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INCOME TAX ALLOCATION

by

Douglas M. Bonsness

B.S. in Accounting, University of North Dakota 1965

A Research Paper

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of the

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This research paper submeitted by Douglas M. Bonsness in partial fulfillment of the requirements for the Degree of Master of Science in the University of North Dakota is hereby approved by the committee under whom the work has been done.

Chairman

Dean of the Graduate School

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ABSTRACT

The problem of allocation of income taxes arises in those cases where there are material and extraordinary differences between the taxable income upon which such income taxes are computed and the income for the period determined in accordance with generally accepted accounting principles. Differences of timing the determinants of business and taxable income have existed since the corporate income tax act of 1913.

The opponents of tax allocation have countered by posing arguments against specific features of income tax allocation rather than by offering an alternative solution. Some of the main arguments for and against income tax allocation are the subject of this paper. The main arguments are as follows:

1. Should income taxes be treated as an expense or income distribution?
2. What is the difference between accounting and taxable income?
3. Tax allocation procedures used today produce inconsistent treatment in the financial statements.
4. Accounting reports which do not incorporate allocation of income taxes are more useful in appraising the performance of management.

The acceptability of the concept of income tax allocation is also covered in this paper.

The impact of income tax allocation upon financial reporting has been, and continues to be, material both in terms of the number of companies affected and the dollar amounts of reported income involved.

CHAPTER I

INTRODUCTION

The basis of the problem of the allocation of income taxes is not new. Differences of timing the determinants of business and taxable income have existed since the corporate income tax act of 1913 became a part of the legislative history of the United States. Throughout the history of corporate income tax legislation, there have been instances of differences in the timing of the components of income for business and taxation. Thus, the question: Why has the problem of tax allocation achieved such prominence for accountants in recent years?

The answer quite obviously can be found in the change which has occurred in the magnitude of the periodic tax charge. With the increase in tax rates during and since World War II, the importance of the tax charge in the determination of business income has increased significantly. As the charge has become more material, it has been natural to expect greater caution by the accountant in the determination of this charge. In addition, as the taxing power of the government has come to be more widely used for the purpose of indirectly regulating the economy of the United States, the differences of timing have become more general. For example, a difference in the timing of revenues results from the doctrine of constructive receipt, but the effects are limited to a relatively few corporations and are rather minor for most of those corporations. On the contrary, a difference in accounting for the

depreciation of plant assets, even though it involves no departure from the cost principle, affects practically all corporations and is quite substantial in many instances. Thus higher tax rates, combined with the generality of the differences of timing determinants of income, have cast doubt on the traditional method of accounting for the tax charge.

The following hypothetical situation illustrates the problem more clearly. The Warranty Company sells a product on which it offers a one-year guarantee at a price of five dollars, the market value of the guarantee. The sales for year I total $10,000, exclusive of $500 of unearned revenue from the sale of product guarantees. Expenses, exclusive of federal income taxes, at a fifty per cent rate, are $8,000. Sales for year II total $10,000 with no unearned revenue. The unearned revenue of year I is earned during year II. Expenses for this year are $8,500, including the cost of servicing the guarantees but excluding income taxes. For tax purposes, the sale price of the guarantee is taxed in the year received, and the costs of servicing it are deducted when incurred. A fifty per cent tax rate is assumed for purposes of illustration.[1]

Table I shows the effect on net income of deducting income taxes as computed according to tax regulation.

In year I, the tax is based on revenues of $10,500, whereas for accounting purposes only $10,000 has been earned. In year II, the

[1] Thomas F. Keller, Accounting For Corporate Income Taxes, Vol. XV, No. 2. Ann Arbor, Mich.: Cushing--Malloy, Inc., 1961, p. 28-29.

TABLE 1

COMPARATIVE INCOME STATEMENTS FOR THE WARRANTY COMPANY FOR THE YEARS I AND II--WITHOUT ALLOCATION OF TAXES

	Year 1	Year II
Revenues	$10,000	$10,500
Expenses, exclusive of taxes	8,000	8,500
Income tax charge.	1,250	750
Total revenue deductions	9,250	9,250
Net income for the year.	$ 750	$ 1,250

tax is based on $10,000 revenues, and earned revenues total $10,500. Thus the result is to reduce income the first year. A portion of the tax is shifted from year II to year I when compared with the tax which would have been paid had business income served as the tax base. Table 2 illustrates the effect of the proposed principle of allocation, given the same facts as were used in Table 1.

