1946

Accounting for Income Taxes,

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ACCOUNTING FOR INCOME TAXES

A Discussion of Certain Phases of the Subject
presented at the Technical Session upon
Developments in Accounting Procedures
at the Meeting of the American Institute of Accountants
October 1, 1946

By Anson Herrick

Any discussion of accounting for income taxes naturally brings to mind Accounting Research Bulletin #23, issued nearly two years ago. The procedures proposed by that bulletin seem to have become generally accepted but I have found a sufficient number of published statements which have not followed its requirements to make it evident that such acceptance is not yet universal. Further, the acceptability became temporarily clouded by Accounting Release #53 issued by the Securities and Exchange Commission. In that release, the Commission objected to one of the two alternative procedures proposed by the bulletin to meet a particular situation and this led to a first impression that the Commission opposed the entire bulletin. However, analysis of the release made it evident that the Commission, by accepting the alternate procedure which accomplished equally the end sought by the bulletin, had reached conclusions basically in accord with those of the Committee on Accounting Procedure.

The acceptance of the procedures set forth by Bulletin #23 to meet the situations with which it deals has been sufficient to make repetitious any supporting argument. However, the committee's view that "income taxes are an expense" appears to be quite controversial and, incidentally, is one with which the Chief Accountant of the Securities and Exchange Commission informally has indicated disagreement. Consequently, it will not be amiss to point out that the procedures recommended by Bulletin #23 do not rest upon that view alone and that, while the acceptance of that view may facilitate, it is not necessary to, the acceptance of the particular procedures recommended.*

While I, personally, subscribe to the committee's view, I do not think the question of sufficient importance to warrant argument. If the view be taken that income taxes are a "sharing of earnings" it still would be essential to show the amount to be distributed in proper relation to the earnings reflected by the income statement. Such a view, from the standpoint of the accounting requirements, places the Government in a position comparable to that of an executive having a special profit sharing contract the provisions of which contemplate a basis for the computation of profits to be shared differing from that adopted by the corporation for the determination of its annual income. Such a contract might contemplate that sales profits to be shared were to be determined only upon the collection of related accounts receivable. In that event there would be a clear necessity for an accrual of the profit to be distributed upon such collection.

I doubt that in such a circumstance any accountant would approve an income statement or the related balance sheet which excluded such an accrual. How then, even though income taxes are considered as profits shared, can we accept as proper an income statement which includes income which, due to statutory provisions, will not be taxed until later, or a balance sheet which excludes the liability therefor? Surely the contingency that tax rates when the income will be taxed may be different is not a sufficient uncertainty to justify the omission. The existing carryback and carryforward

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*See letter of Carman G. Blough at page 151 of Vol.79(Feb.1945) of Journal of Accountancy.

provision of the taxing act makes even less probable that no tax will be paid because the item will affect the tax refund computation in a year of loss.

The practice, and the Securities and Exchange Commission requirement, of a separate showing of taxes measured by income seems to have developed the idea that the <u>amount of taxes currently to be paid</u> was something sacrosanct. I believe that, except as informative notation, there is no more requirement for always making the amount of taxes currently payable, as opposed to the applicable tax cost, an item of the income account than there is to require that the income account show rental payments, royalty payments, or interest payments which are not applicable to the particular income account. The situation would be clarified I feel if income taxes were always thought of in terms of a <u>"tax cost"</u> rather than as taxes payable. There is no sound reason why we should not recognize the requirement of an inclusion within the tax cost of a year of the prospective taxes on income which is untaxed when taken up in the income statement but which will be taxed in the future. Similarly, I know of no sound reason why we should not consider as a deferred charge taxes paid upon taxable income excluded from the statement either through a deferring of an income item for purposes of the income statement or through a charge to create a reserve the expenditures against which will be a matter of future tax effect. It should be obvious that to do otherwise too frequently would result in a clear failure to match properly cost against income which is one of the main objectives of sound accounting.

