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1959

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Recommended Citation
Haskins & Sells Selected Papers, 1959, p. 135-142

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Allocation of Federal Income Taxes

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Presented before the Tulsa Chapter of the Oklahoma Society of Certified Public Accountants—December 1959

THE principal problem of federal income tax allocation stems from the differences in determining income for financial statement purposes under generally recognized principles of accounting and in determining taxable income under the provisions of the income tax laws.

The Code, the regulations, and other pronouncements of the Treasury Department establish the rules as to what items are to be included in gross income and what items are to be deducted therefrom in arriving at taxable net income. When these rules conform to generally accepted accounting principles in all respects there is then no question but that the income tax computed represents a proper charge to book income for the year.

There are, however, many differences between the rules for ascertaining taxable income and the rules for reporting net income under generally accepted accounting principles. This results in an income tax actually payable that is not matched with revenue and other costs included in the income statement for the year. In such a case it may be decided to provide for an income tax expense in the income statement in an amount that is based on book income rather than on the actual income tax computed under the Internal Revenue Code.

Allocation of income tax generally falls into three major classifications: (1) allocation within the income statement itself, (2) allocation between the income statement and the surplus statement, and (3) allocation with respect to accounting periods. It is only with respect to this third class that the reason or necessity for allocation of income tax expenses arises from differences between book net income and taxable net income computed under the IRC. The first two types of allocation are discussed briefly, and the third type at greater length, in subsequent paragraphs.

ALLOCATION WITHIN INCOME STATEMENT

The first classification (allocation within the income statement

itself) does not appear to present any momentous problems. The total income tax estimated to be legally due is merely split within the income statement. Neither the final net income reported for the year nor the balance sheet is affected. An example of this type of allocation would be where a steel mill sold its coal mining properties and included in its income statement the tax applicable to the profit on the sale separate from its tax on other items. Another example is contained in the published annual report of E. I. DuPont de Nemours & Company where in its income statement it deducts from its operating income the provision for taxes on operating income in ascertaining net operating income. It then deducts from other income (which includes a large item of dividends on General Motors Corporation common stock) the provision for taxes on other income in determining net other income.

ALLOCATION BETWEEN INCOME AND SURPLUS STATEMENTS

The second classification (allocation between the income and surplus statements) is discussed in Accounting Research Bulletin 43, Chapter 10, Section B (which was the old Bulletin 23 issued in 1944). Here the Committee on accounting procedure recommended that when a transaction resulting in a material increase in income taxes is credited to surplus, the amount of tax attributable thereto should be charged to surplus and conversely, when a transaction resulting in a material decrease in income taxes is charged to surplus, the tax deduction should be recorded as a reduction of such a charge.

The Committee suggested that, although the amount of tax attributable to a credit to surplus should be charged to surplus, the entire amount of income tax due be shown in the income statement and the portion charged to surplus be shown in the income statement either as a deduction from the actual tax due or as a separate credit.

With respect to a surplus charge, the Committee recommended that, although the tax deduction attributable thereto should reduce the charge to surplus, the tax allocation also be reflected in the income statement. It recommended that this disclosure in the income statement be made in either of two ways: (1) the provision for income taxes be shown as if surplus charge were not deductible, the total amount of tax legally due for the year being indicated (presumably parenthetically or in a footnote), or (2) a special charge to income be made in an amount equal to the tax reduction resulting

from the surplus charge. The Securities and Exchange Commission rejected the first method. It objected to showing in the income statement a provision for taxes in excess of the actual taxes believed to be payable.

ALLOCATION AMONG DIFFERENT ACCOUNTING PERIODS

The remainder of my discussion deals with the third major classification of tax allocation (allocation among different accounting periods) which affects both the income statement and the balance sheet. Although discussed briefly in Bulletin 23 in 1944, it gained prominence when the government started issuing certificates of necessity during the Korean action under which all or part of the cost of so-called emergency facilities could be amortized over a period of sixty months for income tax purposes.

