San Fernando Valley State College

INTERPERIOD CORPORATE INCOME
TAX ALLOCATION

A Thesis Submitted in
Partial Satisfaction of the Requirements
for the Degree of Master of Science
in Business Administration

by
James A. Jenkins
ABSTRACT

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by

James Arthur Jenkins

Master of Science in Business Administration

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The analysis of interperiod allocation of corporate income taxes has been made in seven distinct areas or chapters. After a brief introduction, the second chapter provides a history of the income tax provision and is included to lend the perspective and understanding necessary for the study. Chapter three examines the differences between tax and financial accounting. The results of this examination will be used to settle the controversy as to whether these differences are reconcilable; or whether the separate and distinct objectives require a difference in treatment. Chapter four discusses and evaluates the income tax allocation principles of the American Institute of Certified Public Accountants and those procedures required for proper application of the principles.
An analysis of the allocation method recommended by A.I.C.P.A. has been made and specific examples will be utilized to illustrate these allocation techniques. Chapter five examines the reporting practices of major corporations in an attempt to determine whether the methods of allocation used in practice are consistent with those methods recommended in theory. Chapter seven provides an insight into the unusual and difficult accounting and tax allocation problems of the regulated industries. And finally, a summary and conclusions of the earlier chapters is provided in Chapter eight.
The thesis of James Arthur Jenkins is approved:

Committee Chairman

San Fernando Valley State College

June, 1970
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CHAPTER I

INTRODUCTION

As corporations have grown in size and complexity of operation, the financial evaluation of corporate activities has also increased in complexity. One of the major factors contributing to this increased complexity is the corporate income tax. Accounting for corporate income tax has become very important since almost one-half of the earnings of the larger corporations must be paid to the federal government. Corporations may keep two sets of records, one for financial accounting and one for tax accounting. "The most important and difficult questions in accounting for income taxes today stem from differences in reporting for income tax purposes and for financial statement purposes."¹

Survey of the Literature

The first major publication in the area of tax allocation was issued by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants in 1944. Bulletin No. 23, "Accounting for Income Taxes,"

recommended that accountants allocate taxes to various accounts and accounting periods when differences in financial income and taxable income effected a tax which does not have "a normal standard of significance."

A "normal standard of significance" is defined as that tax payable which has the usual relationship to financial income reported on the financial statement based on the particular tax rate in effect for that period.

In the following year, the Securities and Exchange Commission issued Accounting Series Release No. 53. This publication denounced allocation and stated that income statements submitted for registration purposes must represent the actual tax liability for the period.

In maintaining its position, the Securities and Exchange Commission said:

...the proper function of an income statement presenting the results of operation is to present an accurate record. On this basis, it is evident that the items included therein should clearly and accurately reflect only actual operations. It is accordingly our view that the amounts shown should be in accordance with the historical facts and should not be altered to reflect amounts that the draftsman considers to be more "normal" or likely to recur in future years.  

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3 Ibid., p. 146.
The S.E.C. implies that the allocation procedure may distort operating results so that management cannot be accurately evaluated. The readers of adjusted financial statements may not realize that the statements have been adjusted and possibly might be misled. This subject will be examined in greater depth later in the thesis.

There are two opposing viewpoints with regard to income tax. One view holds that income tax is a distribution of income, the other considers income tax as an expense. Those supporting the distribution of income view contend that income taxes (as opposed to property and sales taxes) are based on a positive income figure. If there is no income, there are no required taxes. Those who maintain that income tax is a distribution of profits assume that the company and the government have a type of partnership. The company provides capital and managerial talent while the government contributes protection and various other public services necessary for continuance of our capitalist economy. Several inadequacies of this concept were stated by Peloubet.
This rather naive concept did no great harm as long as tax rates were low, but when rates began to rise steeply, it became increasingly apparent that the government was a most peculiar partner. It was a partner that had to be paid first, that increased its share in the profits without consulting the other partner, and that it did not share the losses nor restore depleted capital.

This government-partnership view must be rejected since there is too little resemblance to a partnership arrangement. Income distribution, by definition, can be made only to owners and since the law does not provide for the ownership of business by government, it cannot share in the profits of business.

The great majority of accountants now agree that the income tax should be treated as an expense. Under the going concern concept, profits are considered to be normal and taxes on these profits are considered an economic expense of doing business. The American Institute of Certified Public Accountants' Committee on Accounting Procedure has stated that "Income taxes are an expense that should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated."\(^4\)


In assuming that income tax is an expense, a determination must be made as to the amount of this expense based on financial or taxable income. If there is no difference in taxable income and financial income for a given period, the tax expense will be the same as the tax payable and no problem of allocation arises. In cases where taxable income differs from financial income, the tax payable (which is computed on taxable income) will differ from the tax expense (which is computed on financial income).

These differences in taxable and financial income may arise due to timing or they may be permanent. Permanent differences between taxable and financial income generally are the result of exempt revenues and non-deductible expenses. Should the difference arise due to a permanent cause, the tax expense calculated on the basis of taxable income will be shown on the income statement only. Permanent differences have no future effect and do not create any problem with respect to periodic income. Differences of this type have therefore been omitted from this study.

Timing differences on the other hand do affect income determination in the future. "These differences arise where accounting transactions affecting income are recognized sooner in financial accounting than in
tax accounting or vice versa, resulting in a materially different income figure and hence tax computation for the period."\(^6\)

Homer Black classifies these timing differences as follows:

1. Reported for income taxes after recognized for accounting income.
   A. Revenues or gains are taxed after accrued for accounting purposes. These differences usually result from voluntary elections of the taxpayer.
   
   B. Expenses or losses are deducted for tax purposes after accrued for accounting purposes. These differences usually result from requirements and interpretations of the tax laws.

2. Reported for income taxes before recognized for accounting income.
   A. Revenues or gains are taxed before accrued for accounting purposes. These differences result from requirements and interpretations of the tax laws.

   B. Expenses or losses are deducted for tax purposes before accrued for accounting purposes. Some of the differences result from voluntary elections of the taxpayer; others may result from requirements and interpretations of the tax laws.\(^7\)


\(^7\)Black, Homer A., \textit{op. cit.}, p. 3.
Timing differences will eventually reverse themselves. For example, research and development costs are deducted in tax returns as a period expense but are deferred and amortized in the books of account. This action results in lower taxes in the current period and higher taxes in subsequent periods; the difference netting out over the amortization period.

Plan for the Study

This thesis will provide a brief history of the tax provision in Chapter II as a background for the study and the four following chapters of the paper will provide a discussion concerning the nature of interperiod income tax allocation and its acceptance and application by the accounting profession. Differences between tax accounting and financial accounting will be thoroughly examined in Chapter III. The resulting discrepancies in the two methods gives rise to the controversy of how these differences should be treated. Chapter III will also consider the possibility of requiring uniformity in both tax and financial accounting. A determination will be made as to whether the objectives of tax and financial accounting are really the same.

Chapter IV will be concerned with the Principles and Procedures of Tax Allocation. The primary objective of this chapter will be to examine the allocation principles of the American Institute of Certified Public
Accountants and the procedures or techniques which are applied to these principles. The allocation techniques will be applied to several specific examples and a discussion will follow evaluating these techniques.

In Chapter V an examination will be made to determine how tax allocation is handled in accounting practice. An examination of financial report practices included in Accounting Trends and Techniques by the American Institute of Certified Public Accountants will be the primary source of material for this chapter. This study of the reporting practices of major corporations should provide data as to the methods of allocation used in practice and provide a basis for comparison to those methods favored in theory.

The problem of tax-allocation in the regulated industries will be considered in Chapter VI. Sources of information for this chapter will include trade publications and commission rulings. Although the problems of interperiod tax allocation are basically the same for the regulated and industrial entities, a separate chapter has been established to examine the special problems of the regulated companies.

A summary and conclusion will be provided in Chapter VII.
CHAPTER II

HISTORY OF THE INCOME TAX PROVISION

This chapter is included on the assumption that it lends the perspective and understanding necessary for the study. The modern income tax in the United States began in 1909. This tax was an excise tax of one per cent on net corporate income above $5,000.\(^1\) The tax was intended to be an income tax but was labeled "excise tax" to circumvent constitutional restrictions prevailing at that time.

Four years later a constitutional amendment was passed which repealed the corporation tax of 1909. The sixteenth amendment gave Congress the power to levy and collect taxes on incomes from whatever source derived without apportionment among the several states, and without regard to any census or enumeration.\(^2\)

In 1918 the tax rate was increased to 12 per cent to help finance the first world war. The rate never fell below the 1918 level again; and in 1942, as industry geared up for the second world war, corporation tax


\(^2\)Ibid.
rates reached 40%. Industry was subject to an excess profits tax during the second war which in some cases reached 85 per cent. At the close of the war, the excess profits tax was removed and the rate was lowered to 38 per cent. As the government required more money to finance the Korean War, the excess profits tax was again added and the tax rate was also raised to an all time high of 52 per cent; the present rate is 48 per cent.

The Tax Provision and Court Decisions

Income taxes payable are computed by application of statutory rates to a base called taxable income. Income is defined as the gain from the combination of capital and labor and must include profits gained through the sale or conversion of capital assets. A U.S. Supreme Court decision provided the following definition of income. 3

Brief as it is, [this definition of income used by the government] it indicates the characteristics and distinguishing attribute of income... The government placed chief emphasis upon the word "gain,"...while the significance of the next three words was either overlooked or misconceived. "Derived-from-Capital," "The-gain-derived-from-capital," etc. Here we have the essential matter: not a gain accruing to the

3252 U.S. 189, 40 S. Ct. 189, (1920).
capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient...for his separate use, benefit and disposal;--that is income derived from property.