TABLE 2

COMPARATIVE INCOME STATEMENTS FOR THE WARRANTY COMPANY FOR THE YEARS I AND II--WITH ALLOCATION OF TAXES

	Year 1	Year II
Revenues	$10,000	$10,500
Expenses, exclusive of taxes	8,000	8,000
Income tax charge.	1,000	1,000
Total revenue deductions	9,000	9,000
Net income for the year.	$ 1,000	$ 1,000

In table 2, the tax charge is based on business income. The obvious effect is to smooth the reported income. If it is established that this is the proper basis for measuring the deduction for taxes, the proposal is desirable; however, should it be decided that the proper period charge for taxes is the assessed amount, the proposal is not valid. Accountants should not adopt procedures which arbitrarily smooth income for the purpose of indicating a constant income flow. The procedures they do adopt should be chosen in order to present a realistic and useful measure of the results of operations for a period of time.[2]

The real problem, presented by the fact that business and taxable income are not equal for a period of time, is how to determine the proper tax charge for each period, not how to manipulate net income in the least objectionable fashion.

Tax allocation is intended to reduce or eliminate distortion when:

a) The income statement does not show the material amounts entering into the computation of the income tax liability.

b) Material amounts included in the income statement do not enter into the computation of the income tax liability.[3]

Thus allocating income taxes has a dual purpose: (1) to charge income with that part of the tax that relates to income included in the figure of net income before income taxes, and (2) to allocate to retained

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[2] Ibid.

[3] H. A. Finney and Herbert E. Miller, Principles of Accounting, Intermediate Text (Englewood Cliffs, N.J.: Prentice--Hall, Inc., 1962), p. 603.

earnings credits or charges, or to other accounts, material and extraordinary taxes or tax savings relating to those accounts that would have a distorting effect on net income if included in computing it. The need for allocation is obvious where a large item of nonrecurring taxable income is classified as a credit to retained earnings. There are other situations, more complicated than this one, where allocation is equally important.[4]

The first important pronouncement on the subject of income tax allocation was made in 1944 by the committee on accounting procedure of the American Institute of CPA's.[5] Perhaps the most significant paragraph in the statement reads as follows:

> Income taxes are an expense that should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated. What the income statement should reflect under this head, as under any other head, is the expense properly allocable to the income included in the income statement for the year.[6]

The position taken, in essence, was that the amount shown in the income statement for income taxes should be the income tax expense properly allocable to the income included in the income statement for the year and not necessarily the amount currently payable for income taxes.

If we accept the underlying principle of the foregoing statement, Mr. Graham says we are forced to accept the two following

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[4] Accountant's Encyclopedia, Vol. I (1962), p. 52.

[5] Willard J. Graham, "Allocation of Income Taxes," The Journal of Accountancy, CVII (January, 1959), p. 58.

[6] Accounting Research and Terminology Bulletin, Final Edition, chap. 10, sec. B, p. 88.

corollary statements.

First corollary statement: Intra-period allocation.

Direct charges or credits to retained earnings or to other capital accounts should be entered "net of tax effects," thereby not affecting the income tax expense item on the income statement.[7]

The problem of intraperiod income tax allocation arises when there are both normal, recurring items such as the results, positive or negative, of business operations and extraordinary items such as gains or losses on the sale of plant and equipment occurring in the same year. If both of these items have an impact on the income taxes which the firm must pay and the income tax effect of the extraordinary items is material in amount, the former Committee on Accounting Procedure recommends an allocation of the income tax between the items. Thus, the after-taxes effect of the transactions is shown in the financial statements.

It is pertinent to note that the allocation procedure may take place between different sections of the income statement, when the all-inclusive income statement is used, or between the income statement and the statement of retained earnings, when the current operating income statement is used.[8]

Second corollary statement: Inter-period allocation.

Period income tax expense is measured by applying an appropriate

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[7]Graham, loc. cit.

[8]Ronald J. Patten, "Intraperiod Income Tax Allocation--A Practical Concept," The Accounting Review, XXXIX, No. 4 (October, 1964), p. 876.

tax rate to the reported net income before tax, adjusted for any permanent differences between net income and taxable net income. Differences between expense so computed and current tax payments result from differences only in the timing of the recognition of net income determinants and are only temporary; they should be accrued as assets (deferred charges to income tax expense) or "liabilities" (deferred credits to income tax expense) subject to elimination by offsetting differences in later periods.[9]

The implication here is that the tax accrues at the time the income is earned, regardless of whether or not the assessment by the government is levied at that time.

