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Practical Aspects of Income Tax Allocation

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Accountants, Tulsa Chapter—December 1968*

IN OPINION 11 the Accounting Principles Board sought to conclude the longstanding debate over income tax allocation by affirming that the interperiod allocation of income taxes should be continued, by deciding that comprehensive rather than partial allocation is called for, and by prescribing the deferred as contrasted with the liability method.

My assignment is to discuss briefly the practical aspects of applying these decisions. There has been placed in your hands a set of simple exhibits, which may help you to follow my comments more easily.

TERMINOLOGY

It is necessary that a few basic terms be understood before we plunge into our subject.

Income taxes means all taxes based on income, whether they be federal, state, or foreign.

Income tax expense means the income taxes allocable to the period for purposes of determining book net income.

Pretax accounting income means book income before income tax expense.

Taxable income means the income (or loss) to be shown by the returns for the period.

Timing difference means an amount which enters into pretax accounting income in one period and taxable income in another.

Tax effects means the differences between income tax expense and taxes currently due arising from timing differences entering into the difference between pretax accounting income and taxable income. It does not include permanent differences. It does include *initial tax effects* which are tax differentials arising from timing differences originating in the period and the *reversal of tax effects* which are the tax differentials flowing from the reversal of timing differences

during the period. It also includes the effect of operating loss carryovers and carrybacks.

BASIC METHOD

The deferred method is simple in principle. The initial tax effect is recorded when the timing difference arises. The initial tax effect is reversed when the timing difference reverses. To illustrate, assume that A Company receives \$100,000 of advance rental in the year 1968 which is to be earned in the year 1969. The advance rental is included in 1968 taxable income, but is deferred and included in 1969 pretax accounting income for book purposes. If a tax of \$52,800 were paid on the \$100,000 in 1968, it would be credited to 1968 income tax expense, treated as a deferred charge on the asset side of the December 31, 1968 balance sheet, and included in 1969 income tax expense to match the rental revenue. See Exhibit A for the tax section of the income statements.

The first practical problem under the basic method is this: How is the initial tax effect measured?

The Opinion states: "The tax effect of a timing difference 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." This sentence bears close analysis.

It calls for two tax computations. The first would be based on taxable income. The second would be based on pretax accounting income with certain adjustments. The difference between the two computations is the initial tax effect.

EXHIBIT A

DEFERRED METHOD OF TAX ALLOCATION ILLUSTRATED

	1968	1969
Income before provision for federal income taxes.	\$1,000,000	\$1,100,000
Provision for federal income taxes:		
Current	573,650	497,175
Deferred	(52,800)	52,800
Total	520,850	549,975
Net income	\$ 479,150	\$ 550,025

The adjustments to pretax accounting income fall into two classes. The first class excludes all permanent differences. These would include such income items as municipal bond interest and life insurance proceeds. These would include such deductions as premiums on officers' life insurance, the deduction for certain dividends received, and statutory depletion in excess of cost depletion. The reasoning behind these adjustments is clear: They must be made because they do not relate to timing differences. The second class of adjustments which are to be made to pretax accounting income is the reversal of timing differences. The reasoning here is this: to measure the tax effect of a timing difference originating in one year, it must be isolated from the tax effect of timing differences which arose in prior years and are now reversing. See Exhibit B for an illustration of such a computation.

A final requirement is this: In computing the initial tax effect, net operating loss carryovers and carrybacks are not considered in either of the two computations.

Consider briefly a few practical problems:

State income taxes: Must they be considered? Yes is the answer, unless their effect is immaterial.

What if several types of timing differences arise in the same period? The Opinion states that similar timing differences may be grouped and this may simplify the mechanics. The word "similar," as used here, would appear to relate to two characteristics. First, it would appear proper to group items having similar initial tax effects. It would appear to be incorrect to group ordinary income or deductions with items entering into the capital gains subject to the alternate tax. Second, it would appear proper to group items having similar reversal periods. It would appear to be incorrect to group a provision for loss on a lawsuit that was expected to reverse in the next year with accelerated depreciation on a building that would turn around over a long period of years.

What if grouping does not reduce all timing differences to one class? It would be my opinion, apart from capital gains or other items requiring special tax treatment, that one would compute the initial tax effect of all classes combined and use the timing difference for each class as a basis for prorating to individual classes the aggregate initial tax effect.

The second aspect of the basic method relates to the reversal of the initial tax effect.