The term taxable income has resulted from various statutes and interpretations. It is financial net income modified to meet statutory requirements. It is determined by Congress through legislative enactments and modified by the courts in their attempt to interpret the intent of Congress.

In income determination cases, which have come before the courts, there has been no distinction made between types of taxes. It was decided in a case involving a munitions tax, U.S. v. Anderson,4 that this type of tax should be handled the same as other accrued expenses.

In U.S. v. Woodward,5 (1921) the court found that Federal income taxes and excess-profits taxes cannot be deducted as expenses in the determination of the taxes themselves. This case reinforced the observation that the determination of taxable net income does not provide for the variation that is allowed in computing accounting net income.

4240 U.S. 1, (1916).
5256 U.S. 632, (1921).
Fleischer v. Pelton Steel Co.⁶ was one of the first cases which involved the determination of income. Fleischer, an employee of Pelton Steel Co., had a bonus agreement which provided for a certain percentage of the company's earnings. The company said the bonus was to be computed on income after Federal income taxes had been deducted, while Fleischer felt his bonus should be computed before income taxes. The court held for Pelton Steel Co. and stated:

We perceive no basis upon which it may properly be said that real-estate taxes may be deducted and income and excess profits taxes may not be deducted. The nature of the liability is the same in each case... while a tax is not in the ordinary sense a debt... because it lacks the element of contractual obligation, it is nevertheless a liability properly chargeable as an operating expense.⁷

The Fleischer case cited a British case, Patent Castings Syndicate, Ltd. v. Etherington,⁸ as a precedent. This case determined that excess profits taxes should not be levied against the stockholders but against the company; and due to such findings, the excess profits taxes are deductible in the determination of net earnings.

⁶183 Wis. 451, (1924).
⁷Ibid.
⁸1 Ch. 306 (1919).
Another case which substantiates the opinion stated in the Fleischer case is that of Neeson v. Sangamon County Mining Company. The court ruled:

The words "net profits" define themselves; they mean what shall remain, as clear gains of any business venture, after deducting the capital invested in the business, the expenditures incurred in its conduct, and the losses sustained in its prosecution... we think it is...clear that the plaintiffs in error (the company) are entitled to a credit of the amount of income tax they paid, which is necessarily an expense they must incur in the prosecution of their business. The tax should be deducted for the same reason any other necessary expense of the business is deducted--because it is an expense necessarily incurred which cuts down the profits or net gains of the business.

As late as 1947 in the case of International Hotel Co. v. Libby, the court determined that all types of taxes are "ordinary and necessary" expenses of doing business. The income tax is as much an ordinary and necessary expense as the property tax. If the tax is to be expected in the normal operation of the business, it must be considered an ordinary expense of the business.

Galveston Electric Co. v. Galveston is a key case regarding the deductibility of taxes in the determination

9 316 Ill. 396, (1925).
10 Ibid.
of net earnings for utility rate making purposes. The Supreme Court found: "All taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between state and Federal taxes or between income taxes and others."\textsuperscript{13} It should be noted that this decision included only the normal income tax then in effect and was not concerned with excess profits taxes. A later case, Detroit v. Michigan Public Service Commission,\textsuperscript{14} considered excess profits taxes the same as income taxes. The court stated:

The excess profits tax is somewhat similar to the income tax in that it is a tax the amount of which depends upon a certain net amount arrived at in part by deducting certain operating costs from gross revenues... It is a tax that the utility is required to pay and necessarily a part of the cost of operation of that utility. In our opinion the commission has no discretion in excluding these taxes in determining the operating expense of the utility.\textsuperscript{15}

The courts have regarded both the income tax and the excess profits tax as a normal expense for ordinary income determination and for the calculation of rates in the case of public utilities.

\textsuperscript{13}\textit{Ibid.}.

\textsuperscript{14}308 Mich. 706, 14 N.W. (2nd) 784, (1944).

\textsuperscript{15}\textit{Ibid.}. 

The Accounting Profession and Tax Allocation

The accounting profession, as stated in the introduction, took little action to correct the confusion regarding income tax allocation until 1944 when bulletin #23, "Accounting for Income Taxes," was published by the American Institute of Certified Public Accountants. Bulletin #23 advocated allocation of taxes when the differences between financial and taxable income resulted in a tax which did not meet "a normal standard of significance." The recognition of timing differences in Bulletin #23 was concerned mainly with costs of refunding bonds and depreciation of emergency facilities.

In 1954, the Internal Revenue Code was amended to allow accelerated depreciation methods in the computation of taxable net income. This action resulted in very significant timing differences which recur regularly over long periods of time. The American Institute of Certified Public Accountants issued Accounting Research Bulletin #44 to deal with this change in depreciation. An interpretation of this bulletin was made by the AICPA Director of Research.

In other words, though stated somewhat negatively, the effect of what it said is that, if the amounts are clearly material, and if it is reasonably certain that the reduction in taxes during the earlier years will be quickly followed by a period during which
the taxes will exceed what they would have been if the book depreciation had been taken for tax purposes, accounting recognition should be given to deferred income taxes.\textsuperscript{16}

This position was stated more explicitly in the Accounting Research Bulletin \#44 (Revised) which was published in 1958. Paragraph 7 reads:

Studies of published reports and other source material have indicated that, where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes...

Accountants may continue to argue whether the Bulletin was intended to apply only to depreciation or to other recurring differences as well, but in fact interperiod tax allocation is now applied for many varied recurring timing differences of both short and long duration.\textsuperscript{17}

The latest publication with regard to the allocation of federal income taxes is Accounting Principles Board Opinion No. 11, Accounting for Income Taxes. This opinion, issued in December 1967, provides a summary of problems regarding the allocation of income taxes


\textsuperscript{17}Black, Homer A., \textit{op. cit.}, p. 65.
and recommended solutions to these problems. The Board's conclusions with regard to important questions in accounting for income taxes are summarized as follows:

1. Interperiod tax allocation is an integral part of the determination of income tax expense, and income tax expense should include the tax effects of revenue and expense transactions included in the determination of pre-tax accounting income.

2. Interperiod tax allocation procedures should follow the deferred method, both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods.

3. Financial statement presentations of income tax expense and related deferred taxes should disclose (1) the composition of income tax expense as between amounts currently payable and amounts representing tax effects allocable to the periods, and (2) the classification of deferred taxes into a net current amount and a net non-current amount.¹⁸

Accounting Principles Board Opinion #11 should eliminate much of the confusion that existed before its publication with regard to interperiod income tax allocation. The guidelines for balance sheet and income statement presentation of the tax effects of timing differences should provide considerable improvement in both quality and consistency of reporting. The effects of APB Opinion #11 will be examined in Chapter V and a

comparison will be made with earlier years to determine what changes have been made in corporate financial statements.
CHAPTER III

TAX ACCOUNTING vs. FINANCIAL ACCOUNTING

The purpose of this chapter will be to examine the differences between tax and financial accounting. The results of this examination will be used to settle the controversy as to whether these differences are reconcilable; or whether the separate and distinct objectives require a difference in treatment.

The 1909 income tax law was developed for a cash basis of accounting. Practicing accountants felt that cash accounting concepts were not suited to modern business. They pressed for a revised law which was passed in 1918. This law provided for the utilization of accrual accounting methods which accountants interpreted as in keeping with the "generally accepted accounting principles" in existence at that time. Section 212 (b) of the Act of 1918 said that the net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall
be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

The above provision does not spell out accrual accounting in the text, but indirectly provides for it. The Treasury Department, therefore, was given a wide latitude in determining what is acceptable in computing taxable income. This latitude has impinged many times on the generally accepted methods used by practicing accountants. The differences in opinion between the Treasury Department and the accountant has been explained by Smith and Butters.

The traditional conservatism in business accounting requires the postponement of doubtful income items and the inclusion of doubtful expense items to avoid any charge of overstating the immediate income. For tax purposes conservatism quite logically calls for an exactly opposite treatment. To maximize the immediate revenue, and to minimize any risk of subsequent unavailability of a taxpayer or his assets, tax law and administrative policy may require the inclusion of income items at an earlier date than accounting practice would generally sanction. Expenses on the contrary are typically not recognized until the amounts involved can be determined accurately.

Much of the controversy and litigation over taxable income revolves around "which year?" or more simply, "when?" Professional accountants increasingly deplore the accounting fiction that annual periods are separate and distinct entities. But since income taxes are levied annually, income too must be calculated for a one year period. The skepticism appropriate for business does not exist for tax purposes, and an inclina-
tion so to decide debatable matters as to maximize income and the immediate tax revenue is altogether understandable.¹

Financial income determination for a period results from matching revenues for the period against the costs associated with earning those revenues. In most instances this matching process is easily accomplished. Unusual transactions which require judgement as to when costs or revenues should be recognized do present a problem for the accountant. In some cases only one or two alternatives exist while in other cases a number of choices may be possible.

To provide such alternatives for tax accounting would be extremely complicated and expensive. The Internal Revenue Service would require much more time to audit tax returns since each return could have various combinations of alternatives.

