ending balances. While it's a complicated calculation, it's arguably the most critical part of compiling the income tax provision. Tax executives give the calculation a lot of attention, because financial auditors give it a lot of attention—suffice to say, getting it right is extremely important. Not only will tax executives want to make sure the deferred roll-forward calculation is correct, but also that there is sufficient supporting documentation to back it up.

"The deferred provision calculates how assets and liabilities accrued now will affect a company's tax position later on, or to put it in simple terms, how a company's tax bill will be impacted in future years by items incurred in past years."

Understanding the Valuation Allowance

While it's imperative for tax executives to calculate a company's deferred assets and liabilities accurately, there is an incentive for companies to over-state assets and understate liabilities (both resulting in less tax expense in the financials, and higher profitability). The U.S. has caught on to how companies might position future assets and liabilities and accounting rules under Generally Accepted Accounting Principles (GAAP) are designed to ensure that values are appropriately stated. That's where the valuation allowance comes in. A valuation allowance forces a company to look at its deferred tax assets and say, "Is the value of this asset correct or is it inflated?"

If it's overstated, then the value of the asset has to be reduced so that it reflects the true future tax benefit that a company will realize. A valuation allowance is the mechanism used to reduce the deferred tax asset to the appropriate amount. During the financial crisis, for example, General Motors faced year-after-year losses, accumulating $39.96 billion in deferred tax assets by the end of 2016, according to a Market Watch report. By this point, however, the company realized it wasn't going to be in a position to benefit from the full amount of these deferred tax assets, and so, using a valuation allowance, it lowered the value of those assets by an estimated $4.64 billion, bringing the company's deferred tax assets down to a realistic amount, without overstating them.

"A valuation allowance forces a company to look at its deferred tax assets and say, "Is the value of this asset correct, or is it inflated?""

Which Tax Assets Require Valuation Allowances—and How Do You Know?

How do you know when you need a valuation allowance? When do you call for it to reduce your deferred assets? In large part, it's a judgment call. Under U.S. GAAP, Accounting Standards Codification (ASC) 740 dictates that companies must reduce a deferred tax asset if there's more than a 50% chance that asset won't be realized "based on the weight of available evidence."

What does that mean? Basically, if it's more likely than not that you won't be able to use the whole asset, then you'll need a valuation allowance. Remember deferred tax assets generally result from unfavorable temporary book-to-tax adjustments, net operating loss carryforwards, and tax credit carryforwards. The key to a valuation allowance is to determine if the deferred tax asset is going to be useful and what it's going to be worth if the company has a future taxable income to offset. If a company has presented losses for the last three years, consider a valuation allowance likely necessary as it will be hard to argue otherwise.
If a company won't have a future tax liability, then the deferred tax assets would just go to waste—so it would be misleading to simply keep that

Do Valuation Allowances Only Apply to U.S. Companies?

While the concept of a valuation allowance is a U.S. concept under Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), the international standard, mandates that companies can only record a deferred tax asset if it's probable (or there's more than a 50% chance) that it will be realized. The difference? Foreign-based companies aren't required to record a valuation allowance, instead they simply report a deferred tax asset at its probable value.

deferred tax asset on the balance sheet at its full value and not reduce it by a valuation allowance.

To sufficiently determine if a valuation allowance is needed, you'll have to do some detective work. GAAP accounting rules call for tax executives to look at all evidence, both positive and negative, that suggests (or proves) that a company will or won't be able to realize a deferred tax asset at the stated value. This means reviewing both objective and subjective evidence, but always start with the most indisputable:

1.) **Evaluate taxable income on a jurisdictional basis.** In the U.S., you would look at the federal taxable income and also, each state individually, and then you'd look at foreign jurisdictions with separate tax-paying components. Historical data, obviously, is going to be key. Consider income in prior carryback years. If you're allowed to carryback your current net operating loss to offset income in a prior year, that would be an easy way to make use of the deferred tax asset resulting from the NOL, so you wouldn't need a valuation allowance because you're able to use up that asset.

2.) **Look at taxable temporary differences.** Scheduling out the reversal of temporary differences is important in determining how—or if—deferred tax assets can be used. This scheduling exercise ensures favorable temporary differences, which result in deferred tax liabilities, or future income, reverse in the right years and are offset by deferred tax assets, or future deductions. Also, scheduling projects allow you to see if future taxable income generated from the deferred tax liabilities can be offset by attributes (like NOLs or credits) before such attributes expire. For example, if a company expects significant favorable temporary differences, or deferred tax liabilities, to flip in a particular year and create substantial income, this would be evidence that the tax benefit available from deferred tax assets, would be able to be realized and no valuation allowance would be necessary.