EXHIBIT B

COMPUTATION OF INITIAL TAX EFFECT—BASIC METHOD

	COMPUTATION BASED ON	
	TAXABLE INCOME	ACCOUNTING INCOME
Pretax accounting income	\$100,000	\$100,000
Adjustments:		
Permanent difference—Municipal bond interest .	(5,000)	(5,000)
Reversal of timing difference—Excess of book over tax depreciation	2,000	2,000
Timing difference—Excess of tax over book de- preciation	(10,000)	
Income, as adjusted	\$ 87,000	\$ 97,000
Federal tax:		
22% of \$25,000	\$ 5,500	\$ 5,500
48% of excess	29,760	34,560
Total	35,260	40,060
Surcharge—10%	3,526	4,006
Total	38,786	44,066
		38,786
Initial tax effect		\$ 5,280

Some timing differences reverse in one period and present no problems. Advance rental received in one year and applicable to the next and a provision for loss made in one year and paid in the next are typical examples.

Others are more complex. When instalment sales are taken into pretax accounting income in the year of sale, the initial tax effect will be amortized as the profit is reported for tax purposes over a period of months or years. When a provision for self-insurance is made, the initial tax effect will be amortized on the basis of losses paid and the final adjustment of the provision to actual losses sustained.

The use of percentage-of-completion method on the books and the completed-contract method for tax purposes may present a situation in which initial tax effects may accumulate for two or more years and be reversed in the year of completion.

Tax depreciation on one year's property acquisitions may exceed book depreciation for several years and be followed by a period of years in which the reverse is applicable.

See Exhibit C for illustrations of reversals of three types of timing differences.

It seems obvious that subsidiary records to account for tax allocation are called for. In essence, each group of initial tax effects will be set up, by years and cumulatively in some cases, so that amortization for purposes of recording reversal can be calculated.

THE INCREMENTAL METHOD

If my comments suggest burdensome record-keeping, two observations may be comforting:

- The Board emphasizes that the Opinion "is not intended to apply to immaterial items." Small timing differences may be ignored. Amortization which only approximately matches the reversal of timing differences should be adequate.
- The Board recognizes an acceptable alternative to the basic method. It is called the incremental method.

Under this method, tax effects are based on the annual net change in the timing difference so that the computation of the initial tax effect and its amortization as separate steps is not necessary. To illustrate, assume that accumulated depreciation at the beginning of the year is \$400,000 per books and \$500,000 per the tax return. Assume that at the end of the year the amounts are \$450,000 and \$600,000, respectively. The cumulative timing difference has increased from \$100,000 to \$150,000, and the tax effect is computed on the net increase of \$50,000 at the rates for the year. The simplicity of this approach is obvious. The \$50,000 may include timing differences arising during the year, reversals of timing differences existing at the first of the year, reversals due to retirements, etc. See Exhibit D for an illustration of a computation under the incremental method.

The theoretical flaw in the incremental method is this: If effective tax rates change, tax effects may be recorded at one rate and reversed at another. It is entirely possible that in many cases the error may be unimportant.

The incremental method, I suspect, will be widely used. It can be used only if deferred taxes have been provided, historically or retroactively, on the cumulative timing differences existing at the beginning of the year.

EXHIBIT C

REVERSAL OF TIMING DIFFERENCES—BASIC METHOD

	<u>TIMING DIFFERENCE</u>	<u>TAX EFFECT</u>		
Profit on installment sales accrued—1968	\$100,000	\$52,800		
Profit reported for tax purposes:				
1969	\$ 25,000	\$13,200		
1970	50,000	26,400		
1971	25,000	13,200		
Total	\$100,000	\$52,800		
Profit accrued on long-term contract on percentage- of-completion basis:				
1968	\$ 25,000	\$13,200		
1969	50,000	25,200		
1970	25,000	12,000		
Total	\$100,000	\$50,400		
Profit reported for tax purposes—1970	\$100,000	\$50,400		
Accelerated depreciation—1968 additions \$100,000 with five-year life:				
	<u>BOOK</u>	<u>TAX</u>		
1968	\$20,000	\$40,000	\$20,000	\$10,560
1969	20,000	24,000	4,000	2,016
Total	\$40,000	\$64,000	\$24,000	\$12,576
1970	\$20,000	* \$12,000	\$ 8,000	\$ 4,192
1971	20,000	* 12,000	8,000	4,192
1972	20,000	* 12,000	8,000	4,192
Total	\$60,000	\$36,000	\$24,000	\$12,576

* Switched to straight-line method.

FINANCIAL STATEMENT PRESENTATION

The Opinion lays down a few rules concerning the presentation of deferred taxes in financial statements.

