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Comprehensive Tax Allocation

by CLAYTON L. BULLOCK
Partner, Executive Office

Presented before The Accounting Conference of the
Electric Utilities of Texas, Amarillo—July 1968

IN THE PAST FEW YEARS there has been a gradual, but accelerating, development of accounting principles relating to deferred taxes. The Accounting Principles Board of the American Institute of Certified Public Accountants and its predecessor Committee on Accounting Procedure have been studying the problems and issuing pronouncements for a number of years. The culmination, of course, is Opinion No. 11 of the Accounting Principles Board, which adopted the principles of comprehensive tax allocation.

Development of accounting principles has been necessary as the use of taxation as an instrument of economic policy has increased. Liberalized capital recovery allowances have been added one after another—including liberalized depreciation, guidelines depreciation, and the investment credit—as have numerous other special tax provisions affecting other aspects of taxation.

DEVELOPMENT OF TAX EFFECT ACCOUNTING

In 1944, the Committee on Accounting Procedure recommended deferred tax accounting in certain circumstances (including amortization of emergency facilities for tax purposes), but not for differences recurring regularly over a comparatively long period of time. In 1958, the Committee issued the controversial ARB 44 (Revised), dealing with liberalized depreciation—its first release requiring tax allocation for a recurring difference. In 1962 the Accounting Principles Board adopted a substantially similar position with respect to guidelines depreciation. Finally, after Accounting Research Study No. 9 in 1966, the Board took up the discussions leading to the issuance in December 1967 of Opinion No. 11. In the meantime, Opinion No. 2 had required deferral accounting for the investment credit and then Opinion No. 4 had accepted, as an alternative, application of the investment credit as a reduction of current income taxes.

An exception for regulated industries, applying particularly to public utility companies, was stated in the well-known paragraph 8 of ARB 44.
(Revised); it was restated and made more explicit in the Addendum to APB Opinion No. 2. Opinion No. 11 contains a similar exception—referring to the Addendum, which remains in effect. Accounting for regulated industries, however, is being studied by the Board, and we may look for an opinion on accounting for regulated industries sometime in the not too distant future.

SUMMARY OF THE OPINION

APB Opinion No. 11 finds that comprehensive interperiod tax allocation is an integral part of the determination of income tax expense. For permanent differences between accounting and taxable income, however, tax allocation is not found to be appropriate, since permanent differences do not affect other periods. In effect, with certain exceptions, the opinion requires deferred tax provisions for all material timing differences between taxable income and accounting income.

Although timing differences are of the greatest general interest (and are the most complicated part of the Opinion), certain other matters are discussed also: operating loss deductions, other unused deductions and credits, tax allocation within a period, and related reporting problems. Accounting for the investment credit, however, which was discussed in an earlier draft, was omitted from the final Opinion pending further study.

The Opinion is effective for all fiscal periods beginning after December 31, 1967. Earlier application, however, is encouraged. Retroactive application, to be accounted for as prior-period adjustments, is provided for, and indirectly encouraged, so long as the procedures are applied to all material items of the prior periods.

The Opinion adopts the deferral approach, in which deferred taxes are provided at current rates and amortized to income as timing differences reverse, without regard to tax rates at the time of reversal. This is in contrast to the liability approach, which is based on estimated taxes payable in the future, and to the net-of-tax approach.

Indirectly, the procedures adopted have the effect of requiring eventual balance-sheet recognition of the cumulative effect of timing differences. This is done by excluding reversals of prior differences from the computations unless the related deferred taxes have been provided.

In addition to the exception for regulated industries when the Addendum applies, certain areas requiring further study are excluded from
the application of the Opinion. These include intangible development costs in the oil and gas industries, statutory reserves of steamship companies, undistributed earnings of subsidiaries, and reserves and surplus of stock savings and loan and life insurance companies.

TIMING DIFFERENCES

Comprehensive tax allocation means that deferred taxes are to be provided for all timing differences when they originate—whether debit or credit. The Board is not aiming at undue complication, however—nor does it intend to require provision of immaterial amounts.

The distinction between timing differences and permanent differences is particularly important. Permanent differences do not result in deferred taxes. Timing differences do. And differences to which the Addendum applies, or those related to intangible development costs or the other excluded areas, although they do or may represent timing differences, are treated much as though they were permanent differences.

