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THE HISTORY OF ACCOUNTING FOR INCOME TAXES: THE MAJOR ISSUES AND THE ACTIONS – AN OVERVIEW

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The current requirements for accounting for income taxes for external reporting purposes are embodied in Statement of Financial Accounting Standards Number 96. Although the date this statement will become a requirement has been delayed, this particular rule follows a long line of efforts to deal with and finally and completely establish the procedures for such accounting. This extended abstract details the chronology of events leading to SFAS #96, and the controversy surrounding its implementation.

This history of accounting for income taxes begins with Article One of the Constitution, which allows for the collection of taxes for the payment of debts and the defense and general welfare of the nation. In the century that followed the framing of the Constitution, the U.S. government imposed income taxes as needed to wage war, or meet other institutional emergencies. These particular taxes did not generally outlast the specific events which caused the pressing need for such funding, however. In addition, over time, Supreme Court interpretations of the original wording in the Constitution limited the power of the government to impose income taxes. Finally the Sixteenth Amendment to the Constitution, which officially authorized Congress to levy income taxes, was proposed and ratified, effective February 25, 1913. [Ratner, 1942]

Since that time, many changes have occurred in the practice of accounting for income taxes. Initially, the accounting profession concentrated simply on how to record the tax. Eventually, however, the nature of the tax became an issue as well. Over time, the corporate income tax was identified, alternatively, as a cost of doing business or effective sales tax passed on to the consuming public, an expense or charge against income on the income statement recognized before determining net income, or a distribution of profits because the payment of taxes reduced the dividend available to the investors. The editor of the Journal of Accountancy concluded that

> the question seems to demand further research and discussion. The issues have not yet been sufficiently clarified to warrant any definite conclusion at this time.
>
> [Carey, June 1944]

In a symposium published in the Journal in October 1944, diverse opinions fostered by the above editorial were presented. [Symposium, 1944] The discussion prompted the editor to comment:

> It is impossible to appraise the economic and social effects of the corporate income tax until its essential nature and the points of its incidence are recognized. Until then, also, the proper accounting for this tax in corporate books and financial statements will be a subject of debate.
>
> [Carey, October 1944]

Chronology of Significant Events:

December 1944 – The Committee on

Accounting Procedure (CAP) issued Accounting Research Bulletin (ARB) Number 23 which identified the income tax as an expense, and that permanent and timing differences existed between accounting income and taxable income. Allocation was restricted to nonrecurring "material and extraordinary" timing differences, which could be "reflected in (a) surplus accounts; (b) deferred-charge accounts; (c) reserve accounts." [AIA, 1944]

November 1946 – The SEC issued Accounting Series Release No. 53 which "reached conclusions basically in accord with Accounting Research Bulletin No. 23," although it did limit the options mentioned in the Bulletin. [Carey, 1946]

June 1953 – ARB #43 replaced all ARBs issued between September 1939 and January 1953. This statement essentially reiterated ARB #23, with the exception of minor terminology changes and the authorized use of "a current over-all effective rate" or "an estimated future tax rate." The Committee continued to limit recognition to nonrecurring items only. [FASB, 1987]

The debate over the treatment of income taxes received even more impetus when the Internal Revenue Act of 1954 authorized the recognition of accelerated depreciation for income tax purposes in order to encourage increased capital investment. This act widened the gap between taxable income reported for tax payment purposes and accounting income reported for external reporting purposes because financial statement preparers were not required to use the same methods.

October 1954 – In ARB #44, the deferred income taxes did not need to be recognized unless the deferral was nonrecurring and material. [Editorial, 1958; FASB, 1987]

July 1958 – ARB #44 (Revised) required that deferred income taxes be recognized, if material, no matter how indefinite or long the period that the taxable income differed from the reported income, and recurring items were now included in the allocation. The Committee recognized that even though the uncertainty of future income and tax rates made any predictions concerning these numbers suspect, and made the associated deferred tax calculation unreliable, the disadvantages of any unreliable values were outweighed by the distortion of income that would be caused by the absence of this information.
[Editorial, 1958; FASB, 1987]

August 1959 – The Committee created controversy, however, because it used the term "deferred tax account" without specifically defining its meaning. Under pressure from the profession, therefore, it issued a letter in August 1959, indicating that it "used the phrase in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit." [Official Releases, 1959]

