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Hugo Nurnberg

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Hugo Nurnberg
BARUCH COLLEGE – CUNY

CONCEPTUAL NATURE OF THE CORPORATE INCOME TAX

Abstract: This paper examines a long-standing controversy about the conceptual nature of the corporate income tax: whether it is an expense, a loss, a distribution of income, or some anomalous item. That controversy reflects in part different theories of the accounting entity.

Despite several authoritative pronouncements stating or implying that the tax is an expense, and despite an extensive discussion in the academic and professional literature, the controversy has never been fully resolved. Additionally, the tax is not characterized as an expense in corporate financial reports. The FASB's conceptual framework does not resolve this controversy, nor does the impending joint FASB-IASB revised conceptual framework.

Within the context of a coalesced (or fused) proprietary-entity theory of the accounting entity, this paper leads to the unsurprising conclusion that the corporate income tax is an expense, albeit an expense with some remarkable characteristics. Additionally, this paper shows how the conceptual nature of the corporate income tax impacts its income statement and cash flow statement reporting, and how a better understanding of this conceptual controversy might preclude fruitless controversies over other accounting issues currently troubling accountants and accounting standard setters.

INTRODUCTION

Most academic and practicing accountants of a certain age are familiar with the long-standing controversy over the financial accounting for corporate income taxes. This controversy centered on whether to ignore deferred income taxes under the flow-through method or recognize them under some version of interperiod income tax allocation. It was largely resolved in the U.S. [ARB-23, 1944; APB-11, 1967; SFAS-96, 1987b; SFAS-109, 1992] and internationally [IAS-12, 1998; IAS-12 (Revised), 2006]

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in favor of comprehensive interperiod income tax allocation under the asset-liability method. Less well known and understood, however, is an even older controversy about the conceptual nature of the corporate income tax: whether the tax is an expense, a loss, a distribution of income, or some anomalous item, and how its conceptual nature affects its reporting on the income statement and cash flow statement.[1] In turn, the conceptual nature of the income tax relates to the entity concept in accounting and to the different theories of the accounting entity. The FASB conceptual framework does not resolve this controversy, nor does the impending joint FASB-IASB revised conceptual framework show much promise of resolving it [see FASB, 2008a, 2008b].

Surprisingly, the conceptual nature of the corporate income tax has never been fully resolved [e.g., Storey, 1966, p. vii]. Most accountants and accounting standard setters say that the corporate income tax is an expense. However, companies do not characterize corporate income taxes as an expense and do not report it among expenses on the income statement. Most companies report an income statement deduction as "provision for income taxes" or just "income taxes," rather than as "income tax expense." Moreover, this deduction may not include all of the income taxes for the period. Due to intraperiod income tax allocation, corporate income tax may be reported partly in discontinued operations, extraordinary gain or loss, other comprehensive income, prior period adjustment, and/or additional paid-in capital.

Initially, this paper examines the entity concept in accounting and three theories of the accounting entity: the proprietary, entity, and residual equity theories.[2] It then examines an exten-

[1] Actually, how the conceptual nature of the corporate income tax affects its reporting on the cash flow statement is a relatively new controversy, at least in the U.S. As such, this controversy may be largely unfamiliar to most U.S. accounting academics and practitioners. See the section "Relevance of the Conceptual Nature of Income Tax to Income Statement and Cash Flow Statement Reporting."

[2] There are three other theories of the business entity that have received considerable attention in the literature: the enterprise, commander, and the fund theories. However, these three theories are not especially relevant to the conceptual nature of the corporate income tax. For a further discussion of the enterprise theory, see Suojanen [1954], ASSC [1975], Hendriksen [1977, pp. 494-495], Kam [1990, pp. 314-318], and Schroeder et al. [2009, pp. 501-502]. For a further discussion of the commander theory, see Goldberg [1965, p. 161-172], Meyer [1973, p. 163], Hendriksen [1977, pp. 497-498], Kam [1990, pp. 312-313], Wolk et al. [2004, pp. 147-148], and Schroeder et al. [2009, p. 502]. For a further discussion of the fund theory, see Vatter [1947], Hendriksen [1977, pp. 495-496], Kam [1990, pp. 310-312], Wolk et al. [2004, p. 147], and Schroeder et al. [2009, p. 501].

sive literature on the conceptual nature of the corporate income tax and how its conceptual nature affects its reporting on the income statement and cash flow statement. This paper demonstrates that within the context of a coalesced (or fused) proprietary-entity theory of the accounting entity, the corporate income tax is best viewed as an expense. It also shows how a better understanding of this conceptual controversy may preclude fruitless controversies over other accounting theory issues currently troubling accountants and accounting standard setters.[3]

ENTITY CONCEPT

A long-standing basic postulate of accounting is the entity concept; namely, economic activity is conducted through specific units or entities, and the financial accounting should be expressed in terms of a clearly defined entity, separate and distinct from the parties who furnish the funds [Paton, 1922, p. 16-17; Gilman, 1939, pp. 25-26; Paton and Littleton, 1940, p. 8; Vatter, 1947, p. 10; Moonitz, 1961, pp. 12-14; AAA, 1957, p. 537, 1965, pp. 358-367; Ball, 1988, p. 73; IASC, 2001, para. 8].[4] The entity concept has been defined in various ways as follows:

- The distinctive unit upon which accounting is based is the private business entity. The accountant looks upon business operations essentially through the eyes of the particular group of managers and owners. Accounting classifications and procedures are significant only as they are related to the conditions of the specific business organization [Paton, 1922, pp. 16-17].
- A unit of business is but a means of specifying the area of attention, a delimited and prescribed set of activities

[3] Studying the history of this controversy illustrates Schumpeter's [1954, p. 5] concept of the filiation of ideas: "the process by which man's efforts to understand economic phenomena produce, improve, and pull down analytic structures in an unending sequence." To follow and extend Schumpeter, much more than in other disciplines it is true in economics (and accounting) that modern problems, methods, and results cannot be fully understood without some knowledge of how economists and accountants have come to reason as they do. As the subsequent discussion will demonstrate, this filiation of ideas process is especially true of the study of the unresolved controversy over the conceptual nature of the corporate income tax.

[4] Ball [1988, pp. 8-9] distinguishes between an accounting entity and a reporting entity. The distinction arises because many organizations comprise a number of distinct, identifiable, accounting entities but report as a single reporting entity. Examples include parent and subsidiary companies that report as a single consolidated entity in the private sector and governmental funds that report as a single governmental unit in the public sector.

which give rise to the kinds of data with which accounting is to deal [Vatter, 1947, p. 10].

- A business entity is a formal or informal unit of enterprise, a collection of economic goods and services and a group of persons, organized to accomplish certain express or implied purposes [AAA, 1957, p. 537].
- The economic unit that has control over resources accepts responsibility for making and carrying out commitments and conducts economic activity [Moonitz, 1961, p. 13].
- Anything that is viewed by an interested individual or group as having a separable and definable existence is an entity. The essence of an entity is its separate existence from a particular point of view [AAA, 1965, pp. 358-359].
- A reporting entity is any unit or activity which controls the utilization of scarce resources to generate economic benefits or service potentials, and which is sufficiently significant to warrant preparing general purpose financial reports for economic decision making and accountability [Ball, 1988, p. 73].
- A reporting entity is an entity for which there are users who rely on the financial statements as their major source of financial information about an entity [IASC, 2001, para. 8].
- A circumscribed area of business activity of interest to present and potential equity investors, lenders, and other capital providers [FASB, 2008b, para. S2].

