INCOME TAX ALLOCATION: APPLICATIONS, INTRICACIES, AND OPINIONS

by

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B. S., Kansas State University, 1963

A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

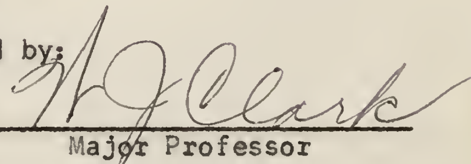
MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1965

Approved by:



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INTRODUCTION

> In December, 1944 the American Institute of Accountants issued Accounting Research Bulletin Number 23, "Accounting for Income Taxes," which is now Chapter 10, Section B, of Accounting Research Bulletin Number 43, Restatement and Revision of Accounting Research Bulletins. This bulletin propounded the principle that "the income statement should reflect under this head (taxes on income), as under any other head, the expense properly allocable to the income included in the income statement for the year.[1]

Since the issuance of Accounting Research Bulletin Number 23, the subject of income tax allocation has become one of the most controversial topics of the accounting profession. The principle suggested by the Institute in Bulletin 23 gained acceptance in numerous circles, but encountered strong opposition in many others.

Income tax allocation may be explained as

> . . . the process of matching in financial reporting the income tax effects of an item of income, cost or expense with the item itself. If there is a need for allocation, it arises principally from the fact that income tax accounting and generally accepted accounting principles are not identical. An item may affect income taxes for a particular year without otherwise affecting net income for that year. The reverse is equally true in that an item may affect net income before income taxes without affecting income taxes as shown by the tax return for the same year.[2]

The principle of income tax allocation deals primarily with the amount of income tax expense to be reported on the current income statement. Proponents of the tax allocation principle state that the tax

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[1]Hans J. Shield, "Allocation of Income Taxes," The Journal of Accountancy, April, 1957, 103:53.

[2]Samuel L. Ready, "Income Tax Allocation in Financial Statements: Occasions and Opinions," NAA Bulletin, December 1960, 52:19.

expense reported on published financial statements should bear a direct relationship to the income reported thereon. The basis for this opinion rests on two notions. First, the readers of published statements (e.g., common stockholders) are aware that the corporate income tax rate is approximately fifty per cent. Reporting a tax expense which does not closely resemble this fifty per cent figure creates confusion. Second, if the allocation principle is not followed, the net income figure, and thus the operating results of the business as displayed on the income statement, are distorted. Allocation of the tax expense, in conjunction with the item of income, cost or expense to which it is related, would tend to smooth out or normalize the net income after taxes reported on the financial statements, and thus would avoid distortion and confusion. The fact that the income tax liability may, in truth, be greater or less than the tax expense reported (due either to the differences in accounting and tax methods used in recognizing revenues and expenses, or to the dissimilarity of accounting principles and tax laws) appears to cause no great concern.

The Internal Revenue Service is cognizant of the fact that accounting principles and tax laws are unlike in many circumstances. It therefore furnishes for the corporate taxpayer two schedules to facilitate the reconciling of differences between net income per books and taxable income on the tax return. These schedules, contained in Internal Revenue Service Form 1120, appear on page three below. Schedule M-1, reconciles book income with taxable income, and Schedule M-2, is an analysis of surplus.

Schedule M-1.—RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1. Net income per books		7. Income recorded on books this year not included in this return (itemize)	
2. Federal income tax			
3. Excess of capital losses over capital gains			
4. Taxable income not recorded on books this year (itemize)		8. Deductions in this tax return not charged against book income this year (itemize)	
5. Expenses recorded on books this year not deducted in this return (itemize)			
		9. Total of lines 7 and 8	
6. Total of lines 1 through 5		10. Income (line 28, page 1)—line 6 less 9	

Schedule M-2.—ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS PER BOOKS (line 23, page 4)

1. Balance at beginning of year		5. Distributions: (a) Cash	
2. Net income per books		(b) Stock	
3. Other increases (itemize)		(c) Property	
		6. Other decreases (itemize)	
		7. Total of lines 5 and 6	
4. Total of lines 1, 2, and 3		8. Balance end of year (line 4 less 7)	

Four cases exist in which the allocation of income taxes is considered appropriate by the proponents of the tax allocation principle. Each case relates to the timing of the recognition of revenue items and of the deductibility of expense items.

Case 1 - Deals with expenses, costs or losses which are deductible for accounting purposes before being deductible for tax purposes.

Case 2 - Concerns expenses, costs or losses which are deductible for tax purposes before being deductible for accounting purposes.

Case 3 - Pertains to the recognition of revenue for accounting purposes prior to recognition on the tax return.

Case 4 - Refers to the inclusion of revenue on the tax return prior to its inclusion on the books.

Certain items of expired cost are considered expenses for accounting purposes, but are nondeductible for tax purposes. On the other hand,

some revenue items included on a corporation's income statement are nontaxable. In both instances, the general concensus of opinion does not favor the allocation of income taxes.

A major area of controversy regarding the concept of income tax allocation pertains to the tax allocation accounts on the balance sheet. As taxes are allocated for income statement purposes, an odd breed of balance sheet account evolves. This account represents either a deferred tax expense or a deferred tax liability, depending on which is greater, income as reported on the tax return or net income before taxes per books.

The income tax allocation procedure followed in this report supports the idea that the difference between tax expense per books and the tax expense per tax return should be either accrued, or deferred to the period benefited. The "netting the tax effect" procedure for income tax allocation is not discussed in this paper.[1] It should be noted that income taxes will be considered an expense rather than a distribution of earnings.

The income statement referred to in this report is prepared in accordance with the all-inclusive or clean-surplus theory. "The advocates of this concept maintain that all items of revenue, expense, gain or loss are necessary factors in determining net income. They believe, and in fact urge, that extraordinary and correction items should be included in the income statement."[2] By adopting the clean-surplus theory, the

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[1]Maurice Moonitz, "Income Taxes in Financial Statements," The Accounting Review, April 1957, 32:179-180.

[2]H. A. Finney and Herbert E. Miller, Principles of Accounting: Intermediate, p. 74.

problem of tax allocation between financial statements is alleviated.

At present, the federal income tax rates applicable to corporate income are:

22% on the first $25,000 of taxable income.

48% on amounts above $25,000 of taxable income.[1]

For convenience, a 50% rate will be used in the illustrations throughout this report.

ACCOUNTING DEDUCTIBILITY PRIOR TO TAX DEDUCTIBILITY

The first type of case to which the principle of income tax allocation applies concerns items of expense, cost, or loss which are deductible for accounting purposes before being deductible for tax purposes.

The principle of accounting known as the matching concept states that

> In the determination of periodic net income, it is imperative that revenues and related expenses be reported in the same period.... In cases where a "future" expense is associated with current revenue, provisions for such future outlays should be made by charges to expense in the period when the related revenue is earned.[2]

As a consequence of the matching concept, businesses often charge an expense against the present income to which it is related, even though the expense will not be fact until a later date. In many instances, the amount of the expense is estimated and therefore the possibility does exist that the actual expense may be greater or less than

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[1] Prentice-Hall 1965 Federal Tax Course, p. 3105.

[2] Finney and Miller, op. cit., p. 183.

the estimate or it may never materialize. When the expense is charged, a reserve or estimated liability for the expense or loss is also recorded on the books of the business.

For tax purposes, "there must be an actual liability before any amount may be accrued."[1] "Although it may be good business practice to set up a reserve to meet a liability that may arise, the reserve is not deductible."[2]

Due to the difference in timing of the deductibility of this type of expense, by the accounting profession and the tax authorities, the income reported for accounting purposes differs from that reported for tax purposes. Since this is the case, the income tax expense variance related to these items is allocated on the financial statements to the period or periods benefitted.

To illustrate this case, assume that Company X sells Thingamajigs which carry a four year guarantee. Company X knows that it will have to make repairs on a few of these Thingamajigs sold each year. By studying the marketing results of other companies selling an article similar to Thingamajigs, it has been estimated that the repairs will amount to approximately 5% of the Thingamajig sales. Therefore, each year Company X charges to an Estimated Product Guarantee Expense account, an amount equal to 5% of that year's Thingamajig sales. At the same time, the Company credits a Reserve For Product Guarantees account. When the repairs are actually made, the reserve account is reduced.