Permanent differences arise from statutory provisions concerning whether an item affects taxable income. Typical examples are the exemption of municipal bond interest, the nondeductibility of life insurance, and the allowance of statutory (percentage) depletion in excess of cost depletion. In contrast, timing differences arise from provisions concerning when an item affects taxable income. Perhaps the typical example is the allowance of depreciation in excess of depreciation for accounting purposes.

TWO METHODS OF COMPUTING DEFERRED TAXES

Two methods are provided in the Opinion for measuring the tax effect of timing differences. The basic method considers initial timing differences separately from reversals of timing differences of prior periods; it allows groupings of similar items, but not offsetting reversals against new initial differences. The second method might be termed the incremental method: it relates the computation of current tax effect to the net change in cumulative timing differences. The incremental method may be used only when deferred taxes have been provided on all material cumulative timing differences at the beginning of a period (either initially or retroactively).
The two methods can have somewhat different results. First, the basic method gives a gross deferral, with offset for reversals only when deferred taxes have been provided on the reversing items. By basing deferred tax provisions on initial timing differences without offset for reversals, the cumulative provision is to be built up out of income if not otherwise provided; the build-up may be gradual or quite rapid, depending upon the rate at which prior differences reverse.

Second, even when deferred taxes have been provided on past timing differences, net provisions may be different. This occurs when there are reversals of prior timing differences that arose when the tax rate was different from that of the current period: the incremental method applies the current rate to the entire net change, while the basic method applies the current rate only to initial timing differences. Some examples may help illustrate the difference.

**Illustration I**

Assume a very simple situation—one where the only differences are in the depreciation deduction. Assume that liberalized depreciation (or perhaps guidelines depreciation) is used for tax purposes only, and that part of the property was amortized for tax purposes as an emergency facility at a time when the tax rate was 52%. Chart I illustrates such a situation and what might be done with it if the current tax rate were 52.8%.

The computation under the *incremental method*—the second method shown on the chart—is extremely simple. All there is to it is the computation of a theoretical tax on the pre-tax accounting income at the current rate (after deducting permanent differences, if any); this theoretical tax is compared with the tax on the taxable income, and the difference is the deferred tax provision.

The *basic method* is somewhat more complicated. The reversals of the prior timing differences—that is, the accounting depreciation on the emergency facilities previously amortized—is added back to the accounting income. Tax is then computed as in the incremental method and the difference is the deferred tax provision. The deferred tax related to the reversal is computed separately at the rate in effect when the deferred tax was provided (assuming it had been provided). This credit provision
**Chart I**

**TWO METHODS OF COMPUTING DEFERRED TAXES**

**ASSUME THE FOLLOWING SITUATION:**

PRE-TAX ACCOUNTING INCOME .......... $100,000

Add: Accounting depreciation on facilities previously amortized for tax purposes (when the tax rate was 52%) .................. 12,500

Total ........................................ $112,500

Less: Excess of tax depreciation over accounting depreciation on other property ........... 15,000

TAXABLE INCOME ........................... 97,500

Income tax at 52.8%* ......................... $ 51,480

1. COMPUTATION OF DEFERRED TAXES—BASIC METHOD

<table>
<thead>
<tr>
<th>ACCOUNTING INCOME</th>
<th>TAXABLE INCOME</th>
<th>DIFFERENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>INCOME BEFORE TAX</td>
<td>$100,000</td>
<td>$97,500</td>
</tr>
<tr>
<td>REVERSAI OF PRIOR TIMING DIFFERENCE</td>
<td>12,500</td>
<td>12,500</td>
</tr>
<tr>
<td>AMOUNTS AFTER ADJUSTMENT .... $112,500</td>
<td>$97,500</td>
<td>$15,000</td>
</tr>
<tr>
<td>TAX AT 52.8%* .................</td>
<td>59,400</td>
<td>51,480</td>
</tr>
</tbody>
</table>

DEFERRED TAX PROVISION (on initial differences) ........................................ $ 7,920

AMORTIZATION OF PRIOR DEFERRED TAXES (on facilities amortized—52% of $12,500) .......... (6,500)

DEFERRED TAX PROVISION—NET .................. $ 1,420

(continued on page 112)

(related to the amortized facilities) of course offsets in part the current deferred tax provision on this year's initial timing differences.