A committee of the AAA [1965, p. 359] notes that the natures of the interests of individuals or groups which serve to identify entities and define their boundaries are many and varied. They may be circumscribed from a legal point of view; but they also may be defined from an economic, social, political, aesthetic, professional, or other point of view. Interestingly, the extant FASB conceptual framework lacks a concept of the reporting entity and the extant IASC Framework [2001, para. 8] discusses it only briefly.

Zeff [1961, pp. 96-97] and Stewart [1989, pp. 98-99] note two dimensions of the accounting entity concept, which they refer to as the "orientation postulate": (1) the subject of financial statements, such as a business enterprise, which they refer to as the first sub-postulate; and (2) the users of those statements, such as creditors and investors, which they refer to as the second sub-postulate. Following Zeff and Stewart, in a May 29, 2008 *Preliminary Views* document jointly developed with the

IASB,[5] the FASB [2008b, para. 6] notes that general purpose financial reports provide information about a particular entity, which it refers to as a reporting entity; it then draws a distinction between the subject (entity) of general purpose financial reports and the users of those reports such as equity investors and lenders:

> Those reports provide information about the entity's economic resources (i.e., its assets), claims on those resources (i.e., its liabilities and equity), and the effects of transactions and other events and circumstances that change an entity's resources and the claims on them. It is the entity itself that is the subject of financial reporting, not its owners or others having an interest in the entity.

The FASB [2008b, paras. 17, 22] notes that legal structure helps to establish the boundaries of the reporting entity because it helps to determine which resources, claims on those resources, and changes in those resources or claims should be included in the entity's financial reports. But it concludes that a reporting entity should not be limited to activities structured as legal entities. Rather, a reporting entity should be broadly described as a circumscribed area of business activity that would apply to a sole proprietorship, partnership, corporation, trust, branch, or group of entities.

In a separate May 29, 2008 Exposure Draft jointly developed with the IASB, the FASB [2008c, para. OB6] notes that an entity obtains economic resources from capital providers in exchange for claims on those resources. It concludes that "by virtue of those claims, capital providers have the most critical and immediate need for general purpose financial information about the economic resources of an entity." Thus, the FASB concludes that the subject of general purpose financial reports should be the entity, not its capital providers, and the primary users of those reports are all its capital providers, not just its equity investors.

CENTRALITY OF THE ENTITY CONCEPT IN ACCOUNTING THEORY

As Moonitz [1961, pp. 13, 31] notes, the significance of the entity concept to accounting is that it defines the area of interest

[5] For succinctness, subsequent references in this paper are to the FASB rather than to both the FASB and the IASB; similarly, subsequent references to joint documents are to documents published by the FASB rather than to those published by the IASB.

and thus narrows the possible objects and activities and their attributes that may be selected for inclusion in financial statements. According to an AAA Committee [1965, p. 361], determining what data are relevant depends on the prior determination of the reporting entity. When a definable area of economic interest exists, it is possible to identify, accumulate, and report financial information about that entity distinct from all other information. This is the essence of the entity concept in accounting. Without such an entity, accounting is impossible.[6] Similarly, in its Preliminary Views, the FASB [2008b, para. 62] concludes that "the reporting entity concept should first determine what constitutes the 'entity' that is reporting, and only then should the asset definition (and other element definitions) be applied to that entity."[7]

The primary concern of financial accounting is with entities that represent areas of economic interest to particular individuals and groups; that is, with entities whose activities involve the utilization of scarce resources. An economic entity could be a business, a governmental unit, or a not-for-profit organization; that is, any activity concerned with the administration of scarce resources. However, this paper is concerned only with one type of entity, the business corporation, because only this type of entity is subject to corporate income taxes.[8]

RELATIONSHIP OF THE ENTITY CONCEPT TO OTHER ACCOUNTING CONCEPTS

The AAA Committee [1965, p. 360] notes that the entity concept is more fundamental than the concepts of going concern, money measurement, and realization. The application of these other concepts depends on the nature of the entity and the needs of the particular interested individual or group. On the other

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[6] Salmonson [1969, p. 51] alludes to a certain circularity in the definition of the accounting entity when he notes that the boundaries of the accounting entity depend solely upon the point of view taken. Since there are many different users of accounting information with differing points of view, there are many different and often overlapping entities.

[7] Most of the FASB *Preliminary Views* [2008b, paras. 29-161] document on the reporting entity addresses the issue of consolidated versus separate parent company financial statements. As such, that document is not otherwise relevant to the present paper on the nature of corporate income taxes and is not further examined.

[8] Certain partnerships may elect to be taxed as corporations under the Internal Revenue Code. Most of the issues addressed in this paper also apply to such partnerships.

hand, these concepts do not have significance apart from the entity. For example, the concept of going concern has no application to entities where the interest of the individual or group is liquidation. As to the concept of money measurement, a tract of timber may constitute an entity for which a meaningful accounting may be made in terms of board feet. Realization depends on the business entity assumed. Intercompany profits on upstream inventory sales are realized by the subsidiary at the time of sale to the parent company, but are unrealized by the consolidated entity until the inventory is resold to outsiders.

Similarly, periodic net income and its components only have relevance to specific accounting entities. For this reason, the entity concept is more fundamental than the concept of periodic net income. Without the accounting entity clearly defined, periodic net income cannot be measured and the conceptual nature of its components cannot be determined.

DIFFERENT THEORIES OF ENTITY

Through the years, various authors have suggested different theories of the business entity for accounting purposes. This paper summarizes the proprietary, entity, and residual equity theories.[9] Thereafter, it examines the conceptual nature of the corporate income tax and how it fits into these three theories. However, as Zeff [1961, pp. 96-97] and Stewart [1989, pp. 98-99] note, none of these theories is completely satisfactory at determining the conceptual nature of the corporate income tax because none fully distinguishes between the subject being accounted for and the party for whose benefit the financial statements are prepared.

Proprietary Theory: According to Sprague [1907, pp. 46-50, esp. p. 49], an early advocate, under the proprietary theory, the accounting represents a reckoning by the proprietor for his own property.[10] In this view, the fundamental accounting equation is Assets – Liabilities = Owners' Equity.[11] The business entity is the

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[9] The entity concept (a business entity exists apart from the personal affairs of its equity holders) is presumed by all three theories; they differ in how they view the business entity [Hendriksen, 1977, p. 490].

[10] Chatfield [1974, pp. 221-223] and Previts and Merino [1998, pp. 209-210] summarize statements of the proprietary theory that predate Sprague.

[11] The fundamental accounting equation is A–L=OE. However, A–L=Net Assets. Thus, OE=NA. In a 1989 monograph on the concept of equity, Kerr [1989, pp. 33-34] suggests that although net assets and owners' equity are measured in the same way and will always have the same amount assigned to them, they may

center of attention, but it is to the viewpoint of the proprietor that the accounting is directed. Implicitly, the business enterprise is the subject being accounted for, and the proprietor is the party for whose benefit the financial statements are prepared [Stewart, 1989, p. 102]. Under the proprietary theory, capital is viewed as a stock of wealth, and income is defined as the amount that can be consumed or distributed without reducing capital.

Chatfield [1974, p. 223] elaborates that under the proprietary theory, revenues immediately increase proprietorship, expenses immediately decrease it, and net income accrues directly as wealth to the owner. As a result, revenues and gains can be treated alike since all go to owner's equity and affect it similarly. For similar reasons, little distinction need be made between expenses and losses.