The usual interpretation of the above corollary is that consideration should be given to differences relating to individual transactions or accounts and separate adjustments made for each such difference, if the amount involved is material. (Then, too, as Mr. Johns points out, the initial intention of the Institute committee, in 1944, was that only amounts that were extraordinary and nonrecurring need be allocated.)[10]

The total area of income tax allocation includes considerations of interstatement (but intra-period) and intercompany (among consolidated corporations) allocation, but neither of these matters has evoked anything like the furor which has taken place over inter-period

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[9] Graham, loc. cit., p. 59.

[10] Ralph S. Johns, "Allocation of Income Taxes," Journal of Accountancy, CVI (September, 1958), p. 41-50.

allocation. While I will be concerned with both intraperiod and interperiod allocation in this paper, I will be mainly concerned with interperiod allocation; the term "allocation" when used here without a modifier, invariably refers to the interperiod variety.

Opponents of income tax allocation deny the validity of the interperiod shifting of the income tax charge and contend that the charge reported for a particular period should be the amount of income tax actually payable for that period. This paper will consider the arguments both for and against income tax allocation, and will elaborate on those points which most strongly argue against allocation. Briefly, these latter points may be summarized as follows:

1. The income tax is a charge determined in accordance with statute and regulations, computed and paid after earnings rather than incurred in the production of revenue. A number of writers have argued that it should be regarded as a distribution of earnings, more nearly like a dividend, rather than as an expense. (See Chapter II.)
2. Income for tax purposes and for annual reporting purposes frequently is not the same. (See Chapter III.)
3. Many writers have questioned the validity of the deferred tax account as a true liability or asset. (See Chapter IV.)
4. Accounting reports which do not incorporate interperiod allocations of income taxes are more useful in appraising the performance of management than are those prepared in accord-

ance with the precepts of allocation.[11] (See Chapter IV.)

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[11]James M. Fremgen, "Interperiod Income Tax Determination, Allocation and Income," NAA Bulletin, XLIV, No. 8, (April 1963), p. 4.

CHAPTER II

INCOME TAXES--EXPENSE OR INCOME DISTRIBUTION

Some accountants hold that income taxes are not a cost but a distribution of profits and are, therefore, not subject to allocation. The common arguments advanced in favor of the theory of distribution of income are as follows:

1. Income taxes are not like other expenses as they are not payable if there is no income.
2. The position of the government is similar to that of a partner or beneficiary with special interests in the business.
3. The incidence of the tax is on the shareholders and, therefore, tax paid by the enterprise is a kind of withholding tax paid to the government for the shareholders.[12]

Arthur Andersen and Co., in a discussion of various current accounting problems, observe that the argument against income tax allocation ignores "the principle of matching costs and revenues." Incidentally, the all-too-common interchange of the terms "expense" and "cost" in various statements of the matching principle does nothing to enhance the clarity and precision of accounting discourse.

However weighty this "matching" argument may sound, it contains

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[12]D.H. Bonham, "Accounting Research," The Canadian Chartered Accountant, XXCIV, No. 6,(June, 1964), p. 454.

a fatal flaw which is apparent when Professor Graham's statement quoted below is read with the present author's emphasis.

> In my opinion, the most convincing case for income tax allocation rests upon its proper matching of expense with revenue, the allocation of income tax expense among periods in relation to the reported net income rather than taxable income.[13]

The matching principle is designed to charge to revenue those costs (efforts) which have expired (i.e., have become expenses) in the production of that revenue (accomplishment). The income tax charge, however conceived, is not incurred in the production of revenue. Rather than an effort necessary to the accomplishment of revenue, the income tax is a charge levied after the recognition of revenues and also of the deduction of expenses from them. And the revenues and expenses upon which the tax is based are determined in accordance with the Internal Revenue Code and the ancillary Treasury regulations, not generally accepted accounting principles. The income tax is a function of taxable income--the excess of includible revenues over deductible expenses--not of revenue.[14] Thus, the opponents of tax allocation maintain that the matching principle is inapplicable to income taxes and "the most convincing case for income tax allocation" collapses.

Herbert E. Miller states that, "the reasoning supporting the distribution interpretation is usually based on the view that income taxes are coerced payments, not representing compensation for goods or

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[13] Graham, loc. cit., p. 59.

