



The Tax Council
Established 1966

Cash Tax vs Book Tax

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There are two ways to measure how much income tax a company incurs each year: the “cash tax” payable and the “book tax” expense. The cash tax amount is determined under the tax laws and reflects the sum a company must pay to satisfy its tax obligations to the government. In contrast, the book tax expense is calculated pursuant to financial accounting rules that are governed by Generally Accepted Accounting Principles (“GAAP”), and is reported on a company’s financial statements.

The tax laws and financial accounting rules have different policy objectives and therefore by design may produce different results. The differences between cash and book taxes if not understood can lead to significant miscomprehensions. As a result, it is important to know whether a reference to a tax liability or tax rate relates to the cash tax paid or the book tax expense.

The most significant difference between the tax laws and GAAP is that while cash taxes owed under the tax laws are determined on a current year basis, tax liabilities reflected on a company’s financial statements include both current and future year tax liabilities. The differences between the tax and book treatments of an item can be broken down into two classes: “temporary” and “permanent”. The definitions and examples below illustrate these concepts.

Definitions

- The term “cash tax” refers to tax paid to government authorities such as the Internal Revenue Service and is based upon the amount of income that is reported on a tax return each year. The income that is reported and amount of cash tax paid is determined under the tax laws and is the means by which revenues are raised for government operations.
- The term “book tax” refers to the taxes shown on a company’s financial statements (also referred to as its “books”). Investors and lenders use these financial statements to understand the financial health of both public and private companies. The amount of income and other items, including tax, shown on a company’s financial statements (or books) is determined under GAAP, which is designed to produce an accurate picture of a company’s current financial results and future prospects so that a lender or investor can accurately evaluate the company’s performance and compare it to the performance and prospects of other companies. In order to present a complete picture, a company’s books will record a tax expense for its total potential cash tax liability, even if a portion of that cash tax liability will be paid in a later year.
- The term “temporary difference” refers to an item of income or expense that is reported on a tax return in a different time period than it is reported for book purposes. Over time both the book and tax amounts will be equal. A common example of this is where an asset is depreciated for book purposes over a different method and time frame than for tax purposes. See Example A.

- The term “permanent difference” is just the opposite. It is a difference between book income and tax income that affects one and not the other and will never reverse. The portion of business meals that is not deductible for tax purposes is an example of a permanent difference. See Example B.

EXAMPLE A

Example of a “temporary” difference between book income and cash (taxable) income

In the example below, “Company A” makes an investment in a machine that costs \$150 and is expected to last three years. This cost is shown on the books as depreciation and is expensed in equal amounts each year over the three year life of the asset (straight-line depreciation).

Company A – Financial Statement

	2013	2014	2015	Total
Sales	\$1,000	\$1,000	\$1,000	\$3,000
Cost of Goods	<500>	<500>	<500>	<1,500>
Depreciation of a New Machine	<50>	<50>	<50>	<150>
Other Expenses	<165>	<165>	<165>	<495>
Book Income Subject to Tax	285	285	285	855
Federal Taxes @ 35% Statutory Rate	<100>	<100>	<100>	<300>
Net Book Income	<u>185</u>	<u>185</u>	<u>185</u>	<u>555</u>
Book Tax Rate	35%	35%	35%	35%

(rounding)

In order to understand Company A’s cash taxes, one would look at the company’s tax return. For cash tax purposes, assume that the machine qualifies for the special tax depreciation expense referred to as “bonus depreciation”. Under this tax rule, the entire \$150 cost of the machine is deducted from taxable income in the first year.

Company A – Tax Return

	2013	2014	2015	Total
Sales	\$1,000	\$1,000	\$1,000	\$3,000
Cost of Goods	<500>	<500>	<500>	<1,500>
Depreciation of a New Machine	<150>	---	---	<150>
Selling and other Costs	<165>	<165>	<165>	<495>
Taxable Income	185	335	335	855
Federal Taxes @ 35% Statutory Rate	<u>65</u>	<u>117</u>	<u>117</u>	<u>300</u>
Tax Rate	35%	35%	35%	35%

(rounding)

For both book and tax return purposes, the taxpayer deducts the \$150 cost of the machine as an expense. The difference is that for cash tax purposes the bonus depreciation rule *accelerates* the timing of this deduction. This accelerated deduction results in an upfront cash tax benefit for the taxpayer in the first year, but results in higher cash tax payments in the next two years.

Thus, by the end of the three years, the taxpayer's taxable income will equal \$855 in both the book tax and cash tax calculations and thus the tax liability will total \$300 in each case. Because the lower cash tax payment in the first year is *temporary*, and reverses in the next two years, the first year cash tax benefit from depreciation does not reduce the tax expense in the taxpayer's books. This is referred to as a temporary difference.

Summary Table – Temporary Difference

	2013	2014	2015	Total
Book				
Income	285	285	285	855
Tax	100	100	100	300
Tax Rate	35%	35%	35%	35%
Cash				
Taxable Income	185	335	335	855
Cash Tax	65	117	117	300
Tax Rate	35%	35%	35%	35%

(rounding)

Note that some temporary differences go the other way – for example, where for cash tax purposes the timing of a deduction is **deferred**. In those cases, the higher cash tax payment in the first year is **temporary**, and reverses and results in lower cash tax payments in later years.