As Zeff [1961, pp. 97-105] notes, the proprietary theory was applied initially to the medieval merchant when most commercial activity was organized as time-limited, distinguishable ventures, such as voyages or caravans. When the venture was concluded, a profit or loss could be unambiguously calculated as the difference between the merchant's wealth at the beginning and conclusion of the venture. At that time, accountants did not separate business from personal affairs; their main concern was ascertaining the amount of changes in the merchant's wealth. The merchant was both the subject and beneficiary of the financial statements. However, with the evolution of capitalism, economic activity became organized increasingly as continuing business enterprises rather than as discontinuous trading ventures. Concurrently, accountants adopted the going-concern assumption, decided to separate business from personal affairs, and applied the proprietary theory to sole proprietorships and partnerships. Implicitly, the proprietorship or partnership became the subject and the proprietor/partners became the primary beneficiary(ies) of the financial statements.

However, the proprietary theory has long been applied to corporations by looking through the corporate veil and considering the stockholders collectively as the proprietary interest [Hatfield, 1909, pp. 144-183, esp. pp. 145-146]. The accounting thereupon becomes a reckoning by management for the stock-

be regarded as separate concepts: "The concept of net assets is appropriate when attention is centered on the resources which are available to an entity whilst owners' equity is appropriate when attention is focused on the owners' interest in the enterprise."

holders' property. To use Zeff's construct [1961, pp. 105-106], the corporation became the subject and the stockholders became the primary beneficiary of the financial statements.

In criticizing the proprietary theory, Previts and Merino [1998, pp. 221-222] note that "the business entity concept (the fact that the legal entity existed apart from its ownership), was not questioned, only ignored, by proprietarists." Perhaps a more accurate criticism of the proprietary theory is that its advocates did not emphasize the distinction between the corporation as the subject and the stockholders as the primary beneficiary of the financial accounting. Nevertheless, the accounting for the corporation is completely separate from the accounting for the personal wealth of the stockholders under the proprietary theory.

Schroeder et al. [2009, pp. 498-499] find "significant [extant] accounting policies that can be justified only through acceptance of the proprietary theory." Ball [1988, p. 89] concludes that the proprietary theory predominates in practice, at least in Australia. Similarly, Hendriksen [1977, pp. 489-490] notes that the proprietary theory is implied in many extant accounting practices and terminology relating to corporations. For example, the net income of a corporation is often referred to as net income to stockholders.

Under the proprietary theory, revenues and expenses are simply increases or decreases in stockholders' equity, respectively. As a result, net income equals the change in stockholders' equity over the period other than changes due to additional contributions from or distributions to stockholders. Consistently, under the proprietary theory, corporate income taxes and interest on debt are viewed as expenses to be deducted from revenues to determine net income, whereas dividends are withdrawals of capital.[12]

Entity Theory: As Zeff [1961, pp. 106-107] notes, with the separation of ownership and control in the modern corporation [see also Berle and Means, 1932] came another shift in accounting emphasis towards the enterprise itself and away from the stock-

[12] See Hatfield [1927, pp. 373-374] and Moonitz [1957, pp. 175-176]. Sprague did not address the accounting for corporate income taxes in his book, which bore 1907 and 1908 copyrights, when there was no federal corporate income tax in the U.S. The current federal corporate income tax emanates from legislation enacted in 1909, reaffirmed by the 16th Amendment to the U.S. Constitution in 1913, and subsequently amended. A federal corporate income tax was enacted in 1862 to help finance the Civil War, but it was repealed in 1872.

holders as the collective owners. But this shift was not complete under the proprietary theory, so it was argued, for under the proprietary theory, the stockholders' viewpoint remains the focus of the financial statements [see also Gilman, 1939, p. 48]. The entity theory, to be distinguished from the entity concept and the entity theory of consolidated financial statements [Moonitz, 1944],[13] was developed ostensibly to make this shift in emphasis more complete.

Paton [1922, pp. 84-89] is perhaps the first American to offer a comprehensive statement of the entity theory.[14] According to Paton, the business entity is not just the center of attention. Rather, the viewpoint of the business entity is the viewpoint to which the accounting should be directed. Under the entity theory, long-term debt and capital stock are considered more similar than different. Long-term creditors and stockholders are considered both separate and apart from the business entity itself (pp. 76-79). In this view, the fundamental accounting equation is Assets = Liabilities + Stockholders' Equity. As Kerr [1989, p. 5] notes, the distinction between liabilities and stockholders' equity is "one of degree rather than of fundamental differences."

Under the entity theory, according to Paton [1922, p. 259], net income is the "increase in *all* [creditor and stockholder] equities," and coincides with the viewpoint of the corporate manager:

> To the manager, the particular manner in which the company is capitalized is a matter entirely outside the determination of operating net income. … Net operating revenue [income] is then the excess of values

[13] Under Moonitz's entity theory of consolidated financial statements, a parent and subsidiary are viewed as one economic entity with two groups of stockholders, the controlling stockholders of the parent company and the noncontrolling stockholders of the subsidiary. The FASB [2007b] largely adopted the entity theory of consolidated financial statements in SFAS No. 160. Prior practice was largely based on the parent company theory of consolidated financial statements. Unlike the three more pervasive theories of the accounting entity, the parent company and entity theories of consolidated financial statements apply solely to consolidated financial statements. Additionally, the same issues concerning the conceptual nature of income taxes and interest on debt arise under both theories of consolidated financial statements.

[14] Chatfield [1974, pp. 223-224] and Previts and Merino [1998, p. 222] summarize earlier statements of the entity theory. Interestingly, Paton [1922, pp. 61-68] espouses a managerial point of view, not the entity theory. However, numerous writers [Husband, 1938, pp. 242 *et passim*; Gilman, 1939, pp. 46-54; Vatter, 1947, pp. 5-7; Stewart, 1989, p. 102] refer to Paton's managerial point of view as his entity theory. This paper continues that practice.

> received over purchased assets utilized in connection with product sold, and represents the increase in capital to be apportioned or distributed among all individuals or interests who have committed cash funds or other property to the undertaking.

Consistently, interest on long-term debt is viewed as a distribution of income similar to dividends on stock [Paton, 1922, p. 267]; neither is an expense to be deducted from revenues to determine net income under the entity theory.

In commenting on the entity theory, Chatfield [1974, pp. 225-226] elaborates that "if the corporation is functionally separate from its owners and creditors then it, not they, should be the center of accounting interest," which implies a wider view not only of the business but of accounting activities generally. Additionally, Chatfield suggests that "the entity theory emphasizes corporate income and a more nearly economic idea of income measurement." He notes that unlike the proprietary theory, under the entity theory:

> Revenues and expenses are no longer simply increases or decreases in stockholder's equity. Revenues are compensation for services provided by the firm. Expenses measure the cost of services consumed in obtaining this revenue. Profit accrues to the corporation, not to its owners or creditors. Its disposition is up to the entity; income distribution is distinct from income finding [determination].

Staubus [1952, pp. 105-107] offers a different version of the entity theory from a managerial point of view. Under Staubus' version, "insofar as managers have a viewpoint towards the income of business that can be distinguished from the viewpoint of owners, distributions to creditors and owners, like distributions to employees [and taxes], are costs [expenses]." Wolk et al. [2004, pp. 144-145] observes that under orthodox entity theory:

> . . . owners' equity accounts do not represent their interest as owners but simply their claims as equity holders. Similarly, net income does not belong to the owners although the amount is credited to the claims of equity holders after all other claims have been satisfied. Income does not belong to capital providers until dividends are declared or interest becomes due. In measuring income, both interest and dividends represent distributions of income to providers of capital.