[14] Arnold W. Johnson, "More on 'Income-Tax-Allocation' Accounting," The Accounting Review, XXXVI, No. 1 (January 1961), p. 80.

services received and not contributing to the generation of revenue."[15] This point of view does not appear to have much following at the present time, but there is enough validity to that approach to conclude that income taxes are not an ordinary business expense that can be readily matched or assigned.

The arguments usually put forth supporting the theory that income taxes are a cost include:

1. Income taxes are not significantly different from other expenses and do not therefore require different classification. Other costs may also be tied to income, e.g., management incentive bonuses.
2. From the viewpoint of national economics, income taxes are an allocation of governmental costs to the income-producing units of the nation. Such costs must be taken into account in setting prices for the product of a business.
3. Distributions of income are generally discretionary and are subject to management control as to amount and timing of payment. There is nothing discretionary about taxes. Although the payment of taxes may be affected as to timing by management's control of certain types of transactions, income taxes may not be avoided entirely so long as profits exist.[16]

The fact that income taxes occur only when there are profits

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[15] Herbert E. Miller, "How Much Income Tax Allocation?" The Journal of Accountancy, CXIV, No. 2 (August, 1962), p. 51.

[16] Bonham, loc. cit.

does not ipso facto void them as an expense. Bonuses to corporate officers based on annual profits arise only when there are profits, yet these bonuses are unquestionably treated as corporate expenses.

Some have likened income taxes to preferred dividends and have suggested that if income taxes are an expense, so are preferred dividends.[17] However, an essential distinction between taxes and dividends seems to have been ignored by these theorists--dividends (both preferred and common) are paid to the stockholders who are the owners while income taxes are paid to an outsider, the government. In conformity with this fact, only if the government were deemed a "silent partner" in the entity could income taxes properly be likened to dividends paid by the corporation to its shareholders.

The government provides sundry services for its corporate citizens and in return for the performance of its governmental functions receives compensation through a tax on the net income of those corporations.

As pointed out by economist Phillip E. Taylor, in discussing the benefit principle of taxation, the benefits of a favorable business climate are extended to unprofitable as well as profitable concerns, while under our net income tax, only the profitable concern pays for these benefits.[18]

There seems to be general agreement among accountants that

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[17] Paul W. Huber, "Corporate Income Taxes: An Expense?" Journal of Accountancy, CXVIII, No. 6 (December, 1964), p. 27-28.

[18] Kenneth Ira Solomon, "Income Taxes--Expense or Income Distribution?" The New York Certified Public Accountant, XXXVI, No. 3 (March, 1966), p. 201.

income taxes are just as much a cost to be provided for in the profit-making process as are costs of payroll, supplies, physical facilities, etc. If this view were not accepted, income taxes would logically be charged against retained earnings, rather than be taken into the income statement.

CHAPTER III

DIFFERENCE BETWEEN ACCOUNTING AND TAXABLE INCOME

Differences between accounting income and taxable income arise from many causes, among which may be mentioned the following:

1. The statement of retained earnings may show items affecting taxes instead of showing them in the income statement. For example, instead of showing an extraneous gain of a material amount in the income statement, it may be shown in the statement of retained earnings.
2. Accounting rules and income tax rules do not agree in all instances in regards to revenue and expense. For example, for income tax purposes, provisions for losses under product guaranty agreements are not deductible; only payments arising from such obligations are deductible. However, to make an expense provision for such losses in the year that the product is sold is considered acceptable accounting.
3. A corporation may adopt one accounting method in its books and financial statements and another method for income tax purposes. For example, a corporation may use the percentage-of-completion method for accounting purposes, and adopt the completed-contract method for income tax purposes.[19]

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[19] Finney and Miller, loc. cit., p. 603.

Three more main causes of such differences are as follows:

1. Expenses and losses not allowable as deductions in computing taxable income, and non-taxable income and capital gains.
2. Carryover of business losses for tax purposes.
3. Differences in timing between the date of items of revenue and expense are recorded in the accounts and the date of their recognition for tax purposes. This usually involves items for which accounting treatment is subject to judgment decision by management, e.g., depreciation on fixed assets; depletion on natural resources; amortization of patents, copyrights, franchises, etc.; costs capitalized or deferred in financial accounts but expensed for tax purposes; costs provided for in financial statements in advance of their deduction for income tax purposes; and deferred revenues, such as on installment sales, contracts, rents in advance, etc.[20]