EXAMPLE B

Example of a “permanent” difference between book income and cash (taxable) income

To build upon Example A, assume that \$80 of the Company A’s “Other Expenses” each year are for business meals which are only 50% deductible under the tax rules. Unlike the depreciation difference, the disallowance of the business meal expenses does not reverse in future years. Since it is permanent, it is reflected as an increase in tax expense on the financial statements. As shown below, the company’s net income in each year is decreased by this additional tax cost for book purposes as well as on the tax return.

Company A – Financial Statement

	2013	2014	2015	Total
Sales	\$1,000	\$1,000	\$1,000	\$3,000
Cost of Goods	<500>	<500>	<500>	<1,500>
Cost of Business Meals	<80>	<80>	<80>	<240>
Depreciation	<50>	<50>	<50>	<150>
Other Expenses	<u><85></u>	<u><85></u>	<u><85></u>	<u><255></u>
Book Income before Tax	285	285	285	855
Federal Taxes @ 35% Statutory Rate	<100>	<100>	<100>	<300>
Additional Tax due to Non-Deductible Business Meals	<14>	<14>	<14>	<42>
Total Federal Tax Expense	<u><114></u>	<u><114></u>	<u><114></u>	<u><342></u>
Net Book Income	<u>171</u>	<u>171</u>	<u>171</u>	<u>513</u>
<i>Book Tax Rate</i>	40%	40%	40%	40%

(rounding)

For tax purposes Company A is allowed to deduct only \$40 of the business meals, creating a difference between the book and tax treatment of this item. The disallowance of this expense results in an additional tax liability of \$14 each year (\$40 times 35%). Since this difference will never reverse, it is considered a “permanent” difference.

Company A – Tax Return

	2013	2014	2015	Total
Sales	\$1,000	\$1,000	\$1,000	\$3,000
Cost of Goods	<500>	<500>	<500>	<1,500>
Tax Deductible Business Meals	<40>	<40>	<40>	<120>
Depreciation	<150>	-	-	<150>
Other Expenses	<85>	<85>	<85>	<255>
Taxable Income	225	375	375	975
Federal Taxes @ 35%	<u>79</u>	<u>131</u>	<u>131</u>	<u>342</u>
Tax Rate	35%	35%	35%	35%

(rounding)

Over three years, the company’s book income remains \$855 but the taxes have increased from \$300 to \$342 because a portion of the business meals are not deductible for tax purposes and they will never reverse (and thus the taxable income for determining cash taxes has increased from \$855 to \$975). This treatment is referred to as a permanent difference and results in a higher book “effective tax rate” since the book tax rate, at 40%, now exceeds the 35% statutory rate.

Note that some permanent differences result in a lower book effective tax rate. One example of a rule that creates a permanent difference is the manufacturing deduction under I.R.C. Section 199, which will be discussed in a later draft.

Summary Table – Temporary v. Permanent Difference

	2013	2014	2015	Total
<i>Example A – Temporary Difference</i>				
Book				
Income	285	285	285	855
Tax	100	100	100	300
Tax Rate	35%	35%	35%	35%
Cash				
Taxable Income	185	335	335	855
Tax	65	117	117	300
Tax Rate	35%	35%	35%	35%
<i>Example B – Permanent Difference</i>				
Book				
Income	285	285	285	855
Tax	114	114	114	342
<i>Tax Rate</i>	40%	40%	40%	40%
Cash				
Taxable Income	225	375	375	975
Tax	79	131	131	342
Tax Rate	35%	35%	35%	35%

(rounding)

Observations

- The tax laws and financial accounting rules have different policy objectives and, therefore, by design sometimes achieve different results as shown in the examples above.
- For example, while all taxpayers are concerned about the cash tax they pay each year, public companies are also concerned about the financial statement results they report to their investors. If a tax rule has the effect of deferring a tax expense from one year to the next (e.g., where depreciation is accelerated more rapidly in the early years for tax purposes than it is for book purposes but is less accelerated in the later years for tax purposes than it is for book purposes), it represents a cash flow benefit for any taxpayer but may be of limited benefit to a public company for financial reporting purposes.
- One noteworthy temporary vs. permanent distinction revolves around income earned by foreign affiliates outside the United States. Under the U.S. tax rules, foreign business income is generally not subject to U.S. tax unless and until it is

repatriated to the United States. This is referred to as “deferral” for tax purposes, and as such is not necessarily a permanent exemption from U.S. cash tax. However, even though the cash tax may only be deferred under the U.S. tax laws, the financial accounting rules do not require U.S. tax to be recorded on the income of non-US subsidiaries if a company can affirmatively assert its intention to indefinitely reinvest those earnings outside the United States and sufficient evidence shows that the earnings are not needed to meet U.S. needs and the subsidiary has invested or will invest the undistributed earnings indefinitely outside the U.S., effectively creating a permanent difference.