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[1]Prentice-Hall, _op. cit._, p. 2728.

[2]_Ibid._, p. 2732.

Table 1, on the following page, illustrates the difference between the expense recognition for accounting purposes and tax purposes, and also shows the tax effect, the amount of tax expense which is deferred until a later period for accounting purposes. It should be kept in mind, however, that the deferral for book purposes has no effect on the actual amount of tax which must be paid in a particular year. For example, in year one, the tax expense per income statement would be $2,500 less than the tax expense shown on the tax return, but the amount shown on the tax return represents the actual liability which must be paid.

According to the principle of income tax allocation, the entries which would be recorded on the books of Company X for the first four years illustrated on Table 1 would be as follows:

1.	Deferred Income Tax Expense	2,500	
	Income Tax Expense		2,500
	(actual tax exceeds book tax)		
2.	Deferred Income Tax Expense	2,000	
	Income Tax Expense		2,000
	(actual tax exceeds book tax)		
3.	Deferred Income Tax Expense	500	
	Income Tax Expense		500
	(actual tax exceeds book tax)		
4.	Income Tax Expense	125	
	Deferred Income Tax Expense		125
	(book tax exceeds actual tax)		

Assuming an accurate estimate made by Company X in setting up its Reserve For Product Guarantees, eventually the tax expenses shown on the books and on the tax returns should offset each other.

Other examples of costs or losses deducted in the income statement before they are deductible for income tax purposes are estimated expenses to be incurred on warranties, allowances

Table 1. Deferred income tax expense. Accounting deductibility prior to tax deductibility.

Years	Thingamajig sales	Estimated product guarantee expense 5%	Tax product guarantee expense: (actual liability)		Difference	Tax effect 50% rate (deferred income tax expense)
1	$100,000	$5,000	*	$0,000	$5,000	$2,500
			1	1,000		
2	120,000	6,000			4,000	2,000
			2	1,000		
			1	2,000		
3	130,000	6,500	2	1,500	1,000	500
			3	2,000		
			1	1,000		
			2	2,000		
4	115,000	5,750	3	1,000	(250)	(125)
			4	2,000		
			2	1,000		
			3	2,500		
5	130,000	6,500	4	1,500	500	250
			5	1,000		
			3	1,000		
6	140,000	7,000	4	2,000	1,000	500
			5	2,000		
			6	1,000		

* Numbers in this column refer to the Sales Year to which the present liability or tax expense is related.

> for cash discounts to be taken by customers, provisions for losses from damage claims against self-insurers, provisions for anticipated losses on abandonments, and provisions for permanent declines in values of investments.[1]

TAX DEDUCTIBILITY PRIOR TO ACCOUNTING DEDUCTIBILITY

The second case to which the income tax allocation principle applies deals with items of expense, cost or loss which are deductible for tax purposes before being deductible for accounting purposes.

> The best known items deducted in the income tax returns before they are deducted in the income statement are deductions for amortization of emergency facilities under Section 168 and for accellerated depreciation under Section 167 of the Internal Revenue Code, when slower methods are used for accounting purposes. Income tax allocation in these instances, as in all others, is based on the principle of matching the income tax benefit, in point of time, with the corresponding deduction in the income statement.[2]

The two principal methods of accellerated depreciation are the declining balance method and the sum of the years-digits method. "The amount of depreciation that can be taken each year under the declining balance method is generally twice the straight line rate (unadjusted for salvage)."[3] In the situation where the sum of the years-digits method is employed,

> the annual depreciation deduction is figured by applying a changing fraction to the taxpayer's cost of the property less any salvage value taken. The numerator of the fraction is the number of remaining years of the estimated useful life of the property. The denominator is the sum of the numbers representing the years of life of the property.[4]

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[1]Ready, op. cit., p. 22.

[2]Ibid., p. 23.

[3]Prentice-Hall, op. cit., p. 2013.

[4]Ibid., p. 2015.

The straight line method allocates an equal amount of the cost less salvage value to each year of estimated useful life.

To illustrate this second case, assume that Company A uses straight line depreciation for book purposes, and sum of the years-digits depreciation for tax purposes. As a result of this procedure, the income before taxes per books will exceed taxable income in the early life of an asset. In the later life of an asset the reverse will occur. Assume also that Company A purchases a depreciable asset with an estimated useful life of four years, cost of $100,000 and no salvage value.

Table 2, on the following page, displays the difference between the expense recognition for book and tax purposes and the resulting tax effect which, in this situation, represents a deferral of tax liability in the first two years and the offset of this deferral in the last two years.

Company A, according to the income tax allocation principle, would record the tax effect for the four year period as follows:

1. Income Tax Expense	7,500	
Deferred Income Tax Liability		7,500
(book tax exceeds actual tax)		
2. Income Tax Expense	2,500	
Deferred Income Tax Liability		2,500
(book tax exceeds actual tax)		
3. Deferred Income Tax Liability	2,500	
Income Tax Expense		2,500
(actual tax exceeds book tax)		
4. Deferred Income Tax Liability	7,500	
Income Tax Expense		7,500
(actual tax exceeds book tax)		

The case of Company A depicts a possible but highly improbable situation. Today, in a period of industrial expansion, a company normally

Table 2. Deferred income tax liability. Tax deductibility prior to accounting deductibility.

Years	Straight line depreciation (book expense)	Sum of the years-digits depreciation (tax expense)	Difference	Tax effect 50% rate (deferred income tax liability)
1	$25,000	$40,000	$15,000	$7,500
2	25,000	30,000	5,000	2,500
3	25,000	20,000	(5,000)	(2,500)
4	25,000	10,000	(15,000)	(7,500)

Table 3. Deferred income tax liability. Tax deductibility prior to accounting deductibility.

Years	Number of assets owned	Straight line depreciation (book expense)	Sum of the years-digits depreciation (tax expense)	Difference	Tax effect 50% rate (deferred income tax liability)	Cumulative deferral
1	1	$12,500	$20,000	$ 7,500	$ 3,750	$ 3,750
2	2	25,000	35,000	10,000	5,000	8,750
3	3	37,500	45,000	7,500	3,750	12,500
4	4	50,000	50,000	0	0	12,500
5	5	50,000	50,000	0	0	12,500
6	4	50,000	50,000	0	0	12,500

owns a number of depreciable assets and steadily increases investment in depreciable assets each year. Under this set of circumstances, if accellerated depreciation is used for tax purposes while a slower method is used for book purposes, the deferred income tax liability will not be offset with the passage of time. The following example will illustrate this case.

Company B purchases one depreciable asset each year for four years. After the first four years, one asset will be purchased each year and one will be retired. Each asset costs $50,000, has no salvage value, has a useful life of four years, and is depreciated for book purposes according to the straight line method and for tax purposes according to the sum of the years-digits method.

Table 3, on the previous page, clarifies this example. As can be seen on Table 3, from year four until infinity, the book depreciation and tax depreciation will be equal and thus the deferred tax liability resulting from income tax allocation in years one through three will not be removed from the books. If Company B were to continue expanding rather than becoming static after year four, the deferred tax liability would continue to increase rather than remain constant.

The case of depreciation differences and income tax allocation has created considerable controversy due to the effects of allocation illustrated in the case of Company B. A number of arguments against allocation of taxes in this situation have been expressed by various members of the accounting profession.