There is almost universal agreement that accounting net income need not correspond to taxable income and, indeed, ought not do so when the latter deviates from generally accepted accounting principles.[21] The opponents of tax allocation maintain, why then should accountants strive to contort the income tax charge, which is a function of taxable income, so as to conform with accounting net income? The two concepts of income are basically different. Accounting income is

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[20] Bonham, *loc. cit.*

[21] Miller, *loc. cit.*, p. 50.

conceived as a theoretically valid measurement of the return on capital invested in a business firm; it is concerned with measurable economic facts, however imperfect the measurement may be. Taxable income, on the other hand, is devised as a basis for raising government revenues. It is a matter of policy, intended as a measurement, however imperfect, of the taxpayer's ability to pay. So, the opponents of income tax allocation maintain that it is neither necessary nor feasible for the accountant to reconcile the differences between these two concepts of income, nor can he validly allocate to one charge based upon the other. After all, they argue, why should amounts determined for such different objectives be of the same order of magnitude.[22]

The proponents of income tax allocation seem to rest their case mainly on the need for income tax allocation to avoid distortion of income. Under existing laws, one of the rights relating to incurred costs, whether expensed or capitalized, is their deductibility for income tax purposes, either directly or through amortization. Consequently, each dollar of cost will reduce taxes by a specific number of cents (based on tax rate) and will reduce profits by the balance. The income tax reduction is, in effect, a recovery of specific portions of each dollar of deductible costs. It would seem unrealistic to report the tax reduction in the income statement before the cost itself is so reported. Similarly, it would not be realistic to charge income with the costs without recording the related income tax reduction.

This means that if a cost is chargeable for accounting purposes

[22]Fremgen, loc. cit., p. 5.

in advance of the recognition of the tax credit on income, the portion of the cost to be recovered from the tax reduction should be deferred until the tax credit is recognized. Conversely, if the tax credit is recognized before cost is charged to income, the tax credit should be deferred until the corresponding charge is taken into account.[23]

The opponents of tax allocation maintain, if a corporation uses one rate of depreciation for accounting purposes and a higher rate for income-tax purposes, it does not overstate its net income by failing to charge income with a provision covering deferred income taxes payable in future years. Taxpayers generally, including corporate taxpayers, have the right to minimize the amount of federal income taxes payable by them by any procedures which are legally appropriate. The opponents argue that for any given year, the charge against corporate income for income taxes should be the amount of income tax actually owed to the United States Treasury.[24]

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[23]Bonham, loc. cit., p. 457.

[24]Johnson, loc. cit., p. 81.

CHAPTER IV

OTHER PROBLEM AREAS

A. Statement Classification

The question of balance sheet presentation of the balance of deferred taxes is influenced by the theory upon which the deferment has been based.

Where the accrual or estimated liability theory is used, the deferment would be shown as a liability or receivable, depending on whether the accumulated balance was a credit or debit.

Under the asset valuation theory, the accumulated deferred credit balance would be deducted from the related asset and any debit balances would be deducted from the related deferred credit or liability.

If the pure matching theory were adopted, the accumulated credit balance would not logically be shown as a deferred credit and the debit balances as a prepaid expense or a deferred charge. However, some accountants who support this theory have taken the stand that the credit balance would more properly be shown as part of the shareholder's equity. Other accountants feel this approach would appear to disregard the essential characteristics of the deferment, and would seem impossible to justify recording the transaction as being, at one and the

the accumulated depreciation rather than the liability account in these circumstances (i.e., reducing the asset's basis).

Proponents of income tax allocation contend that assets and liabilities can be presented correctly only if tax deferrals are recorded. Quite apart from considerations of income reporting, allocation is necessary to place the balance sheet in its proper perspective. They go on to argue that, if an asset is to be recorded at the present value of its stream of future services, the future tax payments relative to that asset must be included in this valuation. As an example, the cost of an asset which is wholly deductible in the year of acquisition for tax purposes but is capitalized on the books, should be reduced by the amount of the tax rate applied to the cost in order to reflect the loss of future depreciation deductions for that asset.[27]

B. Evaluation of Management

Opponents of tax allocation maintain that when financial statements are used to evaluate the performance of management during a given period of time, income tax allocation tends to make them less useful. They contend that the performance of management is, in part at least, measured by income after taxes; and the timing of tax payments is a very important element in that performance. The deferral of tax payments to some future period(s) is likely to be advantageous to a firm and to its stockholders; it may, of course, prove unfortunate. In any event, it should not be obscured in the firm's income statement.