Husband [1938, pp. 246-247, 1954, pp. 555-556] adds that under a consistent application of the entity theory, stock dividends are income to the stockholders, although he finds this to be an inherent defect of the entity theory.

Zeff [1961, pp. 187-188] distinguishes Paton's version of the entity theory from Staubus' version (and subsequent elaborations) as traceable to a disagreement over the meaning of the word "entity": Staubus views the managers or the entity itself as the parties for whom the financial statements are prepared, whereas Paton does not establish either the managers or the entity as the dominant beneficiary of financial statements. Zeff characterizes Staubus' conception of the entity as the "institutional-entity view"; he characterizes Paton's managerial view of the entity as the "distributional-entity view." Because management acts in a fiduciary capacity in reporting to outsiders, not to itself, Zeff [1961, p. 205] concludes that the distributional-entity view of Paton is to be preferred over the institutional-entity view of Staubus.[15]

Zeff [1961, pp. 129-140, 188] also notes that, just as with the proprietary theory, it is useful under the entity theory to distinguish between the subject being accounted for and the party for whose benefit the financial statements are prepared. Implicitly, under Paton's conception of the entity theory, the business enterprise is the subject being accounted for and its capital suppliers, both creditors and stockholders, are the parties for whose benefit the financial statements are prepared [see also Stewart, 1989, p. 102].

Clark [1993, p. 26] suggests that because modern capital structure theory literature supports the notion that financing activity impacts operating cash flow and vice versa, corporate financial policy appears to affect firm value. Although this does not invalidate the idea that both bondholders and stockholders supply capital to the firm, it does raise doubts that debt can be viewed in the same light as equity as under the entity theory. Previts and Merino [1998, p. 213] add that although many view Paton's entity theory as an advance in conceptualizing the accounting entity, its underlying assumptions are inconsistent with private property rights and have never been accepted: "Accounting theory today continues to adopt a proprietary focus; that is, managers should maximize stockholders' wealth, rather than an entity focus."

[15] Staubus' view and its elaborations is also a decidedly uncommon interpretation of the entity theory. Additionally, Staubus abandons his version of the entity theory in favor of the residual equity theory, discussed in the next section.

According to Paton's original formulation [1922, pp. 180-181, italics added], where the long-term creditors and stockholders are implicitly the beneficiaries of the financial statements, the corporate income tax is viewed as a distribution of income akin to dividends on stock:

> Taxes in general constitute a coerced levy on net earnings (or capital if no earnings are available) ... The state virtually has a latent prior equity in the properties of every business enterprise; private ownership is not absolute. ... Income and excess-profits taxes furnish, of course, a clear case. Here the state is levying specifically upon net earnings (derived in general from the stockholders' standpoint) and *consequently such levies from an accounting view represent distributions of net revenue*.

However, Paton also notes that the corporate income tax could fall into one of four classifications – an expense, a loss, a distribution, or an anomalous item. He suggests that the tax "can best be considered a loss ... or a distribution ...; it cannot reasonably be viewed as an expense." Similarly, Paton and Littleton [1940, p. 102] conclude that "interest and income taxes ... are not costs of producing the economic service which accounts for the revenue from sales." But as a result of the higher tax rates of the 1940s, Paton [1943, p. 13] changed his mind and concluded that all taxes, both income taxes and property taxes are not an expense, loss, or distribution of income, but rather are an anomalous item that should be deducted from revenues to compute corporate net income.

Accordingly, the entity theory is subject to different interpretations. The treatment of corporate income tax under the entity theory is also subject to several interpretations, even by Paton, its developer. However, the prevailing interpretation is that the corporate income tax is a distribution of income under the entity theory.

Residual Equity Theory: As suggested initially by Staubus [1959], under the residual equity theory, the fundamental accounting equation becomes Assets – Specific Equities = Residual Equity, where specific equities include those of creditors and preferred stockholders. Staubus [1959, p. 8, italics in originial] defines residual equity as "*the equitable interest in organization assets which will absorb the effect upon those assets of any economic event that no interested party has specifically agreed to absorb*";

the residual equity holders "are that group of equity claimants whose rights are superseded by all other claimants." Under the residual equity theory, common stockholders are viewed as having a residual equity in the income of the business and in the net assets upon final liquidation. According to Staubus, the focal point of investors' interest in the income statement should be the change in the residual equity.

Meyer [1973, p. 117] notes that advocates of the residual equity theory consider the proprietary theory inadequate because it treats as identical the interests of various stockholder groups that are basically antagonistic to one another. Such antagonism results from the desire of the lowest ranking investors to minimize returns to the highest ranking investors while the latter seek to maximize these returns. The entity theory may be similarly criticized for ignoring the antagonism of creditors and stockholders.

Under the residual equity theory, because the common stockholders are viewed as having a residual equity in the income of the business and in the net assets upon final liquidation, the income statement should report the income available to the residual equity holders after all prior claims are met, including interest on debt, income taxes, and dividends to preferred stockholders.[16] Accordingly, income taxes and dividends to preferred stockholders are more akin to expenses than to income distributions. As a result, Meyer [1973, pp. 117-118] and Wolk et al. [2004, p. 146] suggest that the residual equity theory is a variant of the proprietary and the entity theories. Zeff [1961, p. 188] characterizes Staubus' residual equity theory as having the entity as the subject and the common stockholders as the principal beneficiary of the financial statements.

Although U.S. and international accounting standard setters have not adopted the residual equity theory, it has considerable conceptual appeal as a more accurate description of the modern publicly owned corporation than either the proprietary or entity theories. Its conceptual appeal stems from its treatment of preferred stock as more similar to debt than to common stock. Moreover, because the FASB and IASB tentatively favor a basic

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[16] Hendriksen [1977, p. 493] notes an alternative and decidedly uncommon interpretation of the residual equity theory. Because the common stockholders' only claim against the corporation is to receive dividends when and if declared, the residual equity in capital is not assigned to the residual equity holders. Both the initial capital supplied by the common stockholders and the retained earnings are equity of the corporation in itself.

ownership approach to the definition of equity, future adoption of the residual equity theory is not inconceivable.[17]

The conceptual nature of the corporate income tax is the same under the proprietary and residual equity theories; the income tax is an expense to be deducted from revenues to derive net income available to all equity holders under the proprietary theory and to residual equity holders under the residual equity theory. For this reason, advocates of the proprietary and residual equity theories suggest some of the same arguments for viewing the income tax as an expense. Moreover, the literature on the conceptual nature of the corporate income tax is usually in the context of the proprietary and entity theories, with little mention of the residual equity theory. This paper continues that practice in order to minimize duplication.

AUTHORITATIVE PRONOUNCEMENTS ON NATURE OF CORPORATE INCOME TAX

Since 1944, several U.S. authoritative pronouncements group corporate income tax with expenses and/or state or imply that it is an expense. However, these pronouncements do not explain why the tax is an expense.

For example, in Accounting Research Bulletin (ARB) No. 23 [1944, para. 3], the Committee on Accounting Procedure (CAP) states that "income taxes are an expense which should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated." That view was reaffirmed in 1953 by the CAP in ARB No. 43 [ch. 10, para. 4]. The CAP's successor, the Accounting Principles Board (APB), reconfirmed that the corporate income tax is an expense in Opinion No. 11 [1967, para. 12(a)]. Similarly, the successor to the APB, the FASB, assumes that corporate income tax is an expense in SFAS No. 96 [1987b, paras. 26-28] and again in SFAS No. 109 [1992, paras. 35, 45-46]. However, all of these authoritative pronouncements merely assert or assume that the corporate income tax is an expense rather than a loss, a distribution of income, or something else without explaining why.