In this example, the net difference between the two methods is the difference between the tax rates (52.8% minus 52%) times the accounting depreciation on the property previously amortized for tax purposes. The difference would have been much greater if there had been no prior deferred taxes to be amortized as a credit provision.
Chart I continued

2. COMPUTATION OF DEFERRED TAXES—INCREMENTAL METHOD

<table>
<thead>
<tr>
<th>ACCOUNTING INCOME</th>
<th>TAXABLE INCOME</th>
<th>DIFFERENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>INCOME BEFORE TAX</td>
<td>$100,000</td>
<td>$97,500</td>
</tr>
<tr>
<td>TAX AT 52.8%*</td>
<td>52,800</td>
<td>51,480</td>
</tr>
<tr>
<td>DEFERRED TAX PROVISION—NET</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

DIFFERENCE BETWEEN THE METHODS

Reversal of prior differences .................. $12,500
Times the difference in tax rates 
(52.8% — 52%) ................................. \times 0.008
NET DIFFERENCE ............................... $ 100

*NOTE: Income tax computed without considering surtax exemption.

Incidentally, Chart I is an example also of the “parallel computation” which is basic to the provisions of the Opinion. Paragraph 36 of the Opinion states that tax effects “...should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income.” There may be situations in which the parallel computation is unnecessary or inappropriate—for example, when it is necessary to keep track separately of numerous types of timing differences. Nevertheless, this method of computation is inherent in the rules set forth in the Opinion.

Illustration II

The example in Chart I is too simple to be realistic. Perhaps we should look at an example at least a little more complicated. First, however, consider the fact that the difference between tax depreciation and accounting depreciation may cover a number of different types of depreciation differences.
Chart II

ANALYSIS OF DEPRECIATION DIFFERENCES

ASSUME THE FOLLOWING SITUATION:

<table>
<thead>
<tr>
<th>PROPERTY</th>
<th>BEGINNING OF YEAR</th>
<th>END OF YEAR</th>
<th>AVERAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property balance per ledger</td>
<td>$1,700,000</td>
<td>$1,740,000</td>
<td></td>
</tr>
<tr>
<td>Construction work in progress</td>
<td>(290,000)</td>
<td>(220,000)</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>(50,000)</td>
<td>(60,000)</td>
<td></td>
</tr>
</tbody>
</table>

DEPRECIABLE PROPERTY FOR ACCOUNTING PURPOSES

$1,360,000 ($1,460,000) $1,410,000 (1)

Emergency facilities previously amortized for tax purposes (20,000) (20,000) (20,000) (2)

Interest and tax capitalized (20,000) (22,000) (21,000) (3)

Balance of property 1,320,000 1,418,000 1,369,000 (4)

Acquisition adjustments charged to surplus in prior years 5,000 5,000 5,000 (5)

DEPRECIABLE PROPERTY FOR TAX PURPOSES

$1,325,000 $1,423,000 $1,374,000 (6)

DEPRECIATION

Tax Depreciation—at 3.3% of $1,374,000 (6) $45,342

Accounting Depreciation—at 3.0% of $1,410,000 (1) 42,300

DIFFERENCE $3,042

ANALYSIS OF DIFFERENCE

PERMANENT DIFFERENCE:

Acquisition adjustments—at 3.3% of $5,000 (5) $165

INITIAL TIMING DIFFERENCE:

Balance of property—at difference between depreciation rates (3.3%—3.0%) —0.3% of $1,369,000 (4) 4,107

REVERSALS OF PRIOR TIMING DIFFERENCES:

Interest and taxes capitalized for accounting purposes only—at 3.0% of $21,000 (3) (630)

Emergency facilities amortized for tax purposes only—at 3.0% of $20,000 (2) (600)

TOTAL DIFFERENCE—NET $3,042
Chart II is an illustration of some of the types of differences that might be found in an analysis of depreciation. Of course, for simplicity, only a few differences are shown. In many utilities it would take a whole page just to list the various categories of items affected by the adjustment from depreciable property for accounting purposes to the basis of depreciable property for tax purposes. The “Analysis of Differences” in Chart II results in the classification needed for computations—permanent differences, initial differences, or reversals—on the basis, however, of certain assumptions concerning them. In actual practice, a particular difference might fall into any one of the categories, depending on the circumstances.