February 1960 – The SEC issued Accounting Series Release (ASR) #85 which essentially agreed with ARB #44 (Revised). [Rappaport, April 1960] Unfortunately, the SEC inadvertently overextended its statement to imply that allocation would be required beyond current GAAP. This alarmed the general accounting profession. Therefore, in ASR #86, issued shortly thereafter, the Commission acknowledged that it was not its intent "to make mandatory the use of deferred tax accounting beyond the requirements of generally accepted accounting principles." [Rappaport, June 1960]

Despite the pronouncements, the treatment of interperiod tax allocation was far from uniform. [Nurnberg, 1971] Accounting Research Study No. 9, "Interperiod Allocation of Corporate Income Taxes," served to crystallize the arguments over the issue. The author of the study, Homer

Black, acknowledged the growing acceptance of some kind of allocation, but also recognized that treatment of the issue in practice was not consistent. He identified three underlying concepts that explained all the variations currently in practice, the liability concept, the deferred concept and the net of tax concept. He found that

> Each of the three concepts has been supported in the literature and to some extent in AICPA pronouncements and SEC Accounting Series Releases. The Accounting Research Bulletins imply support for all three concepts and do not select one to the exclusion of others.
> [Black, 1966]

He also recommended the comprehensive approach, which involved allocation of both recurring and nonrecurring differences between taxable income and accounting income.

December 1967 — Accounting Principles Board (APB) Opinion #11 was issued which supported the use of the deferred method in conjunction with comprehensive interperiod allocation of the timing differences between taxable income and accounting income. Under the deferred method, the impact on the balance sheet of these timing differences would be the recognition of deferred charges and/or deferred credits which would reverse in future periods. The account(s) did not constitute "receivables or liabilities in the usual sense," and would be classified as current or noncurrent depending on the classification of the related asset or liability. [APB, 1967]

July 1980 — The FASB amended APB Opinion #11 and issued Statement of Financial Accounting Standards (SFAS) #37 which recognized that in some instances no related asset or liability existed. In these cases, the deferred tax account would be classified as current or noncurrent depending on the expected period in which timing differences would reverse. [FASB, 1987]

December 1987 — SFAS #96, Accounting for Income Taxes, was issued effective for fiscal years beginning after December 15, 1988. Adoption of the new statement has been delayed until 1990 by SFAS #100, at which time it will supersede APB Opinion #11. Until that time, firms may still use the deferred method for recognizing interperiod tax allocation. Subsequently, the Board will require the use of an asset and liability approach, however. This will result in the recognition of a deferred tax liability or asset for temporary differences between the tax basis and book basis of assets and liabilities, although recognition of the deferred tax asset will be limited. The accounts will be classified as current or noncurrent based on criteria specified in the statement. Both the deferred tax liability or asset will be adjusted as necessary to conform to changes in the tax laws, or tax rates. The comprehensive method of interperiod tax allocation will also still be required. [FASB, December 1987; FASB, 1988] The statement is extremely controversial and will be very difficult, time consuming and expensive for most firms to enact in practice.

The history of accounting for income taxes, even though I have limited the discussion, is very complicated. Numerous outside interests have influenced decisions on the procedures used to account for income taxes. The profession does not operate in a vacuum, but must be reponsive to a changing environment. The results often are imperfect solutions to problems that evolve over time. Accounting for income taxes will continue to be an issue of concern to the profession. Of course, one solution may be to consider, as an alternative suggestion, that

> a more logical approach to the problems resulting from differences ex-

isting between accounting income and taxable income is to revise the provisions of the Internal Revenue Code to conform more nearly with generally accepted accounting principles.

[Johns, 1958]

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QUOTABLE QUOTES ABOUT TAXES

It is a sad commentary on political honesty to compare the 1913 tax law with that of 1938, and the endless procession of laws in between. "Soak the rich without regard to honesty" should be the official title of the present law. "Take from those who have and give to those who have not" is the theme. The use of a tax on income as a means of social reform is common in an autocracy but novel in a democracy.

In our country it has produced billions of dollars in revenue which is used to pay for killing little pigs, for not raising peanuts, and for 1,000 other purposes which have tended and will continue to tend to check thrift, ambition, and incentive on the part of anyone who has any money left to embark on new enterprises.

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FIFTY YEARS OF ACCOUNTANCY; p. 123, PART II. "Taxes and how I was forced into the practice of Law"