Tax and Financial Accounting Uniformity

From the above discussion it is reasonable to assume that the wide degree of latitude provided in financial accounting is incompatible for use in tax accounting. An obvious solution to this problem is to require the same treatment for both financial and tax accounting.

It is unrealistic to do this [provide for uniformity] because, on the one hand, it would preclude a theoretically acceptable accounting treatment in the fact of a required tax treatment, and on the other hand, it would sacrifice a tax benefit where tax options exist but not where accounting options exist. Hence, uniformity between tax and financial accounting is not an operational objective.

As was stated in the introductory chapter, the differences between taxable and financial income may be one of two types. The difference might be permanent—these are differences caused by congressional enactments or other legal causes. Or the difference may be due to timing which would result in income recognition for tax accounting purposes in periods different than those for financial accounting purposes. These timing differences are those with which we are concerned. In the exhibit included below, from the article "Tax Allocation from Timing Differences: A Theoretical Viewpoint," by John W. Buckley, the author states:

Some timing differences result from required accounting treatment as determined by the Accounting Principles Board's Opinion, generally accepted accounting treatment, or the Internal Revenue Code, as the case may be. Other timing differences result from optional treatment, where management wishes to achieve dual objectives, such as minimizing taxable income in reporting to the Internal Revenue Services, and maximizing financial income in reporting to stockholders. Any

2Buckley, John W., op. cit., p. 9.
optional treatment that is selected must, of course, conform with generally accepted accounting principles and tax law.

\[3\text{Ibid. p. 1.}\]
### Timing Differences

#### Nature of Choice

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Financial Accounting</th>
<th>Tax Accounting</th>
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<tbody>
<tr>
<td>(I) Items which are included in financial income before they are included in taxable income (i.e., financial income) will be higher in part (A) and lower in part (B).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(A) Revenues or gains are taxed after accrued for accounting purposes</td>
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- **Profits on installment sales** are recorded in accounts at date of sale and reported in tax returns when later collected. Required Optional
- **Revenues on long-term contracts** are recorded in accounts on percentage-of-completion basis and reported in tax returns on a completed-contract basis. Required Optional
- **Revenue from leasing activities** is recorded in a lessor's accounts based on the financial method of accounting and exceeds rent less depreciation reported in tax returns in the early years of a lease. Determined by nature Required of business
- **Earnings of foreign subsidiary companies** are recognized in accounts currently and included in tax returns when later remitted. Required Required

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### Timing Differences (Continued)

<table>
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<th>Treatment</th>
<th>Nature of Choice</th>
<th>Financial Accounting</th>
<th>Tax Accounting</th>
</tr>
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<tbody>
<tr>
<td>(B) Expenses or losses are deducted for tax purposes after accrued for accounting purposes:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated costs of guarantees and product warranty contracts are recorded in accounts of date of sale and deducted in tax returns when later paid.</td>
<td></td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Expenses for deferred compensation, profit-sharing, bonuses, and vacation and severance pay are recorded in accounts when accrued for the applicable period and deducted in tax returns when later paid.</td>
<td></td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Expenses for pension costs are recorded in accounts when accrued for the applicable period and deducted in tax returns for later periods when contributed to the pension fund.</td>
<td></td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Current expenses for self-insurance are recorded in accounts based on consistent computations for the plan and deducted in tax returns when losses are later incurred.</td>
<td></td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Treatment</td>
<td>Nature of Choice</td>
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<td>--------------------------------------------------------------------------</td>
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<td></td>
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</tr>
<tr>
<td>Estimated losses on inventories and purchase commitments are recorded in accounts when reasonably anticipated and deducted in tax returns when later realized.</td>
<td>Required</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated losses on disposal of facilities and discontinuing or relocating operations are recorded in accounts when anticipated and determinable and deducted in tax returns when losses or costs are later incurred.</td>
<td>Required</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated expenses of settling pending lawsuits and claims are recorded in accounts when reasonably ascertainable and deducted in tax returns when later paid.</td>
<td>Required</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provisions for major repairs and maintenance are accrued in accounts on a systematic basis and deducted in tax returns when later paid.</td>
<td>Optional</td>
<td></td>
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### Timing Differences (Continued)

<table>
<thead>
<tr>
<th>Nature of Choice</th>
<th>Treatment</th>
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<tbody>
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<td><strong>Depreciation recorded in accounts exceeds that deducted in tax returns in early years because of:</strong></td>
<td></td>
</tr>
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<td></td>
<td><strong>Financial Accounting</strong></td>
</tr>
<tr>
<td>accelerated method of computation for accounting purposes.</td>
<td>Optional</td>
</tr>
<tr>
<td>shorter lives for accounting purposes.</td>
<td>Optional</td>
</tr>
<tr>
<td>Organization costs are written off in accounts as incurred and amortized in tax returns.</td>
<td>Optional</td>
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</table>

(II) Items which are included in tax income before they are included in financial income i.e. financial income will be lower in part (C) and higher in part (D).

(C) Revenues or gains are taxed before accrued for accounting purposes:

<table>
<thead>
<tr>
<th></th>
<th><strong>Required</strong></th>
<th><strong>Required</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent and royalties are taxed when collected and deferred in accounts to later periods when earned.</td>
<td>Required</td>
<td>Required</td>
</tr>
<tr>
<td>Fees, dues and service contracts are taxed when collected and deferred in accounts to later periods when earned.</td>
<td>Required</td>
<td>Required</td>
</tr>
</tbody>
</table>
### Timing Differences (Continued)

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Nature of Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profits on inter-company transactions</strong> are taxed when reported in separate returns, and those on assets remaining within the group are eliminated in consolidated financial statements.**</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Gains on sales of property leased back are taxed at date of sale and deferred in accounts and amortized during the term of lease.</strong></td>
<td>Optional</td>
</tr>
<tr>
<td><strong>Proceeds of sales of oil payments or ore payments are taxed at date of sale and deferred in accounts and recorded as revenue when produced.</strong></td>
<td>Required</td>
</tr>
<tr>
<td><strong>(D) Expenses or losses are deducted for tax purposes before accrued for accounting purposes:</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Depreciation deducted in tax returns exceeds that recorded in accounts in early years because of: accelerated method of computation for tax purposes.</strong></td>
<td>Optional</td>
</tr>
</tbody>
</table>
### Timing Differences (Continued)

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Nature of Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>shorter guidelines lives for tax purposes.</td>
<td>Optional Optional</td>
</tr>
<tr>
<td>amortization of emergency facilities under certificates of necessity.</td>
<td>Required Optional</td>
</tr>
<tr>
<td>Unamortized discount issue cost and redemption premium on bonds refunded and deducted in tax returns and deferred and amortized in accounts.</td>
<td>Required Required</td>
</tr>
<tr>
<td>Research and development costs are deducted in tax returns when incurred and included in the cost of assets in accounts.</td>
<td>Optional Required</td>
</tr>
<tr>
<td>Interest and taxes during construction are deducted in tax returns when incurred and included in the cost of assets in accounts.</td>
<td>Required Required</td>
</tr>
<tr>
<td>Preoperating expenses are deducted in tax returns when incurred and deferred and amortized in accounts.</td>
<td>Required Required</td>
</tr>
</tbody>
</table>
As shown in the preceding exhibit, the treatment of items in computing financial and taxable income may be either required or optional. In the cases where timing differences occur due to required treatment, no choice is allowed. In optional cases, however, where a choice is possible, management must sometimes decide between the theoretically correct method or the method which is most advantageous to them.

The assumption of the Accounting Principles Board is that methods used for financial reporting are those which management believes to be theoretically correct, and that other methods are substituted for tax advantages. While this may not necessarily be true in every instance, it is probably true for the most part and we accept it as an operating premise.  

**Objectives of Tax and Financial Accounting**

An operating objective may be to keep financial and tax accounting separated so that financial income can be maximized and taxable income can be minimized.

The objective of financial accounting and the resulting statements is to inform the reader as to the financial condition of a firm and the results of its operations so that he can make sound decisions relative to the company.

---

5Ibid., p. 10.
Those external users who have or contemplate having a direct relationship with an enterprise must decide, on the basis of all available information, whether to affiliate with or to modify an existing relationship with the firm. Investors and prospective investors must decide whether to buy or sell, or to retain their holdings. Suppliers must decide about lines of credit to be made available to the firm. Credit grantors must decide whether to make loans to the firm, what security or terms to require or in the case of an existing commitment, whether to increase or decrease the loans or to require payment in full at maturity...

The objectives of taxation policy are quite different from the objectives of financial accounting. While financial accounting is concerned with the statements of an individual firm, tax accounting is concerned with the national income or people in general.

The objectives of taxation policy are socially oriented. These objectives include:
1. Promoting short-run stabilization in the economy.
2. Encouraging economic growth.
3. Helping serve national priorities.
4. Promoting social justice.
5. Preserving the competitive position of small firms.
6. Encouraging the growth of some industries while discouraging others.

Tax and Financial Accounting Depreciation

The diversity of purpose with regard to tax and

---


financial accounting is illustrated by an examination of depreciation. The American Institute of Certified Public Accountants describes depreciation as "...distributing the cost or other basic value of tangible capital assets, less salvage, over the estimated useful life of the unit...in a systematic and rational manner." The method of depreciation used, whether straight-line, sum-of-the-years-digits, declining balance, or any other method, will depend upon the type of asset and its individual service characteristics. The method selected is intended to provide a matching of expense with revenue which will provide the reader of related financial statements with an objective picture of the financial position of the firm.