Sidney Davidson, Professor, The Johns Hopkins University, considers the permanently deferred tax liability as a gift. He states that

> so long as a firm follows a regular investment policy; it will receive a "gift" of having its income tax payments permanently reduced. It may well be argued that a gift should not be permitted to distort comparative operating results by reducing an expense, but the solution is to treat income taxes as an income distribution rather than to recognize an expense that simply does not exist.[1]
>
> . . . Although a liability for future taxes from this source should be recognized only in rare cases, disclosure of any difference between the amount of depreciation claimed on the tax return and that shown in the income statement is a desirable reporting practice and should be employed regularly.[2]

Dale S. Harwood, Jr., Assistant Professor, University of Oregon, is another opposed to income tax allocation in this situation for the following reasons:

> The case which can be made for tax allocation because of a difference between book and tax depreciation must be logically predicated, no matter the direction of argument, on the assumption the tax differential is in reality a loan, with or without interest. This . . . is a most tenuous assumption and . . . rests on considerations which seem no more significant than other-side-of-the coin situations in which the tax bill is over- rather than underpaid because of existing tax law. There is always the possibility that another Congress will revoke the more rapid tax-depreciation methods, but even postulating revocation, tax-allocation advocates would still have to defend assumptions that a loan exists in fact.[3]

Ralph S. Johns, CPA, partner in charge of the Chicago office of Haskins & Sells, author of Palmer and Bell's Accountants' Working Papers and co-author of Auditing by Bell and Johns, is another highly respected member of the accounting profession who has expressed an unfavorable opinion pertaining to income tax allocation in the case of

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[1]Sidney Davidson, "Accelerated Depreciation and the Allocation of Income Taxes," The Accounting Review, April, 1958, 33:177.

[2]Ibid., p. 180.

[3]Dale S. Harwood, Jr., "Yet More on Tax Allocation," The Accounting Review, October, 1961, 36:624.

different depreciation methods being used for accounting and tax purposes. Mr. Johns believes that depreciation provisions should not be used to normalize reported net income. If a corporation wishes to use straight-line depreciation for book purposes, when this method represents the most realistic approach to depreciation, while using an accelerated depreciation method for tax purposes as a legitimate means of reducing the tax expense, the corporation should be permitted to do so without deferring income taxes equivalent to the tax benefit. If the amounts of depreciation and tax benefit involved are material, they should be disclosed by way of footnote.[1]

Even though some accountants have argued against income tax allocation related to depreciation differences for accounting and tax purposes, the authoritative bodies of the accounting profession view the situation in a somewhat different light. Andrew Barr, Chief Accountant of the Securities Exchange Commission, in a talk given in June 1957, made the following remarks.

> A number of cases have come to our attention in which sum-of-the-years-digits or declining-balance depreciation has been claimed for tax purposes but straight-line depreciation has been continued on the books without any adjustment for deferred taxes. The improvement in earnings resulting from this practice has been so large in some cases that amendment of the statements to include an additional amount equal to the tax benefit has been required on the grounds that failure to do so would make the statements seriously misleading.[2]

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[1]Ralph S. Johns, "Allocation of Income Taxes," The Journal of Accountancy, September, 1958, 106:47.

[2]*Ibid.*, p. 43.

Probably the most significant argument for allocation of taxes in this situation was expressed by the American Institute of Certified Public Accountants in its Accounting Research Bulletin Number 44 (Revised), "Declining-Balance Depreciation," which was issued in July, 1958. Bulletin Number 44 stated that deferred income taxes, related to depreciation differences resulting from declining-balance depreciation being adopted for tax purposes while other appropriate methods are used for accounting purposes, should be given accounting recognition if the amounts are material. This recognition of deferred income taxes applies to single assets, to groups of assets which are expected to be retired from service at about the same time, to groups of assets of differing lengths of life which are expected to be continually replaced, and to expanding plants where the tax deferment might increase as long as expansion continues. In situations where regulatory authorities do not permit deferring the tax, full disclosure should be made of the amount of the deferred income taxes.[1]

ACCOUNTING INCOME PRIOR TO TAXABLE INCOME

The third case for which the income tax allocation principle is appropriate involves income which is includible on the income statement before it appears on the tax return. This circumstance occurs as a result of the difference in timing of the recognition of revenue for accounting and tax purposes. A common example of this situation is encountered in the construction industry where work is done on a long-term contract basis.

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[1] Accounting Research and Terminology Bulletins, Final Edition 1961, American Institute of Certified Public Accountants, pp. 1A-3A.

For tax purposes, a contractor may recognize revenue on the completed contract basis.

> Under this method, the gross income is reported in the year the contract is completed, a deduction being permitted at that time for all expenditures during the life of the contract which are properly allocable to it.[1]

For financial statement purposes, the contractor may use the percentage-of-completion method of recognizing revenue.

> Use of the percentage-of-completion method calls for the selection of either of the following approaches: (1) The degree of completion is developed by comparing costs already incurred with the most recent estimates as to total estimated costs to complete the project. The percentage that costs incurred bear to total estimated costs is applied to the estimated net profit on the project in arriving at the profit to date. Profit is thus recognized in terms of a percentage-of-cost-completion. (2) Estimates of the progress of a project in terms of the work performed are obtained from qualified engineers and architects. Such estimates are applied to total contract price, and costs incurred to date are subtracted from estimated revenue in arriving at current earnings.[2]

Due to the difference in methods used for accounting and tax purposes, the reported income and taxable income will differ. Accompanying the variation in income will be a variation in the income tax expense. Since this situation does arise,

> the principle of income tax allocation requires that the provision for income taxes be computed as though the tax return had also been prepared on the percentage-of-completion basis. This, of course, results in setting up a deferred income tax liability relating to the profits which have been included in the income statement but not in the tax return.[3]

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[1]Prentice-Hall, op. cit., p. 2818.

[2]Wilbert E. Karrenbrock and Harry Simons, Intermediate Accounting, pp. 273-274.

[3]Ready, op. cit., p. 24.

To illustrate this case, assume that Company Y is a construction company which contracts with various corporations to erect buildings. In Year 1, Company Y contracted to construct a building for Corporation A; in Year 2, for Corporation B; and in Year 3, for Corporation C. The estimated profits on the contracts were, Corporation A, $100,000; Corporation B, $75,000; and Corporation C, $90,000, The contracts were completed as follows:

Table 4. Percent completed on contracts over a four year period.

Contracts	Year 1 %	Year 2 %	Year 3 %	Year 4 %
A	80	20		
B		60	40	
C			40	60

On the following page, Table 5 illustrates the difference between the income recognition for accounting and tax purposes. It also displays the tax effect, the amount of deferred income tax liability which will be recorded on the books as a result of income tax allocation.

The entries which would be recorded on the books of Company Y for the four years illustrated on Table 5 would be as follows:

		Debit	Credit
1.	Income Tax Expense	40,000	
	Deferred Income Tax Liability		40,000
	(book tax exceeds actual tax)		
2.	Deferred Income Tax Liability	17,500	
	Income Tax Expense		17,500
	(actual tax exceeds book tax)		

Table 5. Deferred income tax liability. Accounting income prior to taxable income.

Years	Contracts	Percentage-of-completion (accounting income)	Completed contract (taxable income)	Difference	Tax effect 50% rate (deferred income tax liability)
1	A	$80,000	$000,000	$80,000	$40,000
2	A	20,000	100,000	(35,000)	(17,500)
	B	45,000			
3	B	30,000	75,000	(9,000)	(4,500)
	C	36,000			
4	C	54,000	90,000	(36,000)	(18,000)

3. Deferred Income Tax Liability 4,500
Income Tax Expense 4,500
(actual tax exceeds book tax)

4. Deferred Income Tax Liability 18,000
Income Tax Expense 18,000
(actual tax exceeds book tax)

As Table 5 illustrates, and as can be seen in the journal entries, as time passes, the taxable income offsets the accounting income and thus the Deferred Income Tax Liability is removed as the actual tax offsets the allocated tax.

Another example of income being recognized for accounting purposes prior to being recognized for tax purposes, deals with installment sales.

> The term "installment sale" . . . is understood to include any sale in which payment is made in two or more installments. The amount of the downpayment is immaterial. It does not matter whether title to the goods passes to the buyer. Sales on the revolving credit plan also may qualify.[1]

> In the absence of extraordinary circumstances, it is a common practice to report the gross profit from an installment sale in the year in which the sale is made, due allowance being made for estimated losses and for collection expenses if necessary. However, if the sales can be reported on the installment plan for income tax purposes, it is usually to the taxpayer's advantage to do so. Income tax allocation in this instance would require a provision in the current income statement for the income tax which would have been payable if the gross profit on such sales had been included in the statement of income for financial reporting purposes.[2]

With respect to the cases in point, the American Institute of Certified Public Accountants has made special mention.