The income tax expense in the income statement should be disclosed in three elements by separate amounts, footnote, or parenthetically:

- Taxes currently payable

- Tax effects of timing differences—that is, deferred taxes and their reversal
- Tax effects of operating losses

Although the Opinion is silent at this point on the matter of the investment credit, it appears to me that disclosure of the use of the credit to reduce taxes currently payable or deferred taxes is called for.

Although deferred tax debits and credits may relate to various items under the comprehensive theory of income tax allocation, the Opinion calls for simplified presentation in the balance sheet. All deferred tax debits and credits are to be combined into two categories. One is to be the net current amount which will appear as a current asset or a current liability, depending on whether the net amount is a debit or credit. The second is to be the net noncurrent amount, which will appear as a non-current asset or a noncurrent liability, depending on whether the net amount is a debit or credit. Classification as current or noncurrent is determined by the classification of the related asset or liability. Thus, a deferred tax credit arising from accelerated depreciation would be shown as a noncurrent liability, while a tax credit relating to uncollected instalment receivables included in current assets and a deferred tax debit relating to a provision for warranties included in current liabilities would both be grouped as current, and in one net figure.

OPERATING LOSSES

Let me conclude with a word concerning operating losses, which will prove to be the most complicated part of this Opinion.

First of all, the Opinion has a word to say concerning tax refunds arising from carrybacks and tax savings resulting from carryovers. Realizable loss carrybacks are to be recognized in the loss year, and the loss of such year is to be reduced by the prior taxes it causes to be refundable. Tax savings arising from carryovers are to be recognized in the loss year only “in those rare cases in which the tax benefits of the loss carryforwards is assured beyond any reasonable doubt.” In the vast majority of cases, the tax benefit of the carryover will be recognized in the year or years in which the same is utilized; and since the tax saving thus produced arises from the prior loss year, the tax saving is to be reported in the income statement as an extraordinary item. In such case,

EXHIBIT D

INCREMENTAL METHOD ILLUSTRATED

	COMPUTATION BASED ON	
	TAXABLE INCOME	ACCOUNTING INCOME
Pretax accounting income	\$1,000,000	\$1,000,000
Adjustments:		
Permanent differences	(50,000)	(50,000)
Cumulative timing difference:		
Beginning	100,000	
End	(150,000)	
Income, as adjusted	\$ 900,000	\$ 950,000
Federal tax:		
22% of \$25,000	\$ 5,500	\$ 5,500
48% of excess	420,000	444,000
Total	425,500	449,500
Surcharge—10%	42,550	44,950
Total	468,050	494,450
Tax effect		\$ 26,400

income before the extraordinary income would be charged with income tax expense before reduction by the carryover loss effect.

So far so good, but this may be only half of the problem. What about net deferred tax credits or debits arising from timing differences?

The Opinion is silent regarding net deferred tax debits. The Opinion contains two references to net deferred tax credits. In discussing realizable operating loss carrybacks, it states; "Appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period." In discussing operating loss carryforwards, it further states: "In the usual case when the tax effect of a loss carryforward is not recognized in the loss period, adjustments of the existing net deferred tax credits may be necessary in that period or in subsequent periods. In this situation, net deferred tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carryforward, or (b) the amortization of the net deferred tax credits that would otherwise have occurred

during the carryforward period. If the loss carryforward is realized in whole or in part in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit accounts should be reinstated (at the then current tax rates) on a cumulative basis as, and to the extent that, the tax benefit of the loss carryforward is realized.”

In the first-mentioned reference where only realizable loss carrybacks exist, it would be my opinion that deferred tax credits would require adjustment to the extent that the carryback altered the initial tax effect as computed in the income years less amortization to date. To illustrate as simply as possible, assume excess tax depreciation of \$10,000 claimed in 1967 and a deferred tax credit of \$5,200 accrued at December 31, 1967, the first year of a company's operation. If in 1968 a loss occurs which exceeds the 1967 income, it would appear proper to reverse the \$5,200 deferred tax credit because there has been no tax cost, and therefore no tax effect, to December 31, 1968.

The rationale of the elimination of net deferred tax credits in the case of unrecognized loss carryforwards, it seems to me, is this: If there is no certainty that future income will exist, there is no certainty that the reversal of a timing difference such as excess tax depreciation will cost additional future taxes. Therefore, the deferred tax credit is eliminated, subject to the limitation described, and is reinstated when and if income to offset the loss carryforward materializes.

CONCLUSION

We have covered a lot of ground in twenty minutes. My object has been to state basic principles. Income tax allocation is not simple. My purpose has been served if you now have a healthy respect for what can be a difficult subject.