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[17] See FASB, *Preliminary Views* [2007a, paras. 16-49]. Under this basic ownership approach, a financial instrument is classified as equity only if it is the most subordinated interest in an entity and if it entitles its holder to a share of the entity's net assets after all higher priority claims have been satisfied. All other financial instruments, such as forward contracts, options, and convertible debt, are classified as liabilities or assets. As a result, only the lowest residual interest in the entity is classified as equity. The basic ownership approach is fully consistent with the residual equity theory.

Even in its conceptual framework statements, the FASB discusses the nature of the corporate income tax only superficially. Financial Accounting Concept Statement (SFAC) No. 3 [1980, para. 65] and SFAC No. 6 [1985, para. 80] define expenses as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Moreover, in discussing the characteristics of expenses, SFAC 6 [1985, para. 81, italics added] notes explicitly that income taxes are an expense:

> Expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the entity's ongoing major or central operations. The assets that flow out or are used or the liabilities that are incurred … may be of various kinds – for example, units of product delivered or produced, employees' services used, kilowatt hours of electricity used to light an office building, or *taxes on current income*.

In a fundamental sense, this SFAC 6 discussion of the characteristics of expenses defines away the controversy as to the conceptual nature of income taxes without indicating the reasons why income taxes are an expense rather than a loss, a distribution of income, or something else.

Additionally, SFAC 6 seems to distinguish between other expenses and income taxes as if to imply that income taxes may not really be an expense. For example, it [para. 137] defines transaction as "an external event involving transfer of something of value (future economic benefit) between two (or more) entities," and distinguishes an exchange and a nonreciprocal transfer. In an exchange, both entities receive and sacrifice value, such as purchases or sales of goods or services, which ultimately become expenses or losses. In a nonreciprocal transfer, an entity incurs a liability or transfers an asset to another entity or receives an asset or cancellation of a liability without directly receiving or giving value in exchange. Importantly, SFAC 6 notes that impositions of taxes, like investments by owners, distributions to owners, gifts, and charitable or educational contributions given or received, are nonreciprocal transfers. In the context of different types of transactions, therefore, income taxes are in some ways more similar to distributions to owners than to expenses. So the conceptual nature of the corporate income tax has not been fully resolved by SFAC 3 or SFAC 6.

Interestingly, at one time, the SEC [1945, p. 151] suggested that the corporate income tax might be viewed more appropriately as a distribution of income rather than as an expense:

> It is readily apparent that normal and excess profits taxes are computed as a part of taxable income. Unlike most expenses they exist if, and only if, there is net taxable income before any deduction for such taxes. There is much to be said therefore for the position that true income taxes are in the nature of a share of profits taken by the government. If it is desired to place emphasis on the necessity of deducting them in order to arrive at net profit available to shareholders, they may perhaps be called an expense – but in such cases they represent a very special class of expense, one that is incurred only by the making of net taxable income.

However, the SEC has always required corporations to treat the corporate income tax as a separate deduction from revenue to derive periodic net income. At no time did the SEC either require or permit the treatment of the corporate income tax as a distribution of income rather than as a deduction in computing periodic net income.

In summary, authoritative pronouncements in the U.S. treat the corporate income tax as an expense or deduction in calculating periodic net income, but without adequately explaining why.

NATURE OF CORPORATE INCOME TAX UNDER DIFFERENT THEORIES OF ENTITY

Through the years, numerous commentators have analyzed the conceptual nature of the corporate income tax, treating it either as an expense, a loss, a distribution of income, or an anomalous item, along the lines suggested by Paton [1922, p. 181]. The most common question is whether the income tax is an expense or a distribution of income. Many of these analyses have implicitly presumed one theory of the reporting entity, often without specifying which theory is presumed or to whom the financial statements are directed.

Income Tax as Expense or Distribution of Income: Paton [1922, p. 181], the first American writer to advocate the entity theory, suggests that the corporate income tax is a distribution of income, not an expense. Another early advocate of the entity theory [Seeger, 1924, pp. 103] elaborates that because the government is a partner in production and as such is entitled to a share of the wealth produced, the income tax is a distribution of income, not an expense, and should not be deducted from revenue to determine entity net income.

Dewhirst [1972, pp. 42-43] also argues that the income tax is a capital distribution, which he implies is the same as an income distribution. He defines expense as the productive use of resources to generate revenue, where a causal and purposive relationship exists between expense and revenue; he defines loss as the unproductive use of resources. He notes that no relationship exists between income taxes and the receipt of government services or revenues earned. Because the income tax does not involve either the productive or unproductive use of resources or services to generate revenue, Dewhirst concludes that the income tax is neither an expense nor a loss. He also assumes that it is not a new category of revenue deduction. By a process of elimination, Dewhirst concludes that the income tax is a capital distribution.

Other writers are more circumspect in discussing whether the income tax is an expense or a distribution of income. For example, in discussing whether taxes of railroads are expenses or distributions of income, Hatfield [1927, p. 374] notes:

> It is impossible to say that any one of these views is absolute and exclusive. … If the stockholder has his dividends lessened by the taxes paid, but in all probability would pay no taxes were his funds invested, say, in bonds or mortgages, the taxes are, from his point of view, in no sense a distribution of profits. But where there is an income tax uniformly enforced, and the payment of taxes by the [rail]road works merely as a stoppage of that part of the income, it is not illogical to consider the tax as a distribution of part of the net profits derived from operating the road.

Similarly, Greer [1945, p. 96-97] notes that whether the income tax is an expense or a distribution of income depends on one's viewpoint. If the government is viewed as a part-owner, the income tax is a distribution of income; if it is viewed as a supplier of goods or services, it is an expense. According to Greer, the government is better viewed as a part-owner; the absence of government equity on the balance sheet reflects that its equity "is not in the property, but in the earnings, of the corporation."

Paton [1946, p. 86] finds persuasiveness in Greer's concept of the government as a part-owner that shares profits with stockholders. However, because the government makes no investment, and because taxes are a coerced levy, Paton finds it unrealistic to view the government as an equity holder. Zeff [1961, pp. 155-156] is still more critical; he suggests that viewing the government as an equity holder that does not contribute funds is an ethereal notion:

> Creditors ... and stockholders seek equity in profits ... but they also furnish funds. To the extent that it is desirable that 'equities' consist of a collection of homogeneous 'rights,' inclusion therein of a 'right' that is not attended by a contribution of capital is not to be recommended. By such inclusion, a party represented as realizing an infinite return on investment would be permitted to distort the aggregate return on investment of those parties who do provide some capital.

In support of treating the corporate income tax as a distribution of income, some entity theorists [e.g., Hill, 1957, p. 357] contend that its incidence is upon the stockholders, that the corporation in effect is paying a tax on the stockholders' income. Proprietary theorists [e.g., Hendriksen, 1958, p. 218] contend to the contrary, maintaining that the incidence of the tax is elsewhere. To add to the confusion, both Hendriksen [1965, p. 369] and Li [1961, p. 266] maintain that the incidence of the tax alone does not conclusively determine its conceptual nature, i.e., whether it is an expense or a distribution of income. Moreover, it has long been recognized [Harberger, 1962; Gravelle, 1995; Auerbach, 2005] that the incidence of the corporate income tax has not been determined conclusively either in theory or empirically.