The objectives behind taxation policy for depreciation are much different. "The primary purpose of allowing accelerated depreciation deductions for tax purposes is to stimulate investment in new capital equipment." Accelerated depreciation will result in a greater flow of internal funds generated than will the straight line method of depreciation. The increase in cash flow in the early years due to using accelerated methods

9Arnett, op. cit., p. 488.
will be offset in later years by a corresponding reduction. In cases, however, where depreciable assets are increasing, accelerated depreciation will provide a larger cash flow than straight line depreciation until the account balance is stabilized. At the point of stabilization, the cash flow will be the same for both methods.

For the business taxpayer relying on a short payoff period approach to allow for the riskiness of investment in depreciable assets, the greater cash flow resulting from the use of accelerated depreciation methods means a greater proportion of the asset's cost will be recovered within the payoff period. For a taxpayer who assigns successively higher rates of discount to receipts of successively later years, the use of accelerated depreciation, which in effect transfers cash flow from later years when the applicable discount is relatively slight, serves to reduce the average effective discount for risk.

In all of the respects indicated above, the acceleration of depreciation allowances should increase a firm's demand for depreciable facilities and expand its financial capabilities for acquiring them.\(^{10}\)

This increased incentive for purchasing depreciable assets is intended to draw a larger share of the economy's resources to fixed capital formation. This, in turn, will enable a more efficient production of goods, while providing the employment to actually produce the fixed assets.

assets. Thus, accelerated depreciation has provided for at least two of the six objectives listed in the previous section of this chapter; it promotes short-run stabilization in the economy, and encourages economic growth.

Financial accounting provides for the collection, recording, testing, and summarization of financial data related to a specific business enterprise. The entity is the focal point of attention, not society in general, or industries in particular, as is usually true in establishing taxation policy. In sum, accounting is micro-economic oriented; taxation is macro-economic oriented.¹¹

With the two completely different intended purposes of tax and financial accounting, it is obvious that no single procedure can simultaneously and effectively accomplish both objectives. It must be concluded therefore, that one method is required to accomplish the accounting objectives, while a different method must be utilized to best serve the objectives of taxation policy. And, although debate continues between accountancy and the Internal Revenue Service, "...both sides must recognize their differing objectives and allow the determination of taxable income and financial income to go their separate ways."¹²

¹¹Arnett, op. cit., p. 437.
¹²Ibid., p. 488.
CHAPTER IV

TAX ALLOCATION PRINCIPLES AND PROCEDURES

This chapter will discuss and evaluate the income tax allocation principles of the American Institute of Certified Public Accountants and those procedures required for proper application of the principles. A determination of the allocation method recommended by AICPA will be made and specific examples will be utilized to illustrate these allocation techniques.

The basic principles of tax allocation are indicated in Chapter 10 of the American Institute of Certified Public Accountants Research Bulletin No. 43.

Financial statements are based on allocations of receipts, payments, accruals, and various other items. Many of the allocations are necessarily based on assumptions, but no one suggests that allocations based on imperfect criteria should be abandoned in respect of expenses other than taxes, or even that the method of allocation should always be indicated. 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.1

As tax allocation was developed, both in theory and practice, three alternative methods of allocation were adopted by accountants. These three methods are all based on separate and distinct concepts of the nature of the differences in timing between financial statements and income tax returns. The net-of-tax and liability concepts were the first to be developed, and, as allocation procedures were proposed and discussed, the deferred concept developed.

**Tax Allocation Concepts**

**The Net-of-Tax Concept**

The net-of-tax concept is based on the proposition that individual assets and liabilities are adjusted to reflect the loss or increase in taxability or tax deductibility. For example, depreciation reduces the value of an asset and therefore reduces future tax deductibility. Accelerated depreciation for tax purposes increases the speed of this reduction and the financial statements would include additional depreciation equal to the net tax effect of the difference between tax depreciation and book depreciation.
If the timing of a revenue or expense accrual differs for tax purposes as compared with accounting purposes, the tax effect is an adjustment of the specific revenue or expense and of the related asset or liability. Direct adjustment of revenue, expense, asset, or liability, items is the customary practice, thereby showing net of tax amounts.

The main thrust of the elaborate explanation developed to justify the net of tax concept is that it is really valuation and not income tax allocation: The underlying assumption is that taxability and tax deductibility are factors in the valuation of assets and liabilities and the amount is measured by the tax effect. If the tax status of a given asset or liability changes, its value is affected, with a concurrent effect on net income. The assumption leads logically to the conclusion that accounting for the tax effect of a timing difference is not accounting for income taxes at all but depreciation accounting, installment sales accounting, or accounting for some other specific item.

It appears that the net-of-tax technique does not provide as much data as the liability or deferred method. In the presentation of accounting statements, the netting of the deferred charge against the asset or liability conceals the actual or gross value.

The Liability Concept

The liability concept is based on the premise that taxes allocated to later periods are either postponed or prepaid.

\[\text{Black, \textit{op. cit.}, p. 14.}\]
...a liability for postponed taxes arises whenever (a) revenue is recognized in the financial statements before taxed or (b) an expense is deducted for tax purposes before recognized in the financial statements; an asset of prepaid taxes arises whenever (a) revenue is taxed before recognized in financial statements or (b) an expense is recognized in the financial statements before deducted for tax purposes. The difference between the current tax expense and the tax currently payable is either a liability for taxes payable in the future or an asset for prepaid taxes.3

The liability concept is consistent with the theory of interperiod allocation and results in the desired matching of costs and revenues. Its greatest single pitfall is the required estimate of liability.

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 the 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 a future time.4

The Deferred Concept

The deferred concept and the liability concept are very much alike in nature. Both concepts utilize

3Black, op. cit., p. 13.

the same principles of allocation. It appears that the major difference is one of semantics. While theorists argued that tax allocation does not result in a true liability, pragmatists gave this allocation the term deferred charge. This term apparently satisfied the theorist and the deferred method was developed.

The deferred concept of tax allocation establishes that each taxable revenue and each deductible expense have a particular effect on income tax expense. If revenues are taxed before they are accrued for accounting purposes, or if expenses are deducted earlier for accounting than for tax purposes, the related tax effect is recorded as a deferred charge to income tax expense of the future years in which the timing differences reverses itself. And, in reverse, if expenses are deducted for tax purposes, or if revenues are accrued for accounting purposes before they are taxed, the tax effect is shown as a deferred credit to income tax expense in future years when the timing differences offset.

It is generally recognized that the income statement is the most important financial accounting report. Through the use of deferrals, the deferred method of tax allocation achieves the desired matching of income tax expense with the revenues and expenses of current income. These tax-causing and tax-reducing elements of net income provide the basis for the tax calculation.
Although it has been argued that both the liability and the deferred method result in a misstatement of the nature of balance sheet items, an important purpose of the balance sheet today is to produce a better income statement.

Another defect of income tax allocation, in the eyes of its opponents, lies in the fact that the resulting balance sheet entries do not qualify as true assets or true liabilities. But balance sheet items may properly represent amounts which have been temporarily diverted from the stream of a company's transactions and are being held for use in determining net income in a subsequent year. This is true of amounts carried forward for inventories, for fixed assets, for deferred research and development expenditures, for items of unearned income. It is also true for the balance sheet amounts, be they charges or credits, resulting from income tax allocation.

Nor as I see it, is tax allocation a process of recognizing currently a tax liability expected to be incurred, or a tax reduction expected to be achieved, in the future; instead, it is in most instances a process of deferring, to a future year or years, a current tax reduction or tax payment.5

The Accounting Principles Board in Opinion No. 11 stated:

...the deferred method of tax allocation should be followed since it provides the most useful and practical approach to

interperiod tax allocation and the presentation of income taxes in financial statements. 6

Application of the deferred method. Four examples of the deferred method for handling the interperiod allocation of income taxes will be provided in the following section. These examples have been taken from P. H. Walgenback, Periodicity and the Provision for Federal Income Tax, 7 and have been modified to reflect the latest recommended AICPA terminology and methodology as set down in Accounting Principles Board Opinion No. 11.

Cases one and two are those in which the tax recognized in financial accounting is less than that declared in tax returns. Cases three and four are those in which the tax payable is smaller than the amount applicable to the income shown in the accounts.

The first example deals with revenue or income deferred for accounting purposes, but recognized currently for tax purposes. Some items that might create the occurrence of this case are rentals, commissions, and royalties. Advance rental payments will be used to illustrate this case. Let us assume that a firm received

6 A.I.C.P.A., Accounting Principles Board, Opinion No. 11, op. cit., paragraph 35.

an advance rental payment on a building for the next five years. Let us also assume that the annual rental is $5,000 and the corporate tax rate is 50%. The entries to record the transaction and the subsequent tax effects follow:

**Current year**

DR. Cash \[\text{DR. Rent Collected in Advance}\] $25,000 $25,000

To record receipt of advance payment

DR. Rent Collected in Advance $5,000

CR. Rental Revenue $5,000

To make end of the year adjustment

DR. Deferred Charge-Federal Income Taxes $10,000

DR. Federal Income Tax Expense 2,500

CR. Federal Income Taxes Payable $12,500

To record tax expense of the first year and allocate federal income taxes to future years.