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[1]Prentice-Hall, op. cit., p. 2803.

[2]Ready, op. cit., p. 23.

> If, because of differences between accounting for tax and accounting for financial purposes, no income tax has been paid or provided as to certain significant amounts credited to surplus or to income, disclosure should be made. However, if a tax is likely to be paid thereon, provision should be made on the basis of an estimate on the amount of such tax. This rule applies, for instance, to profits on installment sales or long-term contracts which are deferred for tax purposes, and to cases where unrealized appreciation of securities is taken into the accounts by certain types of investment companies.[1]

TAXABLE INCOME PRIOR TO ACCOUNTING INCOME

The fourth case for which income tax allocation is considered acceptable relates to situations where income is on the tax return before being included on the financial statements.

According to generally accepted accounting principles, if accrual basis accounting is being employed, revenue is to be recognized on the financial statements as it is earned. In situations where income is collected in advance of the performance of a service or the delivery of goods, this income is considered unearned and is considered a liability since it may have to be returned to the customer if services are not performed or if goods are not delivered.

The tax authorities consider income collected in advance of the performance of services or delivery of goods as prepaid income and state that "prepaid income is to be reported in the year received. It cannot be prorated over the period that the services are to be performed."[2]

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[1] Accounting Research and Terminology Bulletins, op. cit., p. 92.

[2] Prentice-Hall, op. cit., p. 2715.

Again the views of the accounting profession and the Internal Revenue Service are in conflict and another tax allocation situation emerges requiring the deferral of income tax expense for financial statement purposes.

Table 6, on the following page, illustrates the effects of this situation on a business dealing in the rental of real estate. In the illustration, real property is rented on a yearly basis with the rental payments being collected in advance. During the first two years shown on the table, the actual tax expense would exceed the tax expense per books since the income reported for tax purposes exceeds accounting income. Hence, a deferral of the income tax expense for financial reporting is required. In the third year, no allocation would be necessary since accounting and tax income are equal. In year four, the actual tax expense is less than the tax expense appearing on the income statement since, during that period, the revenue actually earned exceeds the rental payments collected. Therefore, in the fourth year, a portion of the deferred income tax expense would be absorbed.

According to the income tax allocation principle, the entries required to allocate the tax effect over the four years illustrated would be as follows:

1.	Deferred Income Tax Expense	17,000	
	Income Tax Expense		17,000
	(actual tax exceeds book tax)		
2.	Deferred Income Tax Expense	8,000	
	Income Tax Expense		8,000
	(actual tax exceeds book tax)		

Table 6. Deferred income tax expense. Taxable income prior to accounting income.

Years	Rent payments collected (taxable income)	Rental income earned (accounting income)	Difference	Tax effect 50% rate (deferred income tax expense)
1	$100,000	Year 1 $ 66,000	$34,000	$17,000
2	120,000	Year 1 34,000 Year 2 70,000	16,000	8,000
3	150,000	Year 2 50,000 Year 3 100,000	0	0
4	160,000	Year 3 50,000 Year 4 120,000	(10,000)	(5,000)

3. No entry

4. Income Tax Expense 5,000
   Deferred Income Tax Expense 5,000
   (book tax exceeds actual tax)

Other examples of items which would be included in income for tax purposes before being included in income for accounting purposes are interest collected in advance and advertising income collected in advance. Both of these items would require the same handling as the rent collected in advance in the preceding illustration.

An exception to the tax rule pertaining to prepaid income exists with respect to subscriptions collected in advance. "Publishers on the accrual basis may elect to report prepaid subscriptions over the subscription period instead of reporting it all in the year received."[1] Therefore, if a publisher reports subscription income on the accrual basis for both accounting and tax purposes, income tax allocation is not necessary.

NONTAXABLE INCOME, NONDEDUCTIBLE EXPENSES AND SPECIAL DEDUCTIONS

Willard J. Graham, CPA, Ph. D., LL.D., Professor of Accounting and Director of the Executive Program at the University of North Carolina, is one of the often quoted proponents of income tax allocation. With regard to inter-period allocation Mr. Graham states:

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[1] *Ibid.*, p. 2720.

> Period income tax expense is measured by applying an appropriate 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.[1]

The above statement is similar to many of the proposals favoring allocation except that Mr. Graham places an emphasis on adjusting the difference between taxable and accounting income for any permanent differences. "'Permanent differences' include items of revenue or expense included in the accounts, but legally excluded permanently from consideration for tax purposes, and special deductions allowed for tax purposes but excluded from the accounts."[2]

A common example of revenue included in the accounts but excluded permanently for tax purposes is that of interest received on municipal or state bonds. According to the Internal Revenue Service, "Interest on obligations of a state, territory, or political subdivision may be excluded from gross income."[3] The accounting profession, on the other hand, includes interest income, no matter what the source, in the computation of net income. This situation, however, is unlike the four cases in which allocation is considered appropriate, since the time difference element is non-existent. Since this is the case, logically a tax expense

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[1]Willard J. Graham, "Allocation of Income Taxes," The Journal of Accountancy, January, 1959, 107:59.

[2]Loc. cit.

[3]Prentice-Hall, op. cit., p. 1203.

and deferred liability should not be recorded on the financial statements resulting from the inclusion of this income item. By following this procedure though, a question may arise. If a deferral is not made, and if the non-taxable income included in the statements without being taxed is material, would this not confuse the statement reader who expects the tax expense to be approximately fifty per cent of the net income before taxes?

Another example of this situation arises with respect to dividends received by a corporation from other domestic corporations. For accounting purposes, the dividends received would be recognized in computation of the final net income figure. For tax purposes though, a different set of circumstances exists.

> Corporations generally can deduct an amount equal to 85% of the dividends received from taxable domestic corporations. The percentage is less for dividends on preferred stock of public utilities. Small business investment companies can deduct 100% of dividends received. Members of the same affiliated group of corporations can elect to deduct 100% of dividends received from another group member.[1]

Proceeds of a life insurance policy taken out on the life of an officer present a third example of revenue included in the accounts but excluded permanently from the tax return.

A common example of an item of expense included in the accounts but legally excluded permanently from consideration for tax purposes is that of life insurance premiums paid on the life of a business officer. For accounting purposes these premiums are considered an expense of carrying on business and as such are deducted from revenue

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[1] *Ibid.*, p. 3111.

in determining net income. For tax purposes, "premiums paid by a corporation on the life of an officer, the corporation being named beneficiary, are not deductible."[1] Consequently, book expenses exceed tax expenses and taxable income exceeds book income. Here again is encountered a situation where the income difference is not dependent upon timing. Therefore, if the tax expense per books is reduced, and a deferred charge recorded, the deferred charge would not cancel out with the passage of time, but would continue to increase indefinitely. Hence, allocation does not seem logical and should not be applied. But, once again, what of the statement reader who expects to see the 50% tax rate.

For accounting purposes, contributions are considered expenses and are deducted from revenue no matter who the recipient. This is not the case for tax purposes. The tax people state that

> Contributions to the following have been held not deductible--American Institute of Certified Public Accountants; Anti-Cigarette League; Bar Association; Communist-action and Communist-front organizations; . . . Scientific Temperance Foundation; organizations substantially active in propaganda influencing legislation, or political campaigning . . . lobbying expenses . . . to promote or defeat legislation and the like.[2]

For accounting purposes, the amount of the contribution is of no particular importance, the full amount being deductible in the year in which such cost expires. Again, for tax purposes, this is not the case. The Internal Revenue Service does allow a corporation a deduction for contributions if the contributions are made to organizations listed by

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[1] *Ibid.*, p. 1820.

[2] *Ibid.*, pp. 1913-1914.

the Service. With respect to the time for deduction,

> The deduction ordinarily is allowed only for the tax year the contribution is actually paid, whether the taxpayer is on the cash or the accrual basis. However, an accrual basis corporation can elect to deduct contributions authorized by its board of directors during the tax year, if they are paid by the 15th day of the third month after the tax year ends.[1]

The time for deduction is not the only specification set up by the Internal Revenue Service, the amount deductible is also limited.