Both proprietary and entity theorists recognize certain obvious differences between corporate income taxes and expenses in general. Proprietary theorists [e.g., Hendriksen, 1958, p. 217] maintain that the similarities outweigh the differences, whereas entity theorists [e.g., Paton, 1922, pp. 179-181] argue to the contrary. More specifically, proprietary theorists like Hendriksen [1965, p. 465] argue that income taxes, like other expenses, represent payment for services required by the entity to further its operations; they may be associated with the right to conduct a profitable corporation in a favorable business environment, certainly a valuable service supplied by the government. Entity theorists like Paton reject this contention, arguing instead that income taxes are coerced levies largely outside of managerial control, representing the latent prior beneficial interest of the government in every business entity. Moreover, these levies do not further the operations of the entity. To substantiate this position, entity theorists note that unlike most expenses, income taxes are not apportioned in accordance with services received from the government; rather, they are apportioned and contingent on the existence of taxable income although the entity presumably receives the same services regardless of the amount of its taxable income and any tax thereon. Accordingly, entity theorists contend that income taxes cannot be viewed as measuring the value of services and, later, a cost of production or expense.

Additionally, although he views the corporate income tax as an expense and not as a distribution of income, Sprouse [1957, p. 374, italics added] notes that:

> … the imposition of income taxes might be looked upon as a method of siphoning off a substantial portion of corporate income to finance the [government] services. … From this point of view, income taxes might well be treated as a distribution of corporate income. … This necessarily assumes that the incidence of the corporate income tax falls upon the incorporated institution; that the tax is not shifted forward in the form of higher prices for the corporation's product or shifted backward in the form of lower prices for the factors of production.

In refutation, some proprietary theorists, including Sprouse, argue that income taxes are an expense, even under a consistent application of the entity theory:

> The state and federal governments are not corporate investors. Accordingly, the number of dollars which could be distributed to corporate equity holders without impairing their cumulative investment is clearly adversely affected by the imposition of income taxes. … Income taxes are expenses … an unavoidable cost of general business operations during a given revenue period.

Other proprietary theorists [e.g., Kelley, 1958, p. 214] note that to argue that income taxes are not a cost of carrying on a business enterprise and a determinant of net income "is to propose a concept of corporate net income which is illogical, contrary to common sense and contrary to universal business practice."

> Taxes, whether levied on property or on income, constitute a basic cost of carrying on a business, which must be paid to the all-powerful sovereignty, the State, for the privilege of remaining in business. In no true sense is the State a partner in the enterprise; it is a sovereign

> demanding periodic payments for the privilege of carrying on the activities of the corporation.

Still other proprietary theorists [e.g., Solomon, 1966, p. 201] argue that the non-proportionality of income taxes to services received or anticipated is irrelevant to their conceptual nature Some degree of government activity is beneficial to earning revenue by providing something of value, if only a favorable environment. Another proprietary theorist [McLaren, 1947, p. 164] notes that:

> The Federal government is still intended to be the servant of the business public – not the master; it contributes no capital, shares no losses, and is not an equity holder. Viewed realistically, income taxes must be regarded as a cost of doing business; they are payments for protective services rendered by the government which, over the long term, enhance or at least preserve business opportunities.

And still other proprietary theorists [e.g., Mateer, 1965, pp. 584-585] argue that the corporate income tax may be viewed as merely one way of allocating the cost of government among some of the corporations benefited. Even some entity theorists [e.g., Zeff, 1961, p. 168] conclude that income taxes "are the cost of establishing and maintaining a free economy within which private enterprise can effectively attempt to attain profitable results. Translated into microeconomic terms, income taxes are thus a cost of a firm's revenues."

Furthermore, the method of measuring the tax, its contingency on taxable income, is held by other proprietary theorists [e.g., Sprouse, 1957, p. 375; Moonitz and Jordan, 1963, pp. 477-489] to be irrelevant to its conceptual nature. Employee bonuses are often contingent on income; nevertheless, they are properly characterized as an expense, not a distribution of income.[18]

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[18] It has been noted that, consistent with the proprietary theory, the corporation might be viewed as an agent for its stockholders in paying the tax that is really a tax on the income of the stockholders; hence, the tax is a distribution of income, not an expense [Hendriksen, 1965, p. 395]. However, the incidence of the corporate income tax has not been determined conclusively either in theory or empirically, and the incidence of the tax alone does not conclusively determine its conceptual nature. Additionally, this is a decidedly minority interpretation of the proprietary theory. Blackie [1947, p. 203] rejects a similar notion that the corporate income tax is really a tax on customers that is collected by the corporation on behalf of the government: "Such an idea rests on a cost-plus method of reasoning which assumes that price is the product of an arithmetical process rather than the result of economic forces which frequently defy the adding machine. The corpora-

Even some advocates of the entity theory take this position. For example, Zeff [1961, p. 167] aptly notes:

> … officers of many large corporations are voted bonuses by the directors on the basis of the profitability of the year's operations. Are these bonuses, therefore, a 'distribution of income?' The point of *reductio ad absurdum* would be reached very soon as more and more cost factors were found to have an affinity toward 'income.'

Indeed, even some advocates of the entity theory contend that the corporate income tax is an expense. For example, Li [1961, pp. 265-268, esp. p. 266] argues that, consistent with the entity theory, the corporate income tax is best viewed as an expense. The tax is imposed upon a corporation because it is a separate entity and because it enjoys the privileges and advantages of being a separate entity. Because the tax is directed at the corporation, it should be considered an expense of corporate administration. Hendriksen [1982, p. 165] also argues against viewing the income tax as a distribution, even if one otherwise subscribes to the entity theory. However, viewing income tax as an expense is not the prevailing interpretation of the entity theory.

Equally important, proprietary theorists [e.g., McLaren, 1947, p. 164; Moonitz, 1957, p. 175] note that income taxes are considered an expense by businessmen themselves and are viewed as such in the business decision-making process. Walgenbach [1959, pp. 582-583] notes that the courts and most rate-making regulatory agencies also adopted this viewpoint.[19] For many years, the majority of the accounting profession has also adopted this view, at least as reflected in authoritative pronouncements on the financial accounting for income taxes.

Income Tax as Expense or Anomalous Item: Most of the early writers debated whether the income tax is an expense or a distribution of income. However, following Paton's [1922, p. 181] suggestion, some writers debated whether the income tax

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tion does not have the power to pay taxes or wages or any other cost without limit. The U.S. federal income tax – levied on the corporation as such – is neither a sales tax upon the customers nor a personal tax upon the stockholders."

[19] In general, the courts have regarded the regular corporate income tax as an expense for determining net income, and the excess profits tax has been similarly regarded for ordinary net income determination purposes, but not generally for the rate-making purposes of the regulatory agencies [Walgenbach, 1959, pp. 582-583].

is an expense or an anomalous item, often without considering whether it might be a loss or a distribution of income instead.

For example, Chambers [1968, pp. 104-105] argues that income taxes are not an expense because they are not levied in proportion to the benefits received by governments. He also argues that the income tax is not an excise tax on the right to operate and earn income because loss companies also have that right but pay no income tax. Additionally, Chambers notes that income taxes are levied on taxable income, which differs fundamentally from accounting income. Because taxable income reflects fiscal and policy functions of governments, Chambers concludes that income taxes "can only be regarded as a form of discriminatory expropriation."