When issuing certificates permitting a five-year write-off, the certifying authority gave consideration to factors other than the probable useful life of the facilities. The government was offering an incentive to private industry to expand its productive capacity in the interest of national defense during an emergency period. However, in many instances the useful life of these facilities exceeded the five-year period, and depreciation recorded in accordance with sound financial accounting procedures was materially less than the amortization permitted for income tax purposes. Consequently, income taxes actually payable during the five-year period were less than the amount would have been if based on book income. At the end of the five-year period the situation would be reversed.

ACCOUNTING RESEARCH BULLETIN 43

Accounting Research Bulletin 42 (now Chapter 9 of Bulletin 43) issued in 1952 dealt with this problem. The Committee stated that during the amortization period, where the difference is material, a charge should be made in the income statement to recognize the income tax to be paid in the future on the difference between book depreciation and tax-return amortization. The Committee further stated that in accounting for this deferment of income taxes it believed it desirable to treat this charge as being for additional income taxes and the related credit as being properly entered in the balance sheet to an account for deferred income taxes. At the end of the five-year period when no further deduction would be available for

tax purposes the annual charge for income taxes would be reduced by charging to the account for deferred income taxes an amount equivalent to the resulting increase in income taxes. This, according to the Committee, would more nearly reflect a proper matching of costs and revenues. It was considered acceptable, although not preferable, to give effect to the amount of deferred income taxes by charging the income account with an equivalent amount for additional amortization or depreciation and crediting the related accumulated amortization or depreciation account in the balance sheet with corresponding reductions following the amortization period.

Bulletin 42, like Bulletin 23, dealt with material and extraordinary items and did not apply to differences between the tax return and the income statement that were expected to recur regularly over a long period of time.

When the Revenue Code of 1954 was enacted new problems were posed with respect to differences between tax and book income. Most taxpayers take advantage of one of the methods of accelerated depreciation permitted by the Code but many of them properly do not employ these methods in computing book depreciation.

ACCOUNTING RESEARCH BULLETIN 44

In 1954, Bulletin 44 entitled "Declining-balance Depreciation" was first issued, which was intended to deal with these problems. Its conclusions applied also to other methods of accelerated depreciation including the "sum-of-the-years-digits" method. The Bulletin as first issued contains the following statement:

> There may be situations in which the declining-balance method is adopted for tax purposes but other appropriate methods are followed for financial accounting purposes. In such cases it may be that accounting recognition should be given to deferred income taxes. However, the Committee is of the opinion that, in the ordinary situation, deferred income taxes need not be recognized in the accounts unless it is reasonably certain that the reduction in taxes during the earlier years of use of the declining-balance method for tax purposes is merely a deferment of income taxes until a relatively few years later, and then only if the amounts are clearly material.

One member of the Committee assented with qualifications and another member dissented to the Bulletin. The opinions of these

two members were especially significant because they indicated changes in thinking from previous official pronouncements. Both individuals expressed a belief that deferred income taxes should be recognized in every case in which the amounts concerned are significant. They were also of the opinion that *the number of years concerned has no bearing on the problem.*

BULLETIN 44 REVISED

I shall not dwell any longer on the original Bulletin 44 since a revised Bulletin 44 was issued in July 1958. The revised Bulletin appeared to reverse the earlier pronouncement with respect to the length of time-differences and to follow the opinions of the two individuals who took exception to the original Bulletin. The revised Bulletin seems to make it clear that in situations where accelerated depreciation is adopted for income tax purposes but other appropriate methods are used for financial accounting purposes, accounting recognition should be given to deferred income taxes if the amounts are material, even though facilities are to be continually replaced or expanded, with the results that the tax deferment built up would in total appear to be permanent, and even though the annual provision for income tax purposes and for accounting purposes would tend to become equal in the long run.

The Bulletin makes an exception to this rule (provided full disclosure is made) in those situations where state regulatory commissions do not recognize deferred income taxes for public utility rate-making purposes, and it is expected that increased future income taxes will be allowed in future rate determinations.

This Bulletin also permits the handling of the income tax deferment through the depreciation or amortization accounts when it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period.