> The corporation's deduction cannot exceed 5% of its taxable income, figured without regard to the contributions deduction, special deductions, any net operating loss carryback to the tax year, and the special deduction for Western Hemisphere Trade Corporations . . . . Contributions over the 5% limit are not deductible as business expenses. They are carried over to the five succeeding tax years. However, the contributions actually made during the year plus the carryover must fall within the 5% limit.[2]

In situations where contributions are not deductible for tax purposes, as in the case of life insurance premiums, income tax allocation is not acceptable. With respect to difference on timing of deductibility, allocation would seem proper. This could be used where the excess contribution carryover is applied, but only up to the amount where the accounting expense is offset by the allowed tax expense. Allocation could not be properly applied to excessive contributions which are not absorbed by the carryover.

With respect to cases involving items of revenue or expense included in the accounts, but legally excluded permanently for tax purposes, it is generally agreed that the tax allocation principle does not apply.

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[1] *Ibid*., p. 3114.

[2] *Loc. cit*.

A possible argument for the use of allocation in these two cases which, to this writer, seems no more inappropriate than some other arguments favoring allocation, might be set forth as follows. A business could possibly have on its financial statements, items of income which are nontaxable and items of expense which are nondeductible. These two items could possibly offset each other over a long period of time and therefore, it would be proper to follow the allocation principle with respect to both items and offset the deferred expense related to the nondeductible items against the deferred credit related to the nontaxable items. A possible example of this situation might exist with respect to the nondeductible insurance premium on an officer's life, and the proceeds from the policy, which are nontaxable.

The third type of "permanent difference" is related to special deductions allowed for tax purposes but excluded from the accounts. An example of a special deduction of this type is depletion.

> Minerals, oil and gas, other natural deposits, and timber are known as wasting assets. Whenever any of them is removed from its natural position or native state, the original amount is reduced by just that much. This gradual reduction of the original quantity is known as "depletion."[1]

According to generally accepted accounting principles,

> Depletion is usually computed by dividing the cost or appraised value of the wasting asset by the estimated number of tons, barrels, thousand feet, or other units in the asset, thus determining a unit depletion charge. The total depletion charge for each period is then computed by multiplying the unit charge by the number of units converted during the period from a fixed nature into merchandise.[2]

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[1] *Ibid.*, p. 2105.

[2] Finney and Miller, *op. cit.*, p. 373.

For tax purposes, depletion may be computed using a method known as percentage depletion.

> Under this method, the deduction, subject to maximum and minimum limits, is a percentage of the gross income from the property during the tax year. It applies to oil and gas wells, coal mines, metal mines, and certain other deposits, but not to timber. For those properties to which the percentage method applies, the deduction should be figured under both the cost method (similar to above method) and the percentage method, and the larger deduction taken. Also, the basis of the property must be reduced by the larger allowance. . . . The allowance may not be less than it would be under the cost basis, but may not other wise exceed 50% of the taxable income of the taxpayer (figured without allowance for depletion) from the property. . . . For oil and gas wells, the allowance for depletion is 27 1/2% of the gross income from the property.[1]

Due to the special deduction allowed for tax purposes, the amount of depletion per tax return will usually exceed the depletion per books in any given year, and over the lifetime of the wasting asset, tax depletion may be considerably larger than book depletion since book depletion may not exceed the cost of the wasting asset whereas, tax depletion is not bound by this limit. Since this is the case, allocation would seem proper up to the point where book depletion and tax depletion offset each other, but beyond this point a permanent difference is encountered which cannot be cancelled with the passage of time, and therefore, the principle of income tax allocation would not apply.

SOME INTRICACIES OF INCOME TAX ALLOCATION

The applications of the principle of income tax allocation previously presented, are commonly encountered in discussions on tax

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[1]Prentice-Hall, _op_. _cit_., pp. 2103-2106.

allocation. There are, however, other items related to this topic which, even though not so popular, do form an intricate segment of the tax allocation concept. Two of these items are (1) the location of the income tax charge in the financial statements, and (2) the effect of tax rates on allocation.

As was stated in the Introduction, this paper has been written under the assumption that the income statement follows the all-inclusive or clean surplus concept. If this were not the case, and if instead, the current operating concept was followed, certain material, extraordinary or nonrecurring items of gain or loss would not appear on the income statement but instead would be credited directly to retained earnings. The line of thought underlying the current operating concept of net income "holds that the income statement should be concerned only with items of revenue and expense that are applicable to the regular operations of the current period."[1]

Although extraordinary gains or losses may not appear on the income statement, they do have an effect on the income as reported on the tax return and, therefore, on the related income tax expense which may appear on the income statement. Consequently, distortion of the final net income figure could result causing considerable confusion for statement readers. For example, if a corporation had ordinary income before taxes of $200,000 and extraordinary income before taxes of $200,000, and if the current operating concept was followed, the income statement could

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[1]Finney and Miller, op. cit., p. 76.

show income before taxes of $200,000, representing the ordinary income, and an income tax expense of $200,000, representing the tax expense on the entire $400,000 earned. To avoid this confusion, income tax allocation between financial statements is suggested. With respect to credits to surplus, the Committee on Accounting Research of the American Institute of Certified Public Accountants states as follows:

> Where an item resulting in a material increase in income taxes is credited to surplus, the portion of the provision for income taxes which is attributable to such item should, under the principle of allocation, be charged thereto. The committee suggests, however, that the provision for income taxes estimated as due be shown in the income statement in full and that the portion thereof charged to surplus be shown on the income statement either (a) as a separate deduction from the actual tax or (b) as a separate credit, clearly described.[1]

Regarding charges to surplus the committee recommends as follows:

> Where an item resulting in a material reduction in income taxes is charged to surplus, the principle of allocation may be applied in the income statement in either of two ways: (a) the provision for income taxes may be shown as if the item in question were not deductible (the total amount of tax estimated to be due for the year being indicated) or (b) a special charge representing the portion of such item equal to the tax reduction resulting therefrom may be separately shown. In either case the amount charged to surplus is reduced accordingly.[2]

With regard to the example above, and following the Institute's suggestion, the following allocation between the income statement and statement of retained earnings would result.

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[1] Accounting Research and Terminology Bulletins, op. cit., p. 89.

[2] Loc. cit.

Corporation
Income Statement
For the Year Ended ______

Ordinary Income Before Taxes		$200,000
Income Tax Expense	$200,000	
Less Tax Allocated to Extraordinary Gain Shown in Statement of Retained Earnings	100,000	100,000
Net Income		$100,000

Corporation
Statement of Retained Earnings
For the Year Ended _____

Retained Earnings--Beginning of Year		$000,000
Net Income		100,000
Add Extraordinary Gain	$200,000	
Less Income Tax Thereon	100,000	100,000
Retained Earnings--End of Year		$200,000

In the applications of income tax allocation in the previous illustrations and examples, the tax effect was based on an assumed income tax rate of 50 per cent. In reality, the normal tax rate, the tax on the first $25,000 of taxable income of a corporation, is 22 per cent, and the tax rate on corporate income in excess of $25,000, is 48 per cent, the additional 26 per cent representing the surtax rate.

Since the tax rate on the first $25,000 of corporate income differs greatly from the rate applied to income in excess of $25,000, a tax allocation problem is encountered in situations when the income of a corporation is at or near the $25,000 level. The problem is related to the rate which should be applied to deferred income. If the tax allocation deferral related to this income is based on the tax rate (22%) applicable to the current income, a difficulty would arise if, in the period that the deferred income is recognized, the tax rate is closer to the 48 per cent

rate. With respect to this problem, the American Institute of Certified Public Accountants states that

> . . . it will be appropriate to use . . . in the case of deferred income, an estimated future tax rate. The estimated rate should be based upon normal and surtax rates in effect during the period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.[1]

Another problem related to the principle of income tax allocation and tax rates deals with items subject to capital gains taxation. Capital gains are usually related to items of income which are extraordinary or nonrecurring such as gains realized on the sale of long term investments or depreciable assets. Here, the problem involves the selection of the tax rate to be applied to these gains, and thus the computation of the tax effect.