**Second through Fifth year**

DR. Rent Collected in Advance $5,000

CR. Rental Revenue $5,000

To make end of year adjustment

DR. Federal Income Tax Expense $2,500

CR. Deferred Charge-Federal Income Taxes $2,500

To charge Federal Income tax to the year earned.

The allocation procedure is not at all difficult as it only requires the construction of a deferred charge account at the end of the first year with subsequent
write-offs each year for the life of the deferred charge. At the end of each year the income statement will reflect $5,000 in rental revenue and $2,500 in federal income tax expense in conjunction with this particular advance rental transaction. The balance sheet will reflect $12,500 of federal income taxes payable with a deferred charge of $10,000 at the end of the first year. This deferred charge represents four years of federal income tax expense which will be incurred at $2,500 per year provided the tax rate remains constant. The treatment of changes in the tax rate will be discussed later in the chapter.

A second example is concerned with cost or expense deferred for tax purposes but recognized currently for accounting purposes. This case arises generally from costs and expenses which have been determined on the basis of reasonable estimates for the determination of accounting income but are not deductible for tax purposes until certainty can be established. Some of these items might include sales returns, warranties, allowances, discounts, vacation pay and deferred management compensation. As an example of this case, let us assume that a company has a deferred compensation agreement with its officers over a three year period for a
total amount of $300,000. The sum will be paid out equally in each year and the tax rate will again be 50%.

**Current year**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR. Salaries Expense</td>
<td>CR. Salaries Payable-3 year period</td>
<td>$300,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

To record deferred compensation transaction.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR. Deferred Charge-Federal Income</td>
<td>CR. Federal Income Taxes Payable</td>
<td>$150,000</td>
</tr>
<tr>
<td>$150,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To allocate Federal Income Taxes to future periods.

**At the End of Each Year**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR. Salaries payable</td>
<td>CR. Cash</td>
<td>$100,000</td>
</tr>
<tr>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

To record payment to officers

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR. Federal Income Tax Expense</td>
<td>CR. Deferred Charge-Federal Income Taxes</td>
<td>$50,000</td>
</tr>
<tr>
<td>$50,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To record income tax expense to the year in which the salaries are paid.

The balance sheet at the end of the first year will reflect federal income taxes payable of $150,000 and a deferred charge of $100,000. The deferred charge represents $50,000 of income tax expense for years two and three when the salaries are paid. The income statement for each year will show salaries expense of $100,000 and federal income tax expense of $50,000.
The two examples previously shown are cases in which the tax payable to date exceeds the amount applicable to the income recognized to date. The next two examples deal with cases in which the income recognized to date is larger than the tax payable to date.

The third example is a case of revenues or income accrued for accounting purposes but deferred for tax purposes. The problem most often found in this category involves the use of sales data for preparation of accounting statements but utilization of installment data for income tax purposes. Assume that a company had $300,000 in installment sales for one year and that $100,000 will be collected each year for three years. If it can be assumed that the gross profit rate is 30% and the applicable tax rate remains at 50%, the following entries would be made:

**Current year**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR. Accounts Receivable</td>
<td>$300,000</td>
</tr>
<tr>
<td>CR. Installment Sales</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

To record installment sales for the year.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR. Cash</td>
<td>$100,000</td>
</tr>
<tr>
<td>CR. Accounts Receivable</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

To record the collection of accounts receivable for the first year.
Current year  (Continued)

DR. Federal Income Tax Expense  $45,000
CR. Federal Income Taxes Payable  $15,000
CR. Deferred Credit-Federal Income taxes (30% X 50% X $200,000)  $30,000

To record tax expense of the current year and allocate taxes payable to the year of collection.

Second and Third Years

DR. Cash  $100,000
CR. Accounts Receivable  $100,000

To record the collection of accounts receivable.

DR. Deferred Credit-Federal Income Taxes  $15,000
CR. Federal Income Taxes Payable  $15,000

To pay Federal Income Tax in the year of collections.

It should be emphasized that the 30% calculation for gross profit and the 50% calculation for income taxes must be estimated for years two and three. When actual rates can be determined the accounts are of course adjusted to reflect the later information. Such things as purchase discounts and uncollectibles were omitted for simplicity. The income statement for year one will show sales of $300,000 with federal income taxes of $45,000 which are matched against those sales. Balance sheet items at the end of the first year reflect federal income taxes payable of $15,000 and a deferred credit of $30,000 which represents two years of income tax.
expenses paid in advance.

The last example is a case of recognizing costs or expenses for tax purposes, but deferring them for accounting purposes. This category is by far the most important with respect to the allocation of income taxes. The reason for this importance is depreciation, which, as we have discussed earlier, is the single largest dollar reason for interperiod allocation of income taxes.

In order to illustrate the effect of handling depreciation different for taxes than for books, it should be assumed that a company has a machine valued at $6,000 with an expected life of 3 years. The applicable tax rate is again assumed to be 50%. The company elects to use the sum-of-years digits method for tax purposes and the straight-line method for accounting purposes.

**Year One**

<table>
<thead>
<tr>
<th>DR. Depreciation Expense</th>
<th>$ 2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR. Accumulated Depreciation</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>

To record depreciation for year 1

<table>
<thead>
<tr>
<th>DR. Federal Income Tax Expense</th>
<th>$ 1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR. Federal Income Taxes Payable</td>
<td>$ 500</td>
</tr>
<tr>
<td>CR. Deferred Credit-Federal Income Taxes</td>
<td>$ 500</td>
</tr>
</tbody>
</table>

($6,000 \times \frac{3}{6} - $2,000) \times 50%

To record income tax expense for current year and defer payment to later years.
Year Two

DR. Depreciation Expense $2,000
CR. Accumulated Depreciation $2,000
To record depreciation for year 2.

DR. Federal Income Tax Expense $500
CR. Federal Income Taxes Payable $500
To record tax liability for year 2.

Year Three

DR. Depreciation Expense $2,000
CR. Accumulated Depreciation $2,000
To record depreciation for year 3.

DR. Deferred Credit-Federal Income Tax $500
CR. Federal Income Taxes Payable $500
To record tax liability of year 3 which was deferred in year 1.

The income statement at the end of year one reflects depreciation expense of $2,000 and federal income tax expense of $1,000. At the end of year two, the income statement shows depreciation expense of $500 while in year three the depreciation expense remains at $2,000 and the federal income tax expense is zero since it was paid in year one. The balance sheet at the end of each year shows federal income taxes payable of $500. The balance sheet also shows at the end of years one and two a deferred credit of $500 which represents the federal income tax expense of year three paid in year one.
A difficulty in allocating corporate income taxes involves the determination of tax rates to be applied. Some items or items may be included currently in the determination of financial income but will be postponed to another period for calculation of taxable income. A decision must be made as to what rate should be used to calculate the resulting deferred charge or deferred credit. There has been some controversy as to whether the calculation should be based on present tax rates or on estimated future tax rates. Accounting Research Bulletin No. 43 explicitly states:

The estimated rate should be based upon normal and sur-tax 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.6

When there is a change in the tax rate which results in a material difference in the accounts, whether gain or loss, a correction must be made. The correction of this non-recurring item should be handled on a basis consistent with the company's policy for treatment of this type item.

An example of how a change in tax rates might be treated in the accounts is illustrated in the following text.

Assume that the tax rate is decreased from 50% to 40% and that the effect will be measured in year 3 of the example for depreciation shown on page 4. A decrease of 10% in the tax rate at the end of year 2 will result in the following entries at the end of year 3.

**DR. Depreciation Expense** $2,000
**CR. Accumulated Depreciation** $2,000
To record depreciation for year 3.

**DR. Deferred Credit-Federal Income Tax** $500
**CR. Income Tax Expense** $100
**CR. Federal Income Taxes Payable** $400
To record tax liability in year 3 which was deferred in year 1 at 40% and paid in year 3 at 50% tax rates.
CHAPTER V

TAX ALLOCATION IN ACCOUNTING PRACTICE

The purpose of this chapter is to examine the reporting practices of major corporations in an attempt to determine whether the methods of allocation used in practice are consistent with those methods recommended in theory.

A study of the financial statements of 600 companies by the American Institute of Certified Public Accountants shows how taxes are treated in accounting practice.\(^1\) It can be noted that an increasing number of financial statements show a tax expense which does not bear a normal relationship to the income derived on the income statement. This situation is often created due to the allocation of income taxes to other accounting periods.

both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods.\textsuperscript{2} The Board also stated "The 'net-of-tax' form of presentation of the tax effects of timing differences should not be used for financial reporting."\textsuperscript{3} In 1966, there were 35 net of tax allocations verses 36 full amount allocations presented in the income statement. It is interesting to note that for year 1967 the number of companies showing items net-of-tax increased to about 2 to 1 over gross methods. A further breakdown is shown below.\textsuperscript{4}

Tax Allocation Items - Income Statement

\begin{tabular}{l|c|c}
\hline
Item shown net-of-tax & No. of Companies \\
\hline
1. Amount of tax effect disclosed & 60 \\
2. Amount of tax effect not disclosed & 17 \\
3. Item stated not to have tax effect & 5 \\
\hline
\end{tabular}

\begin{tabular}{l|c}
\hline
Items shown full amount & No. of Companies \\
\hline
1. Tax effect stated but included with regular tax provisions & 3 \\
2. No statement as to tax effect & $\frac{32}{35}$ \\
\hline
\end{tabular}

\textsuperscript{2}A.I.C.P.A., Accounting Principles Board Opinion No. 11, op. cit., paragraph 12b.