Barton [1970, pp. 4-8] supplements Chambers' argument that the income tax is an expropriation. He suggests that to understand the nature of the corporate income tax, one must examine its purpose and the manner in which it is levied. Barton notes that income taxes are levied on taxable income in order to raise revenue to finance government activities. The measurement of taxable income reflects government policies of raising revenue according to ability-to-pay, influencing the allocation of productive resources, and making the tax laws easy to administer. According to Barton, because it reflects government policy objectives and administrative simplifications, taxable income need have no relation to accounting income. As a result, corporate income tax is not related to specific transactions. For these reasons, Barton argues that corporate income taxes do not possess any of the characteristics of operating expenses.

Like Chambers, Barton also disputes the view that the income tax is an expense because it represents a payment for the right to conduct a profitable business in a favorable economic environment. He notes that unlike expenses, income taxes are not proportional to services received from the government. Some of the largest companies pay relatively little tax because of various tax incentives though they often use more public services than smaller companies. He also disputes the view that income tax is an expense even though it represents a cost of conducting a profitable business.

Additionally, Barton objects to the view that income tax is an expense because it fits the definition of expense as a reduction in proprietorship other than repayments to owners. Barton [1971, p. 173] finds that definition of expense to be too broad because it hides several important differences between items in the expense category and does not indicate the reason for incurring expenses. For example, the definition lumps income taxes (which reflect the success of a company's operations), with sales taxes and bad debts (which relate to sales), and with wages and payroll taxes (which relate to the resources acquired by management to generate revenue).

However, Baylis [1971, pp. 161-165] aptly refutes Barton's arguments that the income tax is not an expense. He finds that Barton's criticism of the all-inclusive definition of expense does not mean that income tax is not an expense. He also finds Barton's and Chambers' term "expropriation" unappealing "because of its obvious link with the term appropriation."

In responding to Baylis, Barton [1971, pp. 173-174] argues that the real issue is whether the expense classification is the most useful one available. Instead of defining expense broadly as a reduction in proprietorship other than repayments to owners, he favors classifying non-owner outlays as revenue deductions, expenses of generating revenue, non-operating losses, and expropriations of profit. Barton argues that this four-way, mutually exclusive classification is more informative than classifying all non-owner outlays as expense.

Baylis [1971, pp. 162-164] counters that the government indirectly serves business by providing the valuable benefit of a favorable environment in which all may operate profitably and that income taxes need not be levied proportionate to the benefits received to justify classifying them as an expense. He observes that trade association membership fees are an expense although a larger company may pay twice as much as a smaller company without receiving twice the benefits. Similarly, the benefits received from paying income taxes may not be proportionate to the amount paid. "These items [trade association membership fees and income taxes] qualify as expenses; they certainly couldn't be called distributions of income."

Moreover, Baylis notes that, like temperature, income taxes are an environmental cost. If a business chooses to work in a cold locale, it would incur more heating costs. Both heating costs and income taxes are environmental costs of business operations; hence, both are expenses properly charged against operating revenues.

Baylis maintains that for accounting purposes, the classification of an expenditure is determined by the reason why the payer makes that expenditure, not by the motives or desires of the payee:

> To suggest that income taxes are not an expense because the government has imposed them to provide revenue

> for its own purposes, or to help reach desired fiscal and economic goals or to achieve a redistribution of income within the economy, and so on, is the same as saying that wages paid to an employee should only be treated as wages in the accounts [of the employer] if that employee utilizes his wages in some specified manner.

Finally, Baylis argues that the conceptual nature of the tax does not change because some companies pay more income taxes than other companies or because of the way the tax is computed. He disputes Barton's contention that income taxes are not an expense because they are not a cost deliberately incurred in anticipation of future benefits. He notes that some other costs besides income taxes, such as bad debts, are not deliberately incurred, are not a result of managerial choice, are not controllable, but are appropriately classified as expenses. Additionally, the fact that income taxes are compulsory does not demonstrate that they are compulsory distributions of income rather than expenses. Rather, Baylis argues that companies presumably have chosen to accept compulsory income taxes as a condition of being able to conduct business in a particular country.[20]

Wheeler and Galliart [1974, pp. 51-63] also argue that the corporate income tax is an anomalous item rather than an expense. They reject the argument that whether the corporate income tax is an income distribution or an expense depends on whether its burden falls on stockholders or someone else. First, Wheeler and Galliart note that the tax may be something other than an expense or income distribution. Second, they suggest that who bears the burden of the tax is an unresolved question. They conclude that previous studies and authoritative pronouncements offer no help in determining the nature of the income tax because they assume the problem away. They also argue that the various theories of the accounting entity do not determine the conceptual nature of the income tax because these theories lead to either ambiguous or contradictory conclusions [see also, Dewhirst, 1972, p. 44].

Rather, Wheeler and Galliart attempt to ascertain the conceptual nature of the corporate income tax by examining its essential characteristics. They argue that the corporate income tax is not a payment for the right to conduct business; that there

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[20] In support of this choice by companies, one could also cite the trend starting in the 1990s of American companies moving headquarters offshore to avoid federal income taxes. Presumably, those companies that do not move their headquarters offshore choose to continue to be subject to federal income taxes.

is no direct relationship between the benefits a corporation receives from income taxes and the amount of income taxes paid; that the government, in its role as a tax collector, has no shareholder interest in a corporation; that the income tax is not a franchise fee; and that the income tax is a compulsory contribution. Wheeler and Galliart also note that an income distribution such as dividends is generally voluntary whereas the income tax is not so, hence is not a distribution. Additionally, although the income tax results from a combination of activities that are profit-directed, they argue that the income tax is neither an expense nor a loss because it does not generate revenue. By a process of elimination, they conclude that "because the income tax fails to qualify as a profit distribution, an expense, or a loss, it is an anomalous item."

Interestingly, as a result of the vastly higher tax rates of the 1940's, Paton [1943, p. 13] concluded that the income tax is an anomalous item rather than an income distribution:

> The terms 'net income' and 'net profit,' by long usage, imply the amount of earnings available for owners or investors, and are not at all appropriate to describe figures which may be eight or ten times the size of actual net corporate income or profits. As long as income and profits taxes were of relatively small amount the reporting of such taxes as a prior participation in the net income produced by the corporation was not particularly objectionable; under present conditions such reporting may be definitely misleading. To report 'net profit before income and profits taxes' of $50,000,000, for example, when such taxes amount to say $40, 000,000, and actual net corporate income is only $10,000,000, borders on the fantastic. . . .

McLaren [1947, p., 163] notes that federal income taxes were not treated as an allowable cost under government war contracts during the 1940s. Federal income and excess profits taxes are still not allowable costs under Federal Acquisition Regulation (FAR) 31.205-41(b) (1). The fact that federal income taxes are not allowable costs might suggest that income taxes are an income distribution or anomalous deduction from revenues to derive net income rather than an expense or loss. However, state income taxes are allowable costs under FAR 31.205-41(a) (1).[21]

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[21] The AICPA's Audit & Accounting Guide for federal government contractors [2007] notes that federal income taxes are not allowable (para. 2.24), but that state income taxes are allowable costs for government contracts [para. 2.37].

Federal and state income taxes have the same conceptual nature although the former are not allowable whereas the latter are. Consequently, it does not make sense to maintain that federal income taxes are an income distribution or anomalous deduction rather than an expense, whereas state income taxes are an expense. A more likely reason why federal income taxes are not allowable costs is that if they were allowable, contractor revenues and government expenditures would increase. But the increase in government expenditures would have to be offset by increases in income taxes for everyone. Presumably, the government finds it easier and politically more palatable to disallow income taxes as an allowable cost of contractors rather than increase income taxes for everyone.