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[27]Fremgen, loc. cit., p. 8.

Herbert E. Miller shares this view:

> Perhaps we should re-examine the question of the need for tax allocation when the difference between reported income and taxable income is the result of managerial decisions. Why shouldn't the consequences of such decisions be shown?[28]

The proponents of tax allocation say that the practice of allocating income taxes on the financial statements of a business makes the statements more useful.

While the income statement does report the results of past operations, its utility to the reader depends primarily upon its validity as a basis for appraising the profitability of--or planning the control of--future operations. The failure to defer to the proper period the credit for a current reduction in income tax payments results in an over-statement of current net income that is likely to lead the "outside" reader of the income statement to incorrect conclusions with respect to future earning power--or to bias the judgment of the "insider" in the formation of plans for the managerial control of future operations.

Financial statements, it should be remembered, are for the use of persons who are qualified to read them with understanding. This means, also, that financial information appearing on the statements of income, for example, is most effectively understood when there is an understanding of the operations of a business supplemented, if possible, by an understanding of important policy-determining directives of management bearing upon income. This includes income-tax policy.[29]

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[28] Miller, loc. cit., p. 51.

[29] Johnson, loc. cit., p. 81

C. Others

Another argument against allocation criticizes the practice on the grounds that it results in artificial normalization of periodic income data. Normalization, in this sense, means some kind of an averaging or normalizing.

Graham defends by stating that his concept of income tax allocation is simply to charge the current accounting period with all income taxes arising from the current accounting income, regardless of the time of payment of taxes. He contends that this can hardly be described as "normalization".[30]

Income tax allocation has been attacked on the grounds that, as commonly presented, it ignores the necessity for recording a deferred tax liability at its discounted present value. This liability is shown in gross terms (i.e., it is not shown in terms of the present value of the government's right to collect these items at some future date) in accordance with present practice, which reflects present values of future sums in the accounts only to the extent that such values are part of the transaction itself. While this attack raises a very important point, it is one which is applicable to many other liabilities besides the one here in question. Thus, its implications are too broad for careful consideration within the scope of this paper.[31]

A somewhat distinctive point in support of allocation was made

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[30]Graham, loc. cit., p. 59.

[31]Raby and Neubig, loc. cit., p. 569.

in an article by Robert K. Jaedicke and Carl L. Nelson. They contend that a deferred income tax payment is a distinct source of funds, namely, a loan from the Federal Government, and should be shown as such in the financial statements.[32]

The opponents maintain that this suggestion, however, seems to presume the validity of what it is intended to support. If allocation is invalid, then there is no identifiable deferral of payment and, hence, no loan and no unique source of funds.

The arguments for and against income tax allocation have been well presented by many writers. I have discussed some of these arguments in this and the preceding chapters. Chapter V will deal with the acceptability of the concept of income tax allocation.

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[32]Robert K. Jaedicke and Carl L. Nelson, "The Allocation of Income Taxes--A Defense," The Accounting Review, XXXV, No. 2 (April, 1960), p. 279.

CHAPTER V

THE ACCEPTABILITY OF THE CONCEPT OF INCOME TAX ALLOCATION

The Accounting Principles Board of the American Institute of Certified Public Accountants, in its meeting on April 11, 1959, took the position that Accounting Research Bulletins issued by the predecessor Committee on Accounting Procedure should be considered as "continuing in force with the same degree of authority as before." Thus, the concept of income tax allocation discussed in Accounting Research Bulletin No. 43 (ARB 43), Chapter 10, Section B, continues to have official support. The following study will show that the income tax allocation concept, applied on an intraperiod basis, also has support in practice as evidenced by a survey of the financial reporting practices of eighty-two firms covering the years 1961, 1962, and the first six months of 1963. All the companies in the sample are linked by a common bond; all of the firms were faced with the decision whether or not to allocate income taxes on an intraperiod basis.[33]

Old tax rates are used since they were in effect at the time this study was made. The particular situations in which the companies in the study were involved lend themselves to classification as follows:[34]

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[33]Patten, loc. cit.

[34]Patten, loc. cit., pp. 876-879.

Group A. The company had a positive figure resulting from normal, recurring items and a positive figure resulting from extraordinary items. For example, assume the following facts:

Sales.	$1,000,000
Cost of Goods Sold	600,000
Other Operating Expenses	100,000
Gain on Sale of Building	200,000

If the concept of intraperiod income tax allocation is applied, the applicable financial statements appear as follows in Table 3 and Table 4 (assuming a current operating type of income statement).