\textsuperscript{3}Ibid., paragraph 64.

\textsuperscript{4}A.I.C.P.A., Accounting Trends and Techniques, op. cit., p. 158.
This tremendous increase in the usage of the net-of-tax method after the issuance of Opinion No. 11 is quite surprising. Although the 1969 Accounting Trends and Techniques will not be available for incorporation into this thesis, it must be anticipated that the net-of-tax method will decrease in usage as more companies begin to adopt the recommended practice.

Opinion No. 11 had a tremendous effect on income tax deferrals. In 1966, there were 253 total tax deferrals among the 600 companies that were studied. The Accounting Trends and Techniques reported that 474 deferrals were made in 1967; up almost 100% over the prior year. The reasons for deferral are listed below:

Reasons for Tax Deferral - 1967

<table>
<thead>
<tr>
<th>Reason</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>233</td>
</tr>
<tr>
<td>Installment Sales</td>
<td>29</td>
</tr>
<tr>
<td>Deferred Charges</td>
<td>21</td>
</tr>
<tr>
<td>Pensions</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>37</td>
</tr>
<tr>
<td>Purpose not Disclosed</td>
<td>118</td>
</tr>
<tr>
<td><strong>Total Deferrals</strong></td>
<td><strong>474</strong></td>
</tr>
</tbody>
</table>

As expected, depreciation is the cause of the majority of tax deferrals; with installment sales and deferred charges running a distant second and third. The 474 tax deferrals were made by 413 companies of the 600 which were examined.

Deferrals reported in the balance sheet are generally
one of two types. They are deferred charges and deferred credits resulting from timing difference or they are adjustments to past or future taxes due to carrybacks or carryforwards of operating losses.

As discussed earlier, the deferral of charges and credits relating to timing differences do not represent receivables and payables as they are usually considered. Accounting Principles Board Opinion No. 11 recommends classifying these charges and credits into two categories: one for the current amount and the other for the non-current amount. This method of reporting is consistent with standard accounting practice. The deferred charges or credits which apply to current assets or liabilities should be classified as current. Likewise, those deferred charges or credits which are applicable to non-current items should be presented as non-current. For example, if deferred executive compensation is listed as a current liability, the deferred charges representing the tax effects of the unpaid compensation should be a current item. If an estimated provision for unsettled lawsuits is classified as a non-current liability, then the deferred charge representing the tax effect of such provision should be a non-current item.

The 1968 Accounting Trends and Techniques revealed 413 companies presented deferred taxes in 1967. These

5 Ibid., p. 175.
deferrals were presented in the Balance Sheet in the following manner:

 Deferred Taxes Presented in Balance Sheet for 1967

<table>
<thead>
<tr>
<th>No. of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncurrent liability only</td>
</tr>
<tr>
<td>Current liabilities only</td>
</tr>
<tr>
<td>Current and noncurrent liabilities</td>
</tr>
<tr>
<td>Asset only</td>
</tr>
<tr>
<td>Asset and noncurrent liability</td>
</tr>
<tr>
<td>Asset and current liability</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Several examples of the most often used deferrals are shown below. American Beverage Corporation presents deferred taxes as a noncurrent liability for 1967.

Current Liabilities:

- Current installments of long-term debt $745,042
- Accounts Payable - Trade and sundry $1,735,512
- Customer's deposit on bottles and cases $105,398
- Accrued payroll, taxes and other expenses $447,509
- Federal Income Taxes $406,250

Total Current Liabilities $3,439,711
Long Term Debt $3,700,885
Deferred federal income taxes $183,221

Notes to Consolidated Financial Statements

Note 8: Depreciation Method - The corporation employs the straight line method of depreciation for financial reporting purposes. However, for Federal income tax purposes, accelerated methods are used, whenever applicable. The effect of the concurrent use of both methods is to postpone depreciation expense otherwise applicable to the current year to a later year. The excess of depre-
ciation for tax purposes over depreciation for financial reporting purposes for 1967 was $204,514. After providing for the future liability for Federal income tax attributable to such excess, the effect was to increase net income for the year by $98,140 over that which would have been reportable had accelerated methods of depreciation been used for financial reporting purposes.

The American Beverage Company treatment of deferred taxes is good in that exceptionally fine details are provided in their footnotes and the method of deferral that was selected is the most generally accepted accounting method.

An example of how current assets are shown may be seen by examining The Sperry and Hutchinson Balance Sheet for 1967:

**Current Assets:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,734,000</td>
</tr>
<tr>
<td>Marketable Securities (at cost)</td>
<td>116,722,000</td>
</tr>
<tr>
<td>Notes and Accounts receivable</td>
<td>43,325,000</td>
</tr>
<tr>
<td>Inventories (redemption merchandise)</td>
<td>49,712,000</td>
</tr>
<tr>
<td>Future Federal Tax Benefits</td>
<td>21,926,000</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>2,577,000</td>
</tr>
</tbody>
</table>

**Total Current Assets** $214,996,000

Notes to Financial Statements

Since redemption service expenses are deducted for Federal income tax purposes as actually incurred, the future tax benefit attributable to the difference between the provision for redemption service expense and the actual expense incurred in each period has been recognized in the statement of earnings. In prior periods the Company reported the liability for stamp redemptions and certain
other minor liabilities net of such future tax benefits; however, in 1967 it adopted the practice of stating these liabilities at their full amount and reporting the future Federal tax benefit separately as a current asset.

The effects of Accounting Principles Board's Opinion No. 9 and Opinion No. 11 have had an impact on 1967 financial statements. Opinion No. 11 was stated to be effective for fiscal periods beginning after December 31, 1967. Many companies, however, have incorporated the suggested refinements for the fiscal year ending December 31, 1967. This fact would indicate that many companies were waiting for this Opinion, and once it was available, quickly integrated it into their financial statement.
CHAPTER VI

TAX ALLOCATION IN THE REGULATED INDUSTRIES

This chapter is intended to provide an insight into the unusual and difficult accounting and tax allocation problems of the regulated industries.

Interperiod tax allocation is generally the same for regulated companies as it is for industrial companies. The one unique factor affecting regulated companies is that of rates which are charged to customers. Since regulated companies are a form of monopoly, commissions have been established to insure that the rates which are charged are equitable and proper. These commissions have determined that companies are entitled to earn a normal profit.

The primary consideration in the determination of a normal profit is the cost of service. Cost of service is made up of production cost, return on capital and reward for risk and efficiency. Production costs would include labor, and such overhead as depreciation of plant and equipment and taxes. A "normal return on investment" is also allowed by the regulatory commissions. Additional recoverable costs might include risks associated
with the enterprise and a reward for managerial efficiency.

The determination of cost of service, of course, impacts on income taxes. Income taxes, in turn, affect the rates charged customers.

Utility Tax Accounting and Deferred Taxes

The accounting for income taxes in the regulated industries might be accomplished by one of four different methods:

1. The industrial method
2. The flow-through method
3. The depreciation reserve method
4. The deferred taxes method

Of the four, the flow-through and the deferred methods are most often used.

The Industrial Method

The industrial method of accounting for income taxes presupposes that one method be utilized for both financial and tax accounting. Since tax accounting is specified by law, financial accounting would be forced to conform to tax standards. A combining of the two will, of course, eliminate any difference which might occur if different methods were used. Assuming a company wished to minimize its taxable income, it would utilize
accelerated depreciation methods for determining taxable income. If the financial accounting method used was the same, the increased cost for depreciation would increase the cost of service, which in turn would increase the rate that is charged. The cost of service would be very high in the beginning and decrease through time as the depreciation decreases. This fluctuation in rates is highly undesirable. For rate making purposes, the straight line method is best as it measures the consumption of capital most accurately and provides in practice a more level cost of service than other methods. Public utilities tend to have a general stability of operation which, unlike most non-utilities, more closely approximates the straight line method with its equal periodic charges. Of the 222 Class A and B utility companies (operating revenues of $1,000,000 or more), that filed reports with the Federal Power Commission at the close of 1961, 203 companies or 91% utilized the straight line method of accruing depreciation.

The Flow-Through Method

The flow-through method applies the actual tax liability as the tax expense for the period. This would reduce the cost of service due to a reduction in taxes from utilizing accelerated depreciation methods
and would pass on to current consumers lower rates as a result of these tax savings.

There are two risks associated with the flow-through method that must be assumed by the regulated company.

(1) A possible cancellation of the law, which would mean a sudden decline in share earnings and probably a drop in market price of the utility's stock; or
(2) the future possibility that during a depression...the company would suddenly find that its taxes were increasing as its growth slowed (since fast depreciation on new assets would be too small to offset slowing depreciation on older units).¹

As a result of these risks, some utility managements have declined to use accelerated depreciation for tax purposes. This naturally, increases the cost of service and does not pass the associated tax savings on to the consumer. A case concerned with this matter was heard by the Maine Public Utilities Commission. The Commission ruled that:

...unless the owners have abused their discretion, the expenses incurred in the rendition of service by the utility are primarily a matter of managerial discretion. However, rate regulation cannot be frustrated by a requirement imposing extravagant or unnecessary costs on ratepayers...In this proceeding

we are convinced that a tax savings, which may be availed of without any risk, is available to management. Commissions have frequently made hypothetical adjustments to debt ratios in test-year computations for rate-making purposes. In the same light we believe that the revenue requirements of Bangor Hydro should be computed to reflect the use of accelerated depreciation even though the company elects to pay a higher tax than it is liable for.2

Thus, incorporation of the flow-through method and application of accelerated depreciation for tax purposes is risky. On the other hand, not utilizing accelerated depreciation methods may result in action by the commission which imposes it.