> If the net long-term capital gain exceeds the net short term capital loss, the tax is figured two ways. The method is used that produces the smaller tax.
>
> 1. In the regular method, the tax is figured on the taxable income, which includes capital gains.
>
> 2. In the alternative method, two steps are taken:
>   (a) A partial tax is figured on taxable income less the excess of net long-term capital gain over the net short term capital loss, if any.
>   (b) 25% of the excess of net long-term capital gain over net short-term capital loss is added to the partial tax.[2]

In other words, the tax rate applied to capital gains may be the tax applied to all taxable income of a corporation for a particular period, or it may be 25% of the capital gain, whichever is smaller. Therefore,

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[1] *Loc. cit.*

[2] Prentice-Hall, *op. cit.*, pp. 3201-3202.

in years when all of the taxable income of a corporation is subject to the normal tax alone, or if the income is small enough such that the normal tax and surtax together would result in an overall rate less than 25% of all taxable income, then the overall rate should be applied to the capital gains. If, however, the overall rate exceeds 25% of all taxable income, a 25% rate should be applied to the capital gains, separate from other taxable income.

Regarding this complexity of tax allocation, the American Institute of Certified Public Accountants states that "in certain cases the tax effect attributable to a particular transaction . . . may be computed directly as in the case of transactions subject to the capital gains tax. There may also be cases in which it will be appropriate to use a current over-all effective rate."[1]

Another problem pertaining to tax allocation and income tax rates is related to changes made in the tax rates by the Internal Revenue Service. This problem is being encountered presently in American business organizations. "Under the 1964 Revenue Act, the basic tax rate was reduced from 52 per cent (the rate applicable to 1963) to 50 per cent for 1964 and 48 per cent thereafter."[2] With respect to the accumulated tax deferrals resulting from income tax allocations, Paul Grady, Director of Accounting Research of the American Institute of Certified Public Accountants has made the following recommendations:

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[1] _Accounting Research and Terminology Bulletins_, _loc. cit._

[2] Paul Grady, "Tax Effect Accounting When Basic Federal Income Tax Rates Change," _Journal of Accountancy_, April, 1964, 117:25.

> The principal objective should be a fair presentation of net income: it follows that any distortions of that figure in comparison with earlier or later years, resulting from adjustments in tax effect accounting, should not be acceptable.
>
> As a general rule, the accumulated amounts carried as debits and credits in balance sheets should be regarded as deferred items. Under this interpretation, current year provisions should be made at the tax rate applicable for the year (52 per cent for 1963 and, prospectively, 50 per cent for 1964 and 48 per cent thereafter). The accumulation at any point in time of the amounts of current tax reduction provided for previously should be allocated to future periods at the same rate that the amounts were accumulated in the account, or at the average rate of accumulation . . .
>
> Where an adjustment for the tax rate change has been made and the accounts of more than one period are presented, the advisability of restatement of prior year financial statements should be considered.[1]

TAX ALLOCATION ACCOUNTS ON THE BALANCE SHEET

In the previous sections dealing with applications of the principle of income tax allocation, two accounts have been used for the purpose of deferring tax expense and for deferring tax liability. In situations where the net income before taxes per books exceeded the income for tax purposes, the tax expense per books exceeded the actual tax liability. The excess of the tax expense per books over the actual tax payable was recorded in an account called Deferred Income Tax Liability. On the other hand, in situations where the taxable income exceeded the net income before taxes per books and thus where the actual tax liability exceeded the income tax expense per income statement, the difference was recorded in an account called Deferred Income Tax Expense.

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[1] *Ibid.*, p. 27.

In the first situation mentioned above, there is no actual obligation to pay the deferred liability. In the second situation, the deferred tax expense is not actually a prepayment as far as the Internal Revenue Service is concerned. Since this is the case, some controversy has arisen as to the propriety of these accounts, and to their location in the financial statements.

What is the "so-called" Deferred Income Tax Liability?

> A credit for deferred income taxes must be either a liability or a net worth value. One of these classifications must be selected by those who would place a credit for deferred-income-taxes payable in the balance sheet.[1]

The Securities Exchange Commission, in Accounting Series Release No. 85, stated that "the deferred-income-tax-payable must not be classified as a proprietary item, otherwise investors will be misled."[2] The Accounting Principles Board of the American Institute of Certified Public Accountants recommends that "the accumulated amounts carried as debits or credits in balance sheets be regarded as deferred items."[3] Here, the Board is referring to deferred charges and deferred credits. Therefore, the authoritative bodies of the accounting profession do not believe that the Deferred Income Tax Liability account should appear as a liability or as a net worth item.

There is some logic behind these decisions made by the S.E.C. and the AICPA.

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[1]Arnold W. Johnson, "'More' On 'Income-Tax-Allocation' Accounting," The Accounting Review, January, 1961, 36:76.

[2]Loc. cit.

[3]Grady, loc. cit.

> One of the fundamental precepts of accounting is that anything of economic value is matched by financial claims against these values. More formally, an accountant would say that: "assets are matched by an equal amount of financial claims against them." These claims, held by legal persons, are of two kinds only: (1) liabilities and (2) the claims of the proprietary interest (or interests) of a business, i.e., "net worth" claims. A liability is a legal obligation to pay a fixed or determinable amount of money, or alternatively, to deliver a consideration of equal value.[1]

It is true that the corporation does not, at the balance sheet date, owe the government anything for the deferred liability shown on the balance sheet, but, as was shown in the illustrations in the previous sections of this paper, the deferred liability account can and often will be offset in later periods.

> The so-called "liability" held to result from a current "under payment" of the period income tax does not fit the common definition of a creditor claim. This is not a matter of degree of certainty surrounding the amount of the supposed debt. It is simply that no one owes anyone anything in the presently accepted sense of the word "liability." The amount shown under this caption represents, not what the firm is liable for, but what the firm expects to be liable for at some future time.[2]

Thomas F. Keller, CPA and associate professor of accounting at Duke University has presented an argument against the handling of the Deferred Income Tax Liability as a deferred credit. According to Mr. Keller, the term "deferred credit" has never been clearly defined. It is commonly used in relation to unearned revenues, advance payments made to a corporation for services to be rendered at a later date. By placing in the deferred credit classification, the credit arising from inter-period

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[1]Johnson, loc. cit.

[2]Thomas M. Hill, "Some Arguments Against the Inter-Period Allocation of Income Taxes," The Accounting Review, July, 1957, 32:358.

income tax allocation, further confusion emerges. This new credit does not represent an advance payment made to the corporation by an outsider, but instead represents an obligation to pay income taxes to the Government at a future date, based on currently reported income and presently effective tax laws. Therefore, the credit account arising from tax allocation should be classified as a liability.[1]

Another possible approach to this problem of location of the Deferred Income Tax Liability account, even though contrary to the position taken by the Securities and Exchange Commission, would be to classify it as a proprietary or net worth item. Items in the proprietary section of the balance sheet represent the claims of the owners of a corporation against the assets of the corporation. Expenses incurred by the corporation reduce the owners' equity. However, in the case of income tax allocation, when book income exceeds taxable income, the tax expense related to this excess does not "actually" reduce the owners' equity. If the corporation liquidated immediately after recording this expense, the claims of the owners of the business would not be affected by this expense, since no assets would be required for its payment. Therefore, it may be suggested that if the income tax allocation principle is being followed, when the income tax expense is increased to match the excess of book income over taxable income, a credit be made to an account entitled Reserve for Possible Future Taxes. This account would then be shown on the balance sheet as a proprietary item

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[1]Thomas F. Keller, "The Annual Income Tax Accrual," _The Journal of Accountancy_, October, 1962, 114:63.

much the same as a Reserve for Contingencies. This having been done, when the Income Tax Expense account is closed to Retained Earnings, the owners' equity will not be reduced by the possible tax expense which may never materialize. By following this procedure, the expense shown on the income statement would be related to the income reported thereon, and the balance sheet would not be distorted.