For illustrative purposes, interest and taxes capitalized are used in the chart as a timing difference, and the related depreciation is treated as a reversal. These amounts would, of course, be covered by the exception in the Addendum for many, if not most, utilities. Also, it is assumed that the interest capitalized is all actual interest, rather than return. The interest (or return) capitalized by utilities may be either partly or wholly a return on equity, and therefore not a timing difference at all.

The depreciation-rate difference also is treated as a timing difference in this illustration, although for a utility this too might well be covered by the Addendum. This leads to a problem that is beyond the scope of the illustration: How can one determine, under group or composite depreciation, when a depreciation-rate difference reverses? I am not at all sure that the reversal can be identified, because it may become merely part of re-evaluations of average life.

**Illustration III**

Using the depreciation analysis from Chart II in a calculation similar to the first example, Chart III is obtained, which includes this depreciation difference as one of the items reconciling book income to taxable income. Current-year interest and taxes capitalized is one of the differences, since cumulative interest and taxes were involved in Chart II. In addition, an insurance reserve and some statutory (percentage) depletion are assumed. In columns beside the assumed data, the reconciling items are analyzed into permanent differences, initial timing differences, and timing difference reversals.
Chart III

COMPUTATION OF DEFERRED TAXES

ASSUME THE FOLLOWING SITUATION:

<table>
<thead>
<tr>
<th>ANALYSIS</th>
<th>ASSUMED DATA</th>
<th>PERMANENT DIFFERENCES</th>
<th>TIMING DIFFERENCES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Initial Reversal</td>
</tr>
<tr>
<td>PRE-TAX ACCOUNTING</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>INCOME ..................</td>
<td>$150,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance reserve additions</td>
<td>150</td>
<td>150</td>
<td>(30)</td>
</tr>
<tr>
<td>Insurance reserve charges ....</td>
<td>(30)</td>
<td></td>
<td>(30)</td>
</tr>
<tr>
<td>Interest and taxes capitalized for accounting purposes only</td>
<td>(2,000)</td>
<td>(2,000)</td>
<td></td>
</tr>
<tr>
<td>Excess of statutory depletion over cost depletion ..........</td>
<td>(10)</td>
<td>(10)</td>
<td></td>
</tr>
<tr>
<td>Depreciation difference (as analyzed in Chart II) ..</td>
<td>(3,042)</td>
<td>(165)</td>
<td>(4,107)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,230</td>
</tr>
<tr>
<td>TAXABLE INCOME ...........</td>
<td>$145,068</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DIFFERENCES .............</td>
<td>$ (4,932)</td>
<td>(175)</td>
<td>(5,957)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,200</td>
</tr>
</tbody>
</table>

COMPUTATION OF DEFERRED TAX BASIS

<table>
<thead>
<tr>
<th>ACCOUNTING INCOME</th>
<th>TAXABLE INCOME</th>
<th>DIFFERENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMOUNTS BEFORE ADJUSTMENT...</td>
<td>$150,000</td>
<td>$145,068</td>
</tr>
<tr>
<td>PERMANENT DIFFERENCES ........</td>
<td>(175)</td>
<td>(175)</td>
</tr>
<tr>
<td>ADJUSTED AMOUNTS FOR INCREMENTAL METHOD ..........</td>
<td>$149,825</td>
<td>$145,068</td>
</tr>
<tr>
<td>REVERSAL OF PRIOR TIMING DIFFERENCES ...............</td>
<td>1,200</td>
<td>1,200</td>
</tr>
<tr>
<td>ADJUSTED AMOUNTS FOR BASIC METHOD ..................</td>
<td>$151,025</td>
<td>$145,068</td>
</tr>
</tbody>
</table>

In computing the appropriate amounts of deferred taxes, accounting income and taxable income are adjusted for the various differences. The differences we have assumed adjust only the accounting income, as is the usual case; conceivably, some adjustments could apply to taxable income in making the comparative calculation.

Chart III stops short of computing the amount of deferred tax. The reason is that we need to bring in one other complication before computing the amounts.
INTERACTION WITH INVESTMENT CREDIT

Under APB Opinion No. 2, investment credit recognized in the accounts is limited to that realized through reduction of income tax liability. There are several indications in Opinion No. 11, however, that in some circumstances investment credit carryovers should be recognized before they are realized. Among these indications are the facts that paragraph 36 refers to "income taxes" related to timing differences and that paragraph 53 indicates the discussion with respect to operating losses also applies to other unused deductions and credits. The investment credit is certainly an integral part of the computation of income taxes, and investment credit carryovers are certainly an unused credit.