The Federal Power Commission ruled on February 3, 1964, that the benefits of tax savings resulting from the use of liberalized depreciation by electric and gas utilities must be flowed through to consumers and not retained by the companies (FPC Release No. 13127).

The commission determined that Congress intended to make tax benefits available to both regulated and unregulated taxpayers and does not mean that these tax benefits are to provide additional profits for the regulated company over and above a reasonable return on its investment. The Federal Power Commission stated

that the liberalized depreciation as provided in the Internal Revenue Code was intended to be a stimulus to investment and is best achieved by the flow-through method. The FPC reasoned that the utilities benefit from using liberalized depreciation because, as a direct result of charging lower rates, it is easier to earn a fair return. This return should result in the utility capturing a larger share of the investor's dollars than a company with a lessor return.

**Tax Normalization Methods**

The third and fourth methods of accounting for income taxes in regulated industry deal with normalization of the tax. Normalization theory is designed to evenly spread the burden of taxes between present and future customers. This even spread of taxes is accomplished by using straight line methods of depreciation in computing the cost of service as a basis for rate determination. On the other hand, accelerated methods of depreciation are used for tax purposes. The savings accruing to the company are held in a reserve for future replacement of assets and/or expansion.

The Florida Railroad and Public Utilities Commission states very well the purpose of normalization.
...it appears that the use of accelerated depreciation will not result in a reduction of income taxes, will not create additional income, will not materially change total new financing requirements of the utilities, but will result only in shifting some part of such taxes and new financing from the early years to the later years of the useful life of the new permanent additions and replacements. This undoubtedly will be of benefit to the utilities, and by normalizing taxes and depreciation in their books of account will not be detrimental to present or future ratepayers but, in fact, should be beneficial to the public generally in that the same will tend to assure the necessary expansion and growth to meet all needs.\(^3\)

The depreciation reserve method and the deferred taxes method are the two procedures which are used to accomplish normalization.

The depreciation reserve method. The depreciation reserve method will be examined first. This method increases the depreciation charge and the associated allowance account by the amount of the tax deferred. The depreciation amount is computed to be that normally determined by straight-line methods plus any reduction in taxes due to utilizing accelerated depreciation methods. This method provides the company with some tax benefits but results in a decreasing rate base due to the higher

than normal accumulated depreciation. Consequently, this action reduces the return on investment which is part of the cost of service. Thus, the customer pays more for depreciation at first but receives a corresponding decrease in cost as the base rate for the rate of return calculation is reduced.

Much controversy has arisen over the guise to use depreciation accounting as a means of rate determination. An objection to the use of this method is succinctly stated as follows:

If the depreciation accruals are supposed to measure the annual consumption of real capital in the rendition of service to the public and if the depreciation reserve is supposed to measure the loss of service value of such capital to date, how can additional charges be made to the annual depreciation accruals and corresponding credits be made to the depreciation reserve of wholly unrelated items? Under this kind of accounting it would be equally logical to deduct the injuries and damages reserve from the rate base merely to make the rate base smaller and consequently lower revenue requirements.4

It is quite evident that the depreciation reserve method is an effort to manipulate the cost of service through the accumulated depreciation account. As might

be expected, this method has not had widespread acceptance by state commissions.

The deferred tax method. The other method employed for normalization is the deferred tax method. The deferred tax method provides for a tax expense included in cost of service that is determined without use of accelerated depreciation. For tax purposes, the company defers payment of taxes to later periods by utilizing accelerated depreciation, but for rate making purposes, straight line depreciation methods are used. Normalized taxes for rate-making purposes are necessary to spread the burden of taxes fairly between present and future customers.

The gain to the company is obvious. It receives a return based on rates computed with higher costs than are actually incurred. This provides a source of interest free money for new construction or whatever. It would certainly appear unreasonable that the company would expect present customers to contribute interest free capital to the enterprise. It is argued by proponents of the deferred tax method that the customer is paying his normal rate, the rate he would expect to pay. In fact, it is not the customer but the government who is providing the interest free capital. By deferring
the payment of the tax to later periods, the government is providing the interest free loan.

Opponents of normalization argue that as long as a utility continues to expand its plant and depreciable facilities, the deferred tax reserve continues to increase. The Federal Power Commission reported that the larger natural gas pipeline companies had accumulated $427,000,000 in deferred income taxes through the end of 1964. Had the flow-through method been used, this $427 million would have flowed through to consumers in the form of lower rates. Although the principle of accumulating a tax reserve for asset replacement through the use of interest free money is basically sound, the amount of the reserve and its relationship to consumers is certainly subject to further analysis.

Although the deferred tax method yields interest free money for a period of time, there is a related cost associated with this benefit. A tax deferral indicates an obligation to pay taxes at some future time. Even though this future tax is contingent on many things, it remains a probable obligation which, if due, will be senior to owners equity. The effect of this obligation increases the risk borne by owners. As was previously stated, return on investment as a cost of service is determined by: (1) interest for use of money; (2) compensation for risk; (3) reward
for managerial efficiency. If the deferred tax increases the risk, the compensation for this risk must be increased and the cost of service rises.

However, in practice, the added risk associated with the deferred tax method for a stabilized or growing utility is not enough to offset the advantage of the interest free money. If the money was not available, funds would have to be raised by issuance of bonds or stock and the cost of obtaining this money can be more than the risk associated with the deferred tax method.

Deferred Tax Credits and Utility Accounting and Rate Making

Normalization will have an effect on the cost of capital of an enterprise. This effect will at least partially be determined by the treatment of the credit balance tax deferral. The item may be shown as restricted-retained earnings in which case it is a portion of the total equity. The credit may also be shown as a liability. The handling of this item may determine how the company will raise additional funds. For example, if a utility has a 25 per cent stock equity ratio which it does not want to change and has $1,000,000 of deferred tax credits, $3,000,000 can be raised by issuing bonds without changing the stock equity ratio, if the deferred taxes are included as a part of stock equity. If, on the contrary, deferred taxes are shown as a liability,
only 75 per cent of the $3,000,000 may be obtained by bond issuance; the remaining 25 per cent must be raised by capital stock.

It is questionable how theoretically correct it is to record a liability as a part of equity. One argument in favor of the equity positioning states that the effect of not normalizing taxes would result in an increase in owners equity by the normal process of retaining part of the earnings. The Securities and Exchange Commission is opposed to recording the deferred tax credit in owners equity and has stated:

So far as this Commission is concerned, since it believes that classifying the item as a component part of common stock equity is misleading for financial statement purposes, it does not intend to consider the item as a part of common stock equity for analytical purposes, although it may give consideration to the item as one of a number of relevant factors in appraising the overall financial condition of a company. The Commission... does not have jurisdiction over rate-making, although under the Public Utility Holding Company Act of 1935 it is concerned with the interests of consumers. Alleged adverse results as to investors and consumers are no different from those complained of whenever any requirement designed to assure financial stability is imposed. 

Although several commissions have approved the use

of the equity method for the normalization of taxes, this procedure is not considered to be standard accounting practice. In fact, very few companies have incorporated the equity procedure, even though it provides a lower cost of financing.

The accounting requirements for regulated industry are generally the same as for non-regulated industry. Opinion No. 11, the latest and by far the most inclusive opinion regarding tax allocation, does not make any specific references to regulated industry. The only Accounting Principles Board publication that discusses accounting principles for regulated companies is an addendum to Accounting Principles Board Opinion No. 2.6

The addendum is quite broad and states that:

Accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses by orders of regulatory authorities and occasionally by court decisions or statutes. The fact that such accounting requirements are imposed by the government does not necessarily mean that they conform with generally accepted accounting principles. For example, if a cost, of a kind which in a nonregulated business would be charged to income, is charged directly to surplus pursuant to the applicable accounting requirements of the regulatory authority, such cost nevertheless should be included in

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operating expenses or charged to income, as appropriate in financial statements intended for use by the public.\(^7\)

Any consideration of greater uniformity in rate making and accounting raises a fundamental question as to whether the accounting should follow rate making or vice versa. The regulatory commissions and the courts have been quite clear that a decision in one area is not binding in the other area. The Uniform Systems of Accounts of the Federal Power Commission recognize this fact. For example, the account no. 426 "Other Income Deductions," stated: "The classification of expenses as nonoperating and their inclusion in this account is for accounting purposes. It does not preclude commission consideration of proof to the contrary for rate making or other purposes."\(^8\)

The Accounting Principles Board suggests that those reports prepared specifically for regulatory purposes of the government must be prepared as required but financial reports for public use should be in conformance with generally accepted accounting principles. An example of how taxes are treated in the financial

\(^7\)Ibid., para. 3.

statements of a utility are shown for Kansas Power and Light Company.\textsuperscript{9}