Bulletin #23 did not purport to cover the entire subject of the treatment of income taxes in financial statements. Among the situations not considered are the following:

(1) Where the income account includes charges which are not deductible for purposes of taxation other than where the nondeduction is due to the item having been deducted in a prior year.

(2) Where the income account includes credits for unused reserves the earlier charges to provide which were not deductible.

(3) Where the income account includes income upon which taxes had been paid in the past.

(4) Where income deferred because applicable to a future period is taxed in the year of its receipt.

(5) Where the allocation of taxes against several sources of income may be desirable.

These are appropriate of consideration at this time and, as they have not been the subject of committee pronouncement, what I will say is to be taken only as an expression of my own views.

Situations in which the income account includes charges which are not deductible for purposes of taxation, other than where nondeduction is due to deduction in a prior year, are concerned with (1) charges to establish reserves the future charges against which will be deductible; and (2) charges to writedown the book amounts at which capital assets are carried which will be deductible upon their sale or abandonment. In such situations a failure to recognize the principle of tax allocation clearly results in the stated income of the year in which the reserve is established, or the writedown is taken, being artificially reduced by an amount which will operate to increase the stated incomes of the years during which the costs for which the reserves have been created are incurred or the written down property is sold. The importance of this is increased by recognition that in the establishment of reserves for estimated accrued costs, or in the timing of property writedowns, judgment of management must be the determining factor with the consequence that an absence of a proper computation of tax cost opens the door to profit manipulation to the end that income of a year will be deferred to future periods. Accordingly, I believe that where the income account includes such charges, the effect of which will be to reduce by significant amounts the taxes payable in future years, that part of the tax paid which is equal to the lesser of (1) the tax paid due to the nondeduction of the charges or (2) the estimated reduction of future taxes, should be treated as a deferred charge to be amortized as an additional tax cost of the years during which the expenditures against the reserves are incurred or the prospective losses are realized. This suggestion of treating a part of a tax payment as a deferred charge may seem radical. But is the propriety any more to be questioned than the propriety of deferring an advance payment of rent or, for that matter, is the carrying of a deferred charge respecting a future tax cost any more to be criticized than the carrying as a deferred charge of preferred stock or bond discount? It is directed towards a more accurate matching of costs and income. It is nothing more than setting up a reserve, or recording a writedown, on a "net" basis and if a deferred tax cost seems too heretical to accept, merely offset it against the reserve and thus satisfy your conscience.

In the case of writedowns of property carrying values, I admit that the objection may be raised that there may be no expectation of the property being currently disposed of with the result that the realization of the deferred tax cost may be so long deferred as to make it unrealistic to carry it as an asset or as a reserve offset. To such objection I answer that to the extent that the property is depreciable the deferred charge will be subject to partial realization each year and that if the property is not depreciable and loss realization sale is not contemplated the write-down becomes a mere juggling of balance sheet amounts which should not enter into the income statement.

The case of income account credits for unused reserves is the other end of the problem created by the nondeductible charges for their establishment. If, when the reserve was established, a deferred tax cost had been set up the remainder would be related to the unused reserve and would be charged off as an additional tax cost of the year in which the unused reserve was returned to income. Such procedure would be wholly consistent with the procedure provided by Bulletin #23 for the accounting of tax reductions incident to deductible expenses excluded from the income account by charge to reserves. If there had been no consideration of a tax cost adjustment when the reserve was established then, as two errors do not make one right, it would seem reasonable to make a return to income on a net basis and credit the remainder of the reserve to surplus as a correction of an error of a prior year.

The situations in which the income account includes income upon which taxes have been paid in the past and in which deferred income is taxed in the year of its receipt are two ends of the same problem. Rental received in advance, under our existing tax statutes, is taxed in the year of its receipt and consequently the related tax is even more clearly appropriate of being accounted as a deferred charge than in the preceding situation of a nondeductible income charge.

So treated the deferred charge becomes applicable as an additional tax cost in the year in which the deferred item is brought into the income statement.