When the investment credit is accounted for under the deferred method, the principal effect of recognizing carryovers before realization would be on the amortization of deferred investment credit. When the investment credit, however, is accounted for under the tax reduction ("flow-through") method, utilization of unused, available investment credit against deferred taxes may have a consequential impact.

This matter may be subject to further interpretation. For the present, however, it seems appropriate to consider unused investment credit in computing the amount of deferred taxes, subject to certain limitations. First, it seems the amount should be limited to the investment credit available—that is, to the investment credit generated and not used. Second, it seems the amount should be limited to the investment credit that would have been recognized had accounting income been the basis for taxation—that is, to the appropriate percentage of the tax that would have been payable on the accounting income adjusted for permanent differences. Third, it seems that investment credit carry-forwards should not be recognized unless their realization is assured beyond any reasonable doubt; such assurance might be indicated by stability of income (as is common with utilities) if, for example, the carry-forward resulted from unusually large construction in a particular year, or by assurance of reversal of the deferred tax provisions within the carry-forward period.

When investment credit carry-forwards are recognized against deferred taxes in this manner, it appears necessary to make a compensating adjustment when the carry-forward is realized on a return. In other words, when the carry-forward is realized, it should be credited to the
deferred tax account that received the original benefit. For this reason, and for convenience in handling the limitations, it probably will be necessary to record deferred taxes on a gross basis and to record the associated investment credit in a contra account.

**Illustration IV**

Chart IV picks up the example from Chart III and shows the computation of the deferred tax, allowing for unused investment credit carry-forward. The computation of the gross amount of deferred tax, under either the incremental or the basic method, is similar to the computation in the first chart (in this case, however, a tax rate of 48% is assumed). In the investment credit section, the three limitations mentioned previously are computed: first, the available investment credit; second, the theoretical investment credit on accounting income less permanent differences; and third, the realization test (assuming realization of the entire carry-forward is assured).

**OTHER FEATURES OF THE OPINION**

Other sections of the Opinion are less complicated than those concerning timing differences and I shall not discuss them at length. The sections on *intra* period allocation and financial reporting, as an oversimplification, might be summarized as consistent with the general approach in the sections we have discussed.

The sections dealing with operating loss deductions are largely a restatement of present practice, but a few comments may be warranted. The principles applicable to operating loss deductions are also applicable to other unused deductions and credits, such as capital losses, contribution carryovers, and foreign tax credits (but not necessarily to the investment credit).

**OPERATING LOSSES AND UNUSED DEDUCTIONS**

Briefly, tax effects of *carry-backs* should be recognized in the loss periods; tax benefits of *carry-forwards* should not be recognized until realized, unless realization is assured beyond reasonable doubt. When
ASSUME THE FOLLOWING SITUATION:

<table>
<thead>
<tr>
<th>AMOUNTS BEFORE ADJUSTMENT</th>
<th>ACCOUNTING INCOME</th>
<th>TAXABLE INCOME</th>
<th>DIFFERENCE</th>
<th>DEFERRED TAX (48%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent differences</td>
<td>$150,000</td>
<td>$145,068</td>
<td>$4,932</td>
<td></td>
</tr>
</tbody>
</table>

ADJUSTED AMOUNTS—INCREMENTAL

| Reversal—timing differences | $149,825         | $145,068       | $4,757     | $2,283 |

ADJUSTED AMOUNTS—BASIC

| Reversal—timing differences | $151,025         | $145,068       | $5,957     | $2,859 |

TAX AT 48%*

| TAX AT 48%* | $69,633 |

AVAILABLE INVESTMENT CREDIT

| AVAILABLE INVESTMENT CREDIT | $35,500 |

INVESTMENT CREDIT ALLOWABLE

| INVESTMENT CREDIT ALLOWABLE | (50% of tax)* | $34,817 |

APPLICABLE INVESTMENT CREDIT

| APPLICABLE INVESTMENT CREDIT | $35,500 |
| Less: Investment Credit on Return* | $34,817 |
| THEORETICAL INVESTMENT CREDIT (on accounting income less permanent differences—50% of 48% of $149,825)* | $35,958 |
| Less: Investment Credit on Return* | $34,817 |
| CARRY-FORWARD REALIZATION ASSURED WITHIN CARRY-FORWARD PERIOD (Assumed) | 683 |
| SMALLEST OF THE ABOVE | $683 |