TABLE 3

INCOME STATEMENT

Sales.		$1,000,000
Cost of Goods Sold		600,000
Gross Margin on Sales.		$ 400,000
Other Operating Expenses		100,000
Net Income Before Taxes.		$ 300,000
Less: Income Taxes		
Income Taxes Payable This Year.	$200,500	
Less: Portion Applicable to Gain on Sale of Building. . .	50,000	150,500
Net Income		$ 149,500

TABLE 4

RETAINED EARNINGS STATEMENT

Beginning Balance of Retained Earnings.		$ xxxxx
Add:		
Net Income per Income Statement		149,500
Gain on Sale of Plant.	$200,000	
Less: Income Taxes Applicable Thereto .	50,000	150,000
Ending Balance of Retained Earnings		$ xxxxx

The tax computation was made using the alternative method for treating capital gains, and is as follows:

Tax on $300,000 equals.	$150,500
Tax on $200,000 @ 25% equals.	50,000
Total Taxes Payable	$200,500

The preceding allocation of income taxes could be reflected on the books in the following manner:

Income Taxes Expense.	200,500	
Income Taxes Payable.		200,500
Gain on Sale of Building (Retained Earnings)	50,000	
Income Taxes Expense.		50,000

Group B. The company had a positive figure resulting from normal, recurring items and a negative figure resulting from extraordinary items. To illustrate, assume the following facts:

Sales.	$1,000,000
Cost of Goods Sold	600,000
Other Operating Expenses	100,000
Loss on Sale of Building	200,000

Application of the concept of intraperiod income tax allocation results in the following financial statements (assuming a cur-

rent operating type of income statement):

TABLE 5

INCOME STATEMENT

Sales.		$1,000,000
Cost of Goods Sold		600,000
Gross Margin on Sales.		$ 400,000
Other Operating Expenses		100,000
Net Income Before Income Taxes		$ 300,000
Less: Income Taxes		
Income Taxes Payable This Year . . .	$ 46,500	
Add: Reduction in Income Taxes Due to Loss on Sale of Building. .	104,000	150,500
Net Income		$ 149,500

TABLE 6

RETAINED EARNINGS STATEMENT

Beginning Balance of Retained Earnings		$ xxxxx
Add: Net Income per Income Statement.		149,500
Less: Loss on Sale of Building. . .	$200,000	
Less: Reduction in Income Taxes Applicable Thereto.	104,000	96,000
Ending Balance of Retained Earnings.		$ xxxxx

The tax computation is as follows:

$300,000--200,000 equals. $100,000
Tax on $100,000 equals. . . . . . .$ 46,500

The following entries reflect the allocation on the books:

Account	Debit	Credit
Income Taxes Expense.	46,500	
Income Taxes Payable.		46,500
Income Taxes Expense.	104,000	
Loss on Sale of Building (Retained Earnings)		104,000

<u>Group C</u>. The company had a negative figure resulting from normal, recurring items and a positive figure resulting from extraordinary items.

<u>Group D</u>. The company had a negative figure resulting from normal, recurring items and a negative figure resulting from extraordinary items.

Since the sample sizes of both Group C and Group D were so small, no meaningful conclusion will be reached as to the acceptability of the concept of income tax allocation in each situation.

Forty-two companies in the study were confronted with a situation of the type in Group A, and thirty-five of them (83.3%) elected to utilize the income tax allocation procedure. Twenty-eight companies in the study were confronted with a situation of the type in Group B, and twenty-one of them (75%) elected to utilize the income tax allocation procedure.[35]

In conclusion, in both Group A and Group B, a substantial majority tended to follow the recommendations of <u>ARB</u> 43. The preceding finding is meaningful since it discloses that the concept of intraperiod income tax allocation has passed the acid test of practicability.

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[35] <u>Ibid.</u>

Not only is the concept acceptable to the former Committee on Accounting Procedure as evidenced by ARB 43, but it is acceptable to practicing accountants and the management as well. Since financial statements are the representations of management, the fact that the majority of firms in the survey actually utilized the income tax allocation concept is an indication that the concept is practical. Further, the accountants who were involved in the audits of the various firms must have done nothing to dissuade their clients from utilizing the income tax allocation concept. It appears to be reasonable to conclude that the practicing accountant also feels that the concept is practical.

On the basis of the foregoing conclusion, it appears that the concept of income tax allocation on an intraperiod basis is practical and capable of being implemented in the world of reality.