Paton [1943, p. 13] alludes to a similar rationale when he notes the similarity of sales allowances pursuant to government contract renegotiations and income taxes during the 1940s. Both are processes by which the government recovers excess payments for war products. If a particular renegotiation adjustment is not made, a large part of the contested amount is still recovered as income and excess-profits taxes. Renegotiated contract prices are properly treated as revenue deductions. According to Paton, so should income and excess-profits taxes:

> . . . the artificiality of treating income and profits taxes as a preliminary distribution of corporate profits becomes evident. There simply are no profits in any appropriate sense – at least as far as corporate reporting to stockholders is concerned – until the processes by which the total governmental recovery is determined have been fully applied.

Thus, even Paton concludes that the corporate income tax is not an income distribution, but rather an anomalous deduction from revenues to compute corporate net income.

Multiple Conceptualizations of Income Tax: Paton [1922, pp. 269-70, lower and upper case as in the original] suggests the following presentation of interest, income taxes, and dividends consistent with his entity theory viewpoint.[22]

[22] The terminology is updated slightly to conform to modern usage by substituting retained earnings for surplus and unreserved for unappropriated. Note that Paton favors combined income and retained earnings statements although they are usually separate in practice.

OPERATING NET REVENUE	$xxxx	
Interest Earned	xxx	$xxxx
Fire Loss		xxx
NET REVENUE TO ALL EQUITIES, Before Deducting Taxes		$xxxx
Interest on Mortgage Bonds	$ xxx	
Interest on Debentures	xxx	
Interest on Notes	xxx	xxx
[Unlabelled Subtotal]		$xxxx
Federal Income and Profits Taxes		xxx
[Unlabelled Subtotal]		$xxxx
Preferred Dividends		xxx
NET BALANCE FOR COMMON STOCK		$xxxx
Common Dividends		xxx
Undivided Profits		$xxxx
Retained Earnings, 1 January 20x3		xxx
Reserve for Contingencies		xxx
TOTAL UNRESERVED RETAINED EARNINGS, 31 December 20x3		$xxxx

Although this presentation omits a figure labeled net income, Paton's Net Revenue to All Equities, Before Deducting [Interest and] Taxes is unequivocally his entity theory net income.[23]

Following Paton, some accountants [e.g., Blough, 1946, p. 89; Mason and Davidson, 1953, p. 168; AAA, 1957, p. 540] argue that the conceptual nature of the corporate income tax depends on the viewpoint of financial statement users. They argue that there is no one measure of periodic net income, but rather an array of measures for different purposes. To the stockholder, income taxes and interest on debt are properly viewed as expenses to be deducted in computing net income available for distribution as dividends without impairing capital, consistent with the proprietary theory. From an enterprise viewpoint, however, Mason and Davidson [1953, p. 168] argue that net income before income taxes and interest on debt is a more meaningful measure of the results of operations, consistent with the entity theory. Net income, so computed, can be more effectively compared from one period to another and from one enterprise to another because it is unaffected by variations in income tax policies and debt versus equity financial policies of otherwise comparable enterprises.

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[23] A consistent application of the entity theory would involve reporting corporate income taxes, along with other distributions, directly in the retained earnings statement, rather than the income statement [e.g., Huber, 1964, pp. 27-28]. However, starting with Paton, many entity theory advocates favor reporting income taxes in a combined income and retained earnings statement. Moreover, reporting corporate income taxes and interest charges directly in retained earnings never conformed to U.S. GAAP.

Other accountants dispute this apparent resolution as no resolution at all. For example, in criticizing the dual presentation of net income before and after income taxes, McLaren [1947, p. 164] notes that "the owners of a business are not concerned with any artificial sub-total, regardless of how it is labeled. What they want to know is how much the corporation has earned after all charges." Kelley [1958, p. 214] also criticizes the dual presentation as confusing. Zeff [1961, p. 160, fn. 1], in criticizing a dual presentation of net income, asks rhetorically, "which of the two balances is meant to be *the* net income? A reader of such an income statement cannot tell."

Sprouse [1957, p. 375] also questions the notion that "net income before income taxes" is a more comparable metric of enterprise profitability than "net income after income taxes." He notes that from a managerial viewpoint, "tax planning represents an extremely significant factor in modern decision making on the part of corporation managers. This would seem to indicate that management's primary concern is the amount of profits after taxes rather than…before taxes." According to Sprouse, interperiod and interfirm profitability comparisons are facilitated by excluding non-operating revenues and expenses from net income, not income taxes.

Zeff [1961, pp. 213-215] offers a resolution of this issue. He favors limiting the use of the terms "income" and "net income" in the income statement to the return to the residual equity common stockholders, not to other capital suppliers:

> Common stockholders participate in the residuum. Because the magnitude of their return is the most sensitive of all to the vicissitudes of enterprise success, their natural mindfulness of swings in business activity warrants their return – if any return is to be so classified – to be singled out as 'income' (preferably called 'net income').

Instead of using the terms "income" or "net income" to the other capital suppliers on the income statement, Zeff suggests that the income statement should report "return to all capital suppliers" and "return to preferred and common stockholders" for these subtotals. Although Zeff's suggestion might resolve the issue, practice continues to use the term "net income" to refer to "return to preferred and common stockholders," not just "return to residual equity" (i.e., common stockholders).

Conclusions on the Conceptual Nature of Corporate Income Taxes: In accordance with the proprietary theory, corporate income taxes are typically viewed as an expense. In accordance with the entity theory, they are typically viewed as an income distribution. However, as Wheeler and Galliart [1972, p. 55] conclude, neither the proprietary nor the entity theory determines unambiguously the conceptual nature of corporate income taxes because each theory leads to either ambiguous or contradictory conclusions or is interpreted differently by different writers. Moreover, neither theory is followed consistently in practice. Rather, as Husband [1938, pp. 252-253] noted, practice seems to mix them, often to the point of vacillation.

Nevertheless, important lessons result from understanding the controversies over the different theories of the accounting entity and the conceptual nature of the corporation income tax. Perhaps the most important lesson is to understand how these controversies evolved in order to avoid needless entanglements over other comparable theory controversies. However, the weight of logic leads inevitably to the conclusion that the corporate income tax is in fact an expense, not an income distribution, loss, or anomalous item. This conclusion relies in part on the definitions of the elements in the FASB conceptual framework and in part on the following refinement of the proprietary and entity theories along lines suggested by Zeff.

It will be recalled that Zeff [1961, pp. 96-97] suggests that neither the proprietary nor entity theory is completely satisfactory because neither theory fully distinguishes between the subject being accounted for and the principal party for whose benefit the financial statements are prepared. Once the proprietary theory is applied correctly to the corporation, the corporation becomes the subject being accounted for, not the stockholders, and the stockholders remain the principal party for whose benefit the financial statements are prepared. Similarly, once the entity theory is applied correctly to the corporation, the corporation remains the subject being accounted for, and the stockholders become the principal party for whose benefit the financial statements are prepared, not the corporation or its managers.[24]

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[24] Zeff [1961, p. 107] comes to a similar conclusion but he expresses it differently. His proprietor-beneficiary version of the entity theory is essentially the proprietary theory where the corporation becomes the subject being accounted for and the common stockholders remain the principal party for whose benefit the financial statements are prepared. His equities-beneficiary version of the entity theory is essentially the entity theory where the corporation remains the subject being accounted for and the common stockholders become the principal party for