3.) **Consider future income tax projections.** Granted, future projections are a nebulous area when determining the need for a valuation allowance, but they should still be a consideration. Forecasts can be based off of revenue trends, industry trends, and economic conditions, which while not an exact science can still be good indicators of a company's financial future. If future projections look bleak, a valuation allowance is likely necessary—while if future projections are strong, this may lead a company to determine they could realize their deferred tax assets, in which case, no valuation allowance is needed.

4.) Evaluate your tax-planning strategies. Is a company maneuvering to execute tax planning to increase its taxable income, or otherwise realize its deferred tax assets? While this is the most subjective determination, it's worth looking into how (and when) a company plans to burn through its attributes without leaving them unused. A planning strategy could illustrate a path to generate income and offset a deferred tax asset, to potentially cause no need for a valuation allowance (though, as the most subjective measure, these planning strategies typically merit the least weight in the analysis of evidence).

What is the Evidence Telling You?

Obviously, a company wants to milk a deferred tax asset for the full value, so taxpayers are hoping that a valuation allowance won't be necessary.
If a company has a history of income, and/or is able to find sources of future income, that's good news. Then it has ample evidence that no valuation allowance is needed as the deferred tax asset can be used against that income. Supportive documents are always helpful—a strong earnings history, scheduled reversals of deferred tax liabilities, a sales backlog, a new customer signing on can all support the stance that a valuation allowance is unnecessary.

On the other hand, the evidence may show that a valuation allowance is needed. Maybe a company has accumulated significant losses in recent years—if a company has three or more consecutive loss years, it will be hard to argue that a valuation allowance isn't essential. Maybe a company does not have significant deferred tax liabilities available to generate future income. Maybe an unexpected situation, like COVID-19 or recent extreme weather events, means that the company is anticipating future losses. Is there a history of any unused loss carryforwards and credit carryforwards expiring? Is management failing to forecast earnings properly? When a company finds itself in these unfortunate situations, then it will most likely require a valuation allowance.
At the end of the day, if a company isn't going to earn income in the future, then it's not going to be able to recognize a deferred tax asset.

That said, there are times when a profitable company can require a valuation allowance. For instance, say a multinational company is profitable in most jurisdictions, but in one jurisdiction (be it a country, state, or locality) it generates consistent losses. Maybe the company hasn't taken off in that jurisdiction or maybe there are financial reasons for that company to not generate income year after year. That could be a situation where you need a partial valuation allowance. Or maybe there are a few jurisdictions with consistent losses and so you would potentially need valuation allowances for each of those countries' deferred tax assets. Essentially, a multinational company would have to say, "Are all of our jurisdictions' operations profitable? Are all of our deferred tax assets going to be recognized?" And then make decisions based on that.

How Does the Valuation Allowance Affect the Income Tax Provision?

Now that you know what a valuation allowance is and how and why it's used, the question becomes: How does it affect a company's income tax provision? The short answer is when you reduce the value of a deferred tax asset, it has a direct effect on your income tax expense and therefore your effective tax rate, which is what the income tax provision is all about.

Think of a journal entry for a deferred tax asset. The deferred tax benefit and the current tax expense are recorded for the same exact amount (along with an income tax payable and deferred tax asset), but one's a credit and one is a debit. Both P&L accounts are going in opposite directions, and they net out and therefore have zero impact on your total tax expense. Of course, if they don't affect your total tax expense, they are not going to affect your effective tax rate either.

But let's say a company needs a valuation allowance on the deferred tax asset they just recorded. To put this on the books, they would debit the deferred tax benefit and credit the valuation allowance. Here we have a P&L account (deferred tax benefit) being impacted with no offset on the P&L. The valuation allowance will reduce the deferred tax asset on the balance sheet—but that still leaves a P&L hit.

What is the effect? When a valuation allowance goes up, a deferred asset goes down. And the debit to the P&L account creates additional tax expense (or less tax benefit), which results in lower earnings and a higher effective tax rate. So, you can see why the valuation allowance is so important—and why they are highly scrutinized—because they have a direct impact on earnings and the effective tax rate.

On the flip side, sometimes taxpayers will realize that the valuation allowance they have in place is no longer necessary—and that's a positive. In this situation, a company would debit the valuation allowance and credit the deferred tax benefit again. This of course, would drive the total tax expense down, as the company would be able to utilize the full deferred tax asset to offset taxable income. As such, this increases earnings and decreases the effective tax rate. Which is exactly what companies like Fed Ex, Amazon, and Tesla were able to do once they flipped from years of losses to profits.

Howard Telson | Senior Manager, Tax Provision

Howard Telson is a tax senior manager, focused on the tax provision product. He has been with CrossBorder Solutions since October 2020, and prior to that, worked at KPMG for more than six years, most recently as tax manager in the business tax services group. Telson has extensive experience with all matters related to income tax for companies ranging from startups to Fortune 500—including tax provisions (both preparing and auditing), corporate tax returns, international tax, state tax, and mergers/acquisitions tax. Telson holds a CPA license in New Jersey and a master's in taxation from Georgetown University.