What is the "so-called" Deferred Income Tax Expense? As was mentioned earlier, the Accounting Principles Board of the American Institute of Certified Public Accountants has recommended that this item appear on the balance sheet as a deferred charge. Thomas F. Keller again opposes the decision of the Board.

> The recommendation that the asset be classified as a deferred charge is rather nebulous, in that the term "deferred charge" has never been clearly defined. Instead the asset might well be labeled "advance payment on Federal income taxes" and be included in the receivables category . . . . The value of the asset stems from the fact that it may be used to satisfy a future claim against the resources of the enterprise. It is not a portion of the tax charge which will contribute to the production of future revenues.[1]

Willard J. Graham looks at the Deferred Income Tax Expense not as a receivable but as a prepaid expense. " . . . it is definitely an advance payment, a payment of an expense related to net income that will be reported on the income statements of future periods. As such it would seem to qualify as a legitimate asset."[2]

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[1] Ibid., pp. 64-65.

[2] Graham, op. cit., p. 62.

There are some, however, who see the Deferred Income Tax Expense as neither a receivable nor a prepaid expense; furthermore, they do not even recognize it as an asset of any kind.

> Few accountants or businessmen would be willing to admit that the debit amount is an account receivable or, indeed, that it is even an asset . . . . Accountants and businessmen have generally long agreed that a prepaid expense means that an expense has been paid in advance of the consumption of value and that, as a cost of future income, the prepayment will be a financial benefit to one or more future accounting periods. "Prepaid income taxes" (arising from the procedures of income-tax-allocation accounting) are not costs to be consumed in the production of future income; and they do not represent a prepaid expense because there is no accounting "inventory" of either a commodity or of services still to be received . . . . These entries, furthermore, will have no effect upon the amount of future income taxes payable to the United States Treasury.[1]

In some accounting circles, the entire concept of income tax allocation has been deemed unacceptable due to the deferred expense and deferred liability accounts related to the topic.

OPINIONS ON INCOME TAX ALLOCATION

The applications and intricacies of income tax allocation have been presented in the preceding pages of this report. In this section, the opinions and arguments, for and against the principle of income tax allocation will be set forth. The following quotations are clearly not exhaustive, nor do all represent authoritative opinion. They do, however, present for analysis, varying lines of thought related to this controversial topic.

One of the most authoritative arguments against the allocation of income taxes has been introduced by the American Accounting Association.

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[1]Johnson, _op. cit._, p. 77.

This association is, for the most part, composed of accounting professors who view accounting academically. In the 1957 Revision of Accounting And Reporting Standards For Corporate Financial Statements, the Association made the following remarks:

> . . . tax objectives are inevitably somewhat different from those of accounting, and continuing differences between reported and taxable business earnings are to be expected.
>
> In any given period, some differences may be attributable to the inclusion or exclusion for tax computation of revenue or expired cost recognized under accounting principles as net income determinants in earlier or later periods. Since such differences are often significant, and since they may give rise to expectations of wholly or partially off-setting differences in later periods, they should be disclosed.
>
> Disclosure is sometimes accomplished by recording the differences as prepayments (given an expectation of future tax savings) or accruals (given the opposing prospect). However, these items do not present the usual characteristics of assets or liabilities; the possible future offsets are often subject to unusual uncertainties; and treatment on an accrual basis is in many cases unduly complicated. Consequently, disclosure by accrual may be more confusing than enlightening and is therefore undesirable.[1]

The main objection proposed by the American Accounting Association pertains to disclosure by accruals and deferrals of the tax effect resulting from the difference in book and taxable income, since they do not represent the usual characteristics of assets or liabilities. Eldon S. Hendrickson, an accounting professor at Washington State College, in an analysis of the Association's stand on income tax allocation, stated that, in his opinion, the presentation of the accruals and deferrals is secondary, the theoretical propriety of inter-period tax allocation being the important issue. He suggested the broadening of the definitions of

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[1]Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, American Accounting Association, pp. 6-7.

assets, to include prepayments of prospective liabilities, and of liabilities, to include the prospective obligation of future taxes.[1]

One of the most renowned names in the accounting profession is that of William A. Paton. Dr. Paton is opposed to the principle of income tax allocation. He believes that the corporate tax charge is definitely an expense, no part of which should be charged as an inventoriable item. He is also of the opinion that the charges to tax expense resulting from tax allocation are questionable since they are based on estimates of future tax requirements which can be determined by conjecture alone. He is also opposed to the balance sheet accruals and deferrals related to income tax allocation and feels that only the amount of tax as computed on the tax return for the year should appear on the income statement, accompanied by a footnote disclosing material differences between the revenues and expenses of the income statement and the taxable revenues and allowable deductions of the tax return.[2]

The footnote procedure, mentioned by Dr. Paton as a means of disclosing differences in book income and tax income, has drawn the full approval of Arnold W. Johnson. Mr. Johnson states that

> The income statement, prepared in this manner, will be fairly stated; it will be factual; it will accord with the precept of "full disclosure"; it will be understandable; and it should be useful to intelligent managements and statement-readers alike.[3]

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[1]Eldon S. Hendriksen, "The Treatment of Income Taxes by the 1957 AAA Statement," _The Accounting Review_, April, 1958, 33:221.

[2]William A. Paton and William A. Paton, Jr., _Corporation Accounts and Statements_, pp. 324-325.

[3]Johnson, _op. cit._, p. 83.

Another accounting professor, Thomas M. Hill, has suggested a procedure as an alternative to both the principle of income tax allocation and to the footnote procedure mentioned above.

> It is proposed that all causes for differences between the taxable and reported net income before tax of a period be shown in a separate supporting schedule, that these be classified as permanent or temporary, and that with respect to temporary (timing) differences the expected period or periods of offset be indicated.[1]

An argument in opposition to the principle of income tax allocation, proposed by David H. Li of Orange County State College, is quite novel in that it approaches the topic as related to the entity concept. Mr. Li argues as follows:

> Corporate income taxes are taxes imposed upon a corporation in return for the right to conduct its business as a separate entity. They are imposed without considering who the beneficiaries of a corporation are or upon whom the incidence of such taxes falls. Income taxes under the entity concept are a cost, a cost of being a separate entity.
>
> As a cost, matching income taxes as they are with revenue is consistent with the purpose of levying such taxes. It cannot result in mismatching. Furthermore, reporting income taxes as they are in the income statement shows the extent to which the management has exercised control in reducing income taxes as a cost. Inter-period income tax allocation, in other words, cannot improve the matching process, nor can it improve the usefulness of the income statement.[2]

One last argument, opposing income tax allocation, is based on the assumption that the principle of income tax allocation becomes generally accepted, thus requiring corporations to utilize the principle in order to gain a favorable opinion from independent auditors. This argument is presented by Ralph S. Johns as follows:

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[1]Hill, op. cit., p. 361.

[2]David H. Li, "Income Taxes And Income Tax Allocation Under The Entity Concept," The Accounting Review, April, 1961, 36:268.

> I can see no compelling reasons why any corporation should be obliged to provide for income taxes, by a charge against income, if it chooses not to do so, in excess of the amounts determined by application of the provisions of the Internal Revenue Code and related regulations to the transactions which took place during the year--in other words, as shown by its tax return--with suitable provision being made for any deficiencies applicable to prior years (not previously provided for) or any deficiencies which are likely to develop from a review of the current year's tax return. I can visualize a situation where in a court of law it would be difficult to prove that a provision for income taxes computed as above was inadequate.[1]

The most authoritative opinion favoring the principle of income tax allocation (the opinion which gave birth to the controversy) is that of the American Institute of Accountants, now the American Institute of Certified Public Accountants, which was proposed in December 1944, in Accounting Research Bulletin Number 23, stating that

> 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.[2]

This proposal of the Institute did not gain complete approval upon its issuance, nor has it gained complete approval today, twenty-one years later. One of the major obstacles to the acceptance was that set up by the Securities and Exchange Commission.

> The Securities and Exchange Commission issued a comprehensive Accounting Series Release 53 in 1945, on the subject of "Charges in Lieu of Taxes." The Commission took the general position that tax allocation accounting was not appropriate and concluded that: "The

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[1]Johns, _op. cit._, pp. 49-50.