Melwood W. Van Scoyoc reasons that it was the position of a majority of the AICPA Committee on Accounting Procedure, in Bulletin No. 44 (Revised) issued July, 1958, that interperiod allocation of income taxes is required, except in cases where it is reasonable expected that a regulatory agency will allow the supposedly higher future taxes to be recovered through future rates.[36]

The Securities and Exchange Commission, in 1945, in its Accounting Series Release No. 53, held that "the amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws." The SEC stand was clearly opposed to tax allocation, although it appears to have gone along with the

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[36] Melwood W. Van Scoyoc, "Tax Allocation--Where It Has Led Us," NAA Bulletin, XLIV, No. 12 (August, 1963), p. 3.

profession subsequently, and recently (in *Accounting Series Releases* No. 85 and 86) expressed support for income tax allocation, although it did not suggest that it be made mandatory.[37]

Although the income tax allocation problem seems to have been generally accepted, there are still many opponents to the concept.

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[37] Miller, *loc. cit.*, p. 46.

CHAPTER VI

SUMMARY AND CONCLUSION

The problem of allocation of income taxes arises in those cases where there are material and extraordinary differences between the taxable income upon which such income taxes are computed and the income for the period determined in accordance with generally accepted accounting principles. The problem of intraperiod income tax allocation arises when there are both normal and extraordinary items from operations, positive or negative, in the same year. The problem of interperiod allocation of income taxes arises out of differences in timing the determinants of income for two diverse purposes--financial reporting and taxation.

The opponents of tax allocation have in general countered by posing arguments against specific features of the proposal rather than by offering an alternative solution. The arguments against allocation have been based primarily on the following objections:

1. The income tax is not an expense in the usual sense of an expired cost of goods or services. While the government does provide economic services which are necessary and useful in the operation of a business firm, a particular firm's income tax does not constitute compensation for the government services rendered to that particular firm.

2. There is no inherent direct relationship, in many cases, between accounting net income and the income tax charge as determined in the tax return. Where these two are incompatible for a particular period, no attempt to establish a direct relation by means of interperiod allocation can be valid.
3. Reporting of the actual tax liability of the period as the tax expense of that period results in financial statements which are more useful for purposes of appraising the effectiveness of management than are statements prepared in accordance with the practice of interperiod tax allocation. The timing of tax payments is a significant element of managerial efficiency in many instances and should not be obscured in the statements by tax allocation.
4. The contention that a proper matching of expenses and revenues necessitates interperiod tax allocation is fallacious. The income tax is not a cost expired in the production of revenue, nor is it a revenue charge in any sense.
5. The techniques proposed for allocation do not recognize the present value concept.
6. The entire proposal is extremely complex and very nearly incomprehensible to the layman.

The proponents of tax allocation base their position mainly on the following features of the proposal:

1. Income taxes are an expense that should be allocated to income and other accounts as other expenses are allocated.

2. The income tax charge reported for any period should be equal to the reported net income, determined in accordance with generally accepted accounting principles and adjusted for permanent differences between accounting and taxable incomes, multiplied by the applicable tax rate.
3. The principle function of the income statement is to facilitate the forecasting of future earning power. From this viewpoint, particularly, the proper matching of expense and revenue demands the allocation of income tax expense, even in those cases where deferment is for a relatively long period.
4. Period income tax expense should be measured by applying the current tax rate to the reported net income before tax, either in total or with respect to individual items of income or expense. Differences between period income tax expense and current tax payments should be accrued as "deferred charges to income" or "deferred credits to income tax expense".
5. The continuity assumption implies continued operation at a profit--future taxable income--thereby validating deferred charges and credits to income tax expense.
6. Direct charges or credits to capital accounts should be entered "net of tax effects".
7. Deferment should be interpreted as the deferment to future periods of a credit to income tax expense rather than as the deferment of the payment of a tax liability. Under this concept, questions relating to the existence of future taxable

income and to future tax rates are irrelevant.

The examples of accounting practice with respect to this problem indicate the confusion which surrounds the allocation of the tax charge.

The impact of income tax allocation upon financial reporting has been, and will continue to be, material both in terms of the number of companies affected and the dollar amounts of reported income involved. The presence or absence of allocation has a material effect on the reported income of many companies. The accountant has an obligation to study the alternatives carefully in order to make the accounting reports as useful and realistic as is humanly possible. It is completely unrealistic to ignore the problem.

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