Four years had elapsed between the enactment of the Revenue Code of 1954 and the issuance of this Bulletin. The Bulletin does not suggest that retroactive adjustments be made where there was no accounting recognition of deferred income taxes for the intervening years. It does provide, however, that the provisions made for periods subsequent to its issuance be based upon all assets acquired after 1953 as to which the declining-balance method has been elected for tax purposes. The Committee stated that *if* a retroactive adjustment

were made for prior periods, the adjustment could be made in a lump sum or the deficiency could be systematically accumulated over a reasonable future period of time.

Although Revised Bulletin 44 was adopted unanimously, five members assented with qualification.

Two members objected to making exceptions to the rules in those cases where there are conflicts with regulatory commission procedures. They were of the opinion that rate-making rules in conflict with accepted principles do not sanction a departure from these principles in financial reporting.

Two other members were of the opinion that the Bulletin called for more extensive allocation of income taxes among periods of time than is necessary or desirable, especially where the situation is such that the so-called tax deferment is in effect a permanent tax reduction.

This Bulletin does not deal entirely with deferred income taxes. As a matter of fact it is a bulletin on depreciation. It recognizes at the outset that the declining-balance method of depreciation may be quite proper for financial accounting purposes and in such instances it is appropriate to change to this method if the change including the effect thereof is disclosed in the year in which the change is made. Three of the Committee members felt that since this was a bulletin on depreciation it was objectionable to use it for reflecting a change in the Committee views on income tax allocation.

This Bulletin does not discuss at any length what balance-sheet account is to be credited for the deferred taxes. At one point it mentions "a deferred tax account."

In a letter dated April 15, 1959 purporting to clarify the phrase "a deferred tax account" as used in this Bulletin, the Committee stated that the phrase was used in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit. The letter further stated that accumulated deferred income taxes should not be credited to earned surplus or to any other account included in the stockholders' equity section of the balance sheet.

Three members of the Committee dissented to the issuance of the letter at that time.

A series of temporary injunctions was obtained by three public utility companies restraining the Committee from issuing this letter. They contended that removal from the equity section of their balance sheet of amounts shown there as earned surplus restricted for future federal income taxes would limit their short-term borrowing power

and otherwise interfere with their activities. It was not until July 6 that the legal barriers were cleared and the letter was actually issued.

There have been no further official releases by the Institute with respect to the allocation of federal income taxes.

SEC'S POLICY

The Securities and Exchange Commission on December 30, 1958 announced a proposed administrative policy whereby any financial statement that designates as earned surplus or its equivalent (even though accompanied by words of limitation such as "restricted" or "appropriated") or includes as a part of equity capital the accumulated credit arising from accounting for reductions in income taxes of various items, will be presumed to be misleading or inaccurate despite disclosure contained in the certificate of the accountant or in footnotes to such statements, provided the matters concerned are material. The announcement indicated that this policy would be effective for financial statements dated as of December 31, 1958 or thereafter.

The Securities and Exchange Commission has completed public hearings on this proposed policy but has not yet announced its decision.

The Federal Power Commission in an order dated May 29, 1958 prescribed a special balance-sheet account entitled "Accumulated Deferred Taxes on Income" for those utilities utilizing deferred tax accounting. The Commission has taken the position that the use of "Restricted Earned Surplus" in this connection violates its order not only with respect to reports to the Commission but also with respect to published reports.

According to a recent survey twenty-four state regulatory commissions have ordered or authorized the classification of deferred income taxes resulting from the use of accelerated amortization or liberalized depreciation as restricted earned surplus.

SUMMARY

In summary, there apparently hasn't been anything important happening recently with respect to allocation of federal income taxes within the income and surplus statements. However, with respect to allocation between the income statement and balance sheet, the situation is somewhat confused especially regarding the balance-sheet location of the accumulated provisions for deferred taxes. The Com-

mittee on Accounting Procedure of the American Institute and the Federal Power Commission disapprove of the classification of deferred income taxes as restricted earned surplus, various state regulatory commissions either order or authorize such a classification. and the Securities and Exchange Commission has the matter under consideration.