[2]_Accounting Research and Terminology Bulletins_, _op. cit._, p. 88.

> amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws."[1]

Since 1945, the SEC has not formally rescinded or amended Accounting Series Release 53 but adherence to this release has not been universally required.

> . . . so far as deferred taxes are concerned, the SEC requires that the amount of the provision for deferred taxes be disclosed.
>
> The general policies followed by the SEC with respect to tax-allocation accounting appear to conform closely to the position of the AICPA . . . .[2]

The principal arguments favoring the allocation of income taxes are based on the age old accounting concept of matching expenses with their related revenues. Willard J. Graham bases his argument, favoring income tax allocation, on this concept.

> 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 the taxable income. 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 give proper recognition to the deferral of credits to income tax expense produces a net income amount that is likely to lead the reader to an overestimate of future earning power; conversely, the nonrecognition of deferred charges to income tax expense may lead to an underestimate of future earning power.[3]

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[1]Arthur Andersen & Co., <u>Accounting and Reporting Problems of the Accounting Profession</u>, p. 34.

[2]<u>Ibid</u>., p. 35.

[3]Graham, <u>op</u>. <u>cit</u>., p. 59.

Arthur Andersen & Company, one of the world's major public accounting firms, in full agreement with Mr. Graham, stated in a presentation of their policies that:

> We support income-tax allocation accounting because it is consistent with our concept of the most useful and meaningful income statement . . . and because it is necessary to meet the basic principle of a proper matching of costs and revenues.[1]

Some accountants, using the matching concept as a basis, state that:

> . . . the measurement of proper tax expense should be directly related to income before taxes as shown in the firm's financial statements, i.e., "let the tax follow the income." This allocation principle appears to be consistent with the accountant's primary standard for the income determination process--"the matching of cost and revenue." The revenue to which the tax should be allocated is the revenue that produces the tax.[2]

The use of the matching concept avoids distortion of the final net income figure. By matching properly, costs with their related revenues, the residual, income, should be properly stated. This is the end which the allocation proponents wish to attain. Whether or not income tax allocation is a means to this end is, to some, questionable, and Ralph S. Johns explains why.

> All items included in the income statement should be shown in accordance with generally accepted accounting principles and all have a bearing on the final net income for the period. Net income is the residuum. It is difficult to understand the thinking that one item--for example, income taxes--should be "distorted" in order to avoid "distortion" of the final net income for the period. Too much emphasis is placed upon this final

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[1]Arthur Andersen & Co., op. cit., p. 36.

[2]David F. Drake, "The Service Potential Concept and Inter-period Tax Allocation," The Accounting Review, October, 1962, 37:677.

> figure with the result that the "tail wags the dog" and we have "normalization" of reported net income because of the accounting profession's impression of what the public thinks the final net income figure means.[1]

Robert K. Jaedicke and Carl L. Nelson favor income tax allocation, however, their opinion is based on an idea quite different than that of the matching concept. They see income tax allocation as a means of generating funds.

> So long as income taxes are treated as expenses, the differential tax resulting from using different accounting methods for reporting and tax purposes should be "allocated" so as to show the new source of funds arising from this practice. This should be done regardless of whether or not the liability (deferred income tax liability) will ever have to be repaid. Such a procedure will be helpful in assessing the effects on working capital of good operations and wise income-tax management.[2]

CONCLUSION

> It is probable that all accountants would like to see the dawn of the day when these words of the code held as much truth as poetry: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computed his income in keeping his books."[3]

The attainment of this ideal situation, although not impossible, is highly improbable. The ideal might be achieved, however, if the Internal Revenue Service advanced a policy restatement to the effect that "the methods used by a business in computing taxable income must

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[1]Johns, op. cit., p. 44.

[2]Robert K. Jaedicke and Carl L. Nelson, "The Allocation of Income Taxes--A Defense," The Accounting Review, April, 1960, 35:281.

[3]Harwood, op. cit., p. 624.

also be used in determining net income per books." Undoubtedly, a regulation of this type would not be accepted without an intellectual skirmish between the members of the accounting profession and the makers of the tax laws; but it could happen, and with favorable results. A partial move in this direction was made by the Internal Revenue Service with respect to the LIFO-method of computing cost of ending inventory and cost of goods sold. "If 'lifo' is adopted for tax purposes, it must also be used for business purposes."[1]

Since the probability of a policy restatement is almost nil, the problem of income tax allocation must be faced. Should the principle of income tax allocation be accepted? It is the conclusion of this writer that it should, but not without deliberation.

The opponents of the tax allocation principle have presented noteworthy arguments. The fact remains, however, that financial statements should present fairly the financial position and results of operations of a business. This can only be accomplished by adequate disclosure of the tax effects on income, and by the proper matching of revenues with their related expenses. The tax allocation principle accomplishes these ends--at least indirectly.

The principle of tax allocation should be studied with regard to the arguments presented in opposition. One controversial area requiring additional study is the accrual and deferral of the deferred income tax expense and the deferred income tax liability. If these items remain an integral part of the tax allocation concept (and it appears that they

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[1]Prentice-Hall, _op_. _cit_., p. 2605.

will), then they must be clearly defined as to their nature and location on the balance sheet. If the definitions of assets, liabilities or other types of accounts must be broadened to encompass these items, then let it be done. Once terminology is clarified, footnotes that clearly explain these deferred accounts should be appended to the balance sheet.

After income tax allocation has been thoroughly investigated, a summary of the principles, definitions, and procedures related to the principle of tax allocation should be formulated and presented to the public. This having been done, the principle of income tax allocation should, and in all probability will, become generally accepted.

ACKNOWLEDGMENT

I wish to express my sincere gratitude to my major professor, Mr. William J. Clark, and to Mr. Merle E. Gugler who have assisted me with this report, and to Dean C. Clyde Jones and the other faculty members who have aided me throughout my graduate program.

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INCOME TAX ALLOCATION: APPLICATIONS, INTRICACIES, AND OPINIONS

by

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B. S., Kansas State University, 1963

AN ABSTRACT OF A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1965

In December 1944, the American Institute of Accountants, now the American Institute of Certified Public Accountants, issued Accounting Research Bulletin Number 23, "Accounting For Income Taxes." This bulletin propounded the principle that "the income statement should reflect under this head (taxes on income), as under any other head, the expense properly allocable to the income included in the income statement for the year." This principle of income tax allocation was proposed due to the differences in income as reported on the tax return and the net income before taxes as reported for accounting purposes resulting from the timing of the recognition of revenue items or of the deductibility of expense items.

The proponents of income tax allocation generally agree that this principle is applicable in four situations. The first situation deals with items of expense, cost or loss which are deductible for accounting purposes before being deductible for tax purposes. The second situation concerns items of expense, cost or loss which are deductible for tax purposes prior to being deductible for accounting purposes. The third case involves items of income includible on the income statement before being included in taxable income, and the fourth case relates to situations where income is reported on the tax return before being included on the financial statements.

Certain items of income appearing on financial statements are nontaxable and certain expenses are nondeductible. Circumstances also exist when items of expense are deductible for tax purposes but not for

accounting purposes. These items are referred to as permanent differences since they will not be offset with the passage of time. In these situations, the principle of income tax allocation does not apply.

Besides deciding when the principle of income tax allocation is applicable, the accounting profession is confronted with other intricacies linked to this concept, such as the location of the allocated tax expense in the financial statements, and the effect of tax rates on allocation.

One of the major difficulties encountered in dealing with income tax allocation is that of determining the nature and location of the tax allocation accounts on the balance sheet, viz., the Deferred Income Tax Expense account that results when the actual tax exceeds the book tax, or the Deferred Income Tax Liability account that results when book tax expense exceeds the actual tax.

The opinions on income tax allocation are varied and numerous. Major opposition to the principle relates to seemingly undefinable balance sheet allocation accounts. Opinions favoring allocation are based primarily on the matching concept, and the fair presentation of financial position and operating results. Because "favoring opinions" appear more acceptable than opposing opinions, the principle of income tax allocation should eventually gain general acceptance.