SUMMARY OF DEFERRED TAXES

| DEFERRED TAX PROVISION—GROSS | $2,859 | $2,283 |
| APPLICABLE INVESTMENT CREDIT | (683) | (683) |
| DEFERRED TAX PROVISION—CURRENT | $2,176 | $1,600 |
| AMORTIZATION OF PRIOR DEFERRED TAXES (if provided) (at 52%) | (624) |
| DEFERRED TAX PROVISION—NET | $1,552 | $1,600 |

*NOTE: Income tax and investment credit computed without considering surtax exemption, etc.
carry-forwards are not recognized, however, deferred tax credits should be adjusted, to the extent of reversals due to occur within the carry-forward period; the adjustments should be reversed as the carry-forwards are realized.

Except in those rare cases where the benefit is recognized at the time of the loss, the tax benefits of carry-forwards should be considered extraordinary items when realized. Carry-forwards of purchased subsidiaries and carry-forwards arising prior to a quasi-reorganization, however, should be treated as adjustments of the purchase or "quasi."

THE UTILITY EXCEPTION

The examples and discussion so far have related largely to cases where deferred taxes would be provided. As mentioned at the beginning, however, the Addendum to APB Opinion No. 2 is still in effect. The Addendum generally is interpreted as meaning that deferred tax provisions are not required to the extent that rates are regulated on a "flow-through" basis, in order to match costs with revenues. The Addendum does not necessarily apply to intra-period tax allocation, but changes in the uniform systems, either adopted or under consideration, should eliminate most conflicts except where "flow-through" accounting for timing differences is employed. Accordingly, Opinion No. 11 may have little effect on most utility companies. In fact, for many utility companies, accounting regulation may preclude following the Opinion.

Regulatory authorities, of course, have not dealt with comprehensive tax allocation. Some commissions, however, have expressed very clear flow-through policies in rate proceedings with respect to liberalized depreciation. In most other jurisdictions, rate-making policy has been indicated indirectly. Evidence of this may be found in negotiations with companies, acceptance of rate filings, or perhaps in the underlying calculations used in a rate case or in regulation by surveillance. Where there is direct or indirect evidence that a regulatory commission uses flow-through rate-making, deferred tax accounting is unnecessary under the Addendum.

In some states it may be more difficult to find evidence of jurisdictional policy. This is particularly true in states where there is only partial
regulation or where regulation is by informal or semi-formal processes. I understand that this is so in several states, including Texas. It should be possible though, even in those states, to find some evidence of the rate-making policy. Generally, there should be some record of the negotiations leading to approval of rate schedules. This may, for example, be in the form of financial statements or schedules submitted in the course of the rate-making procedure.

Where there is evidence of the basis of regulation, it should be possible to decide whether deferred taxes are required. If flow-through accounting has been used in reports to the rate-making body, then flow-through accounting should be appropriate for financial purposes under the Addendum. Of course, on the other hand, if deferral accounting is used in the reports to the regulatory body, deferred taxes would be required in financial statements also.

To the extent that rates are entirely unregulated, the Addendum does not apply. When rates are set on a uniform basis, however, and when the unregulated service areas are comparatively minor, generally it would seem unnecessary to provide deferred taxes with respect to the unregulated areas only. If the effect of the unregulated areas is material, however, a deferred tax provision probably would be required to the extent applicable to such unregulated areas.

The principles outlined in the preceding examples would apply in cases where part of the operations are unregulated, but one or more additional classifications of differences would be needed—"special" (utility) differences and their reversals—for transactions or accounts subject to "flow-through" rate-making.

These special differences would have much the same effect as permanent differences on the "gross" deferral. Their effect on the investment credit presumably would depend on regulatory policy. Since some areas might well be unresolved, it is quite possible that deferred taxes would actually be provided on a piecemeal basis, and the "basic" method used as a test to determine whether a material difference resulted from transactions whose classification was not determinable.
I can foresee some interesting problems as we attempt to apply the calculations in complicated situations. In fact, many of us have already had the luck (or should I say misfortune) to meet such situations.