<table>
<thead>
<tr>
<th>Operating Revenue:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Electric</td>
<td>$53,967,294</td>
</tr>
<tr>
<td>Gas</td>
<td>24,651,916</td>
</tr>
<tr>
<td>Water and other</td>
<td>180,000</td>
</tr>
<tr>
<td><strong>Total Revenues</strong></td>
<td><strong>$78,799,210</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Revenue Deductions:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Expenses</td>
<td>$34,971,618</td>
</tr>
<tr>
<td>Maintenance</td>
<td>4,008,297</td>
</tr>
<tr>
<td>Depreciation</td>
<td>8,525,425</td>
</tr>
<tr>
<td>Federal Income Taxes</td>
<td>7,514,304</td>
</tr>
<tr>
<td>State Income Taxes</td>
<td>450,008</td>
</tr>
<tr>
<td>(1) Provision for Deferred</td>
<td></td>
</tr>
<tr>
<td>Income Taxes</td>
<td>952,703</td>
</tr>
<tr>
<td>General Taxes</td>
<td>7,521,544</td>
</tr>
<tr>
<td>Deferred Investment Tax Credit</td>
<td>332,420</td>
</tr>
<tr>
<td><strong>Total Deductions</strong></td>
<td><strong>$61,276,319</strong></td>
</tr>
</tbody>
</table>

**Net Operating Revenue**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$14,522,891</td>
</tr>
</tbody>
</table>

(1) Represents amounts deferred at current rates as a result of accelerated depreciation for income tax purposes of certain defense facilities, and that portion of depreciation claimed on the declining balance over the amount claimed had the property been depreciated on a straight line basis.\textsuperscript{10}

An examination of many Annual Reports for regulated companies indicated that basically all utilities use


\textsuperscript{10}Kansas Power and Light Company, Annual Report, 1968.
the same reporting methods as Kansas Power and Light Company. In all cases, the deferred tax credit was shown as a liability on the balance sheet. There was no indication or reference that this credit was reported in the equity section of the balance sheet for any of the companies that were studied.

The primary problem of inter-period income tax allocation in regulated industries involves maintaining equitable rates between different generations of customers. Although the normalization methods provide the most equitable rates between generations of customers, the flow-through method is used by a majority of utilities due to the requirements of various commissions and their interpretation of the law.

Another issue of importance is the intent of Congress regarding regulated industry and taxes. This intent is interpreted in the various rulings by commissions. These rulings are dependent on the same basic considerations, but reveal different interpretations of what is equitable and what was the intent of Congress.
CHAPTER VII

SUMMARY AND CONCLUSIONS

Accounting for income taxes has become extremely important since almost one-half the earnings of large corporations must be paid to the federal government. Tax accounting has become quite complex, and, because it is required by law, accounting for taxes is very inflexible. Normal financial accounting allows various options which may be exercised by management depending upon circumstances and the desired results. Tax accounting, on the other hand, has very few options and provides management with little choice as to alternatives. This, of course, leads to discrepancies between financial and tax accounting. These discrepancies generally result in a tax expense (based on financial accounting) which is different than the tax payable (based on tax accounting). These differences are normal and expected. Although it has been suggested that uniform accounting practice for both financial and tax accounting is desirable, management may keep the two separated so that financial income can be maximized and taxable income can be minimized.
The purposes of financial accounting are quite different than those of tax accounting. Financial accounting is designed to provide information to those parties interested in the financial condition of one firm and the results of its operations. Tax accounting, on the other hand, provides revenue for the federal government. Thus, with objectives so diverse, it is obvious that no single accounting method can necessarily accomplish both objectives.

The principles of tax allocation imply that since taxes are an expense they are allocable to income included in the income statement for the year. Three methods of allocation have been adopted by accountants; the net-of-tax method, the liability method, and the deferred method.

The net-of-tax concept is based on the proposition that individual assets and liabilities are adjusted to reflect the loss or increase in taxability or tax deductibility. There is considerable criticism of the net-of-tax method due to netting the deferred charge or credit against the asset or liability because this conceals the actual or gross value.

The second concept, liability, assumes that taxes allocated to later periods are either postponed or prepaid. This concept is consistent with the theory of
interperiod allocation and results in the desired matching of costs and revenues. The one major disadvantage applicable to the liability method is the requirement to estimate the "asset" or "liability." Opponents of this method argue that the amount shown represents (in the case of a liability) not what the firm is liable for, but what the firm expects to be liable for at a future time.

This argument was refuted by changing the terminology from asset and liability to deferred credit and deferred charge. This change resulted in the third method of tax allocation, the deferred method.

The third method of tax allocation is the deferred method. Through the use of deferrals, this method achieves the desired matching of income tax expense with the revenues and expenses of current income. Although theorists argue that the deferred method results in misstated balance sheet items, one of the most important functions of the balance sheet is to provide a sound basis for producing a good income statement. This method has been recommended by the Accounting Principles Board in Opinion No. 11 and is most often used in practice. It must be concluded that the deferred method of tax allocation should be followed since it provides the most pragmatic approach to tax allocation and meaningful reporting of income taxes in financial statements.
Generally, accounting practice follows those opinions presented by the Accounting Principles Board. The Accounting Trends and Techniques studies of 600 companies verifies this fact in that financial statements for years following significant APB opinions reflect marked changes to conform with these opinions. The most significant opinion regarding the allocation of Income Taxes was published in December 1967. It is Opinion No. 11 entitled "Accounting for Income Taxes." This opinion was very much needed and provided an excellent guideline which had been absent for so long. The effects were felt immediately. There were 474 tax deferrals in 1967 compared to 253 in 1966. This is an increase of almost 100%. It appeared as though many companies were waiting for this opinion as to a preferred method of tax allocation and took the earliest opportunity to conform to the recommended deferred method.

While industrial companies have had their tax allocation methods and procedures clarified by various publications of the A.I.C.P.A., regulated industry has not been so fortunate. Four methods of tax allocation have been recognized by various commissions. These are: (1) the industrial method, (2) the flow-through method, (3) the depreciation reserve method, and (4) the deferred taxes method.
The industrial method is the least used method and is based on the rather unrealistic notion that one method be utilized for both financial and tax accounting. This method would, of course, eliminate any variances between financial and taxable income but would also remove the variables that management wishes to keep available. This disadvantage is so great that the industrial method cannot be considered as a logical choice for a method of tax allocation.

The flow-through method has received more widespread acceptance among commissions. This method applies the actual tax liability as the tax expense for the period. The use of accelerated depreciation reduces the cost of service by reducing taxes and passes on to current consumers lower rates as a result of these tax savings.

The Federal Power Commission has ruled that electric and gas utilities must use the flow-through method of tax allocation. The FPC states that the use of the flow-through method benefits the ratepayer by effecting lower rates, and the utility which then has a lower cost of service can more easily earn a fair rate of return.

The third and fourth methods of accounting for income taxes in regulated industry deal with normali-
zation of the tax. The depreciation reserve method and the deferred taxes method are the two procedures which accomplish normalization. The depreciation reserve method is a means of manipulating the cost of service through the accumulated depreciation account. It is merely a guise to use depreciation accounting as a means of rate determination. This method has not had widespread acceptance and must be considered unsuitable since it is not generally accepted accounting practice.

The fourth method is the deferred tax method. This method provides for a tax expense which is included in cost of service without utilizing accelerated depreciation. For tax purposes, the company defers payment of taxes to later periods by using accelerated depreciation methods. The company receives a return based on rates computed with higher costs than are actually incurred. This is a source of interest free money which is made available to the firm by the government which defers payment of the tax until later periods. If this money was not available through this source, it would have to be raised by issuance of stock or bonds which would be more costly than the avenue afforded through utilization of the deferred tax method.

Although the deferred tax method provides a cheap means of obtaining funds, the question as to whom this
effort benefits must be asked. The fact that the rate-
payer is burdened with higher rates while the utility
may continue to increase its reserve as long as its
depreciable assets increase is certainly not equitable.

It must be concluded that the flow-through method
provides the lowest possible cost to the consumer at
any point in time. This conclusion is borne out by
the fact that 91% of class A and B utility companies
use the flow-through method. Although normalization
provides the greatest benefit to the utility, commissions
must make decisions based on their interpretation of
the intent of Congress with the aim of providing a method
that is equitable to the majority of ratepayers and
taxpayers.

For accounting purposes, the tax allocation problem
is the same whether a company is regulated or not.
The primary concern deals with the determination and
differences between financial and taxable income; it
is recommended that a reconciliation between these two
items be included in financial statements. A format
for this reconciliation has been suggested by
P. H. Walgenbach.¹

¹Walgenbach, op. cit., p. 161.
Accounting net income $XXX

Add:
- Profit resulting from Treasury Stock Transactions, carried to Capital Surplus $XXX
- Extraordinary gain on sale of assets, carried to Earned Surplus XXX XXX $XXX

Deduct:
- Excess of amortization taken for tax purposes over book purposes:
  - Amount taken for tax purposes $XXX
  - Amount taken for book purposes (XXX) XXX
- Operating loss carry-forward deduction attributable to year 19XX XXX (XXX)
- Taxable net income $XXX

Taxable at ordinary rate, $XXX @ X%. $XXX
Extraordinary gain, $XXX @ X%. XXX
Current year's tax liability $XXX

If a reconciliation of this type was required for all statements with differing financial and taxable incomes, much of the confusion would be eliminated.

There has been an increasing consistency as to the handling of tax allocation in recent years. The A.I.C.P.A. bulletins and opinions have aided greatly toward this cause. This is especially true for industrial companies while regulated companies are still subject to individual commission rulings. It is believed, however, that a combination of tax allocation in the income statement and a separate reconciliation of any
differences between financial and taxable income will adequately serve the needs of anyone desiring data from financial reports.
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