It should be clear that the avoidance of such a procedure does nothing more than artificially to reduce the stated net income of the year in which the deferred income is received and artificially to increase that of the year in which it becomes realized.

It probably should be unnecessary to point out that the procedures suggested, as well as the procedures set forth to meet the situations considered by Bulletin #23, are necessary of adoption only where the items involved are significant. The element of significance, however, should be determined by consideration of all of the related factors and not alone by the amount of tax involved. An amount of tax cost may be a relatively small percentage of the total income charges and yet the difference between true tax cost and tax payable may be an important percentage of the latter or of the net income. The tax cost in one year may not be significant but, as in the case of increasing installment sales, the effect of avoiding the correct procedure may be cumulative and soon result in significant understatement and overstatement, respectively, of tax accruals and surplus.

The general practice of considering the element of income taxes as a final deduction in the income statement has led away from the thought of allocation of the cost between the several items that affect income but it is beginning to be recognized that there are circumstances in which such an allocation increases the usefulness of an income statement and, in particular circumstances, it may be necessary if misleading inferences are to be avoided. It is not infrequent for an income statement to include extraordinary or infrequently recurring items of income or loss and unless there be an allocation of the tax cost the statement does not set forth fairly the results of ordinary operations or of the true income or true loss incident to the extraordinary items. Consequently, I believe that in all cases in which the statement includes such items of any appreciable significance an allocation of tax cost is desirable.

There is one other point I would mention. While no accounting will be required where variations between taxable and stated income before tax cost are due to items nondeductible or nontaxable because of statutory prohibition or exemption, and while it is recognized that a reconcilement between taxable and stated income is not usually to be considered a requirement of proper disclosure, there will be cases in which variations due to such causes will be of sufficient significance to require a note of explanation. Here also the question of what constitutes sufficient significance is one of judgment to be determined by the accountant.

To recapitulate, I believe that where taxable income exceeds stated income before provision for tax cost due to charges which are nondeductible because they anticipate realization, or to the deferring of income taxed on its receipt, the tax to be paid for the year should be reduced to a tax cost applicable to the stated income by a deferring of an appropriate amount to be applied as added tax costs of appropriate future years. Such belief, and the procedures which I have proposed, are, I believe, consistent with the procedures proposed by Bulletin #23 to care for other problems.

I point out, in conclusion, that I have not touched upon problems of accounting for income taxes that arise in consolidated statements. Some of these are most interesting and I should like to discuss them but time does not permit.

Resume of variations between corporate stated income before tax cost and taxable income

			Considered by:
Stated income greater than taxable income	Due to: Inclusion in Income Stmt. of nontaxable income	Income exempt by statute	
		Income previously taxed - 1 Income taxed when rec'd but deferred in stmt.	Item 3 herein
		2 Return to income of unused reserves the chgs. to create which were nondeductible	Item 2 herein
		Income to be taxed in the future	B#23 Par.10
		Tax refunds due to E.P.Tax Cr. carryback	B #23 Par.6
	Deductible costs excluded from income statement	Percentage depletion & other statutory deductions	
		Expenditures against reserves the chgs. to create which were nondeductible	B #23 Par.4
		Expenditures deferred for chge. against future income	B #23 Par.4
		Expenditures chgd. to surplus	B #23 Par.3
		Losses brought forward	B #23 Par.7
Stated income less than taxable income	Due to: Nondeductible income charges	Statutory prohibition	
		Previously deducted 1 Amortization of deferred costs deducted when incurred	B #23 Par.4
		2 Deprecn. of emergency facilities deducted but not written off or reestablished	B #23 Par.4
		To be deducted in the future 1 Provision for reserves	Item 1 herein
		2 Writedown of asset carrying value in anticipation of loss realization	Item 1 herein
	Exclusion of taxable income	Income deferred in statement but taxed when received	Item 4 herein
		Income credited to surplus	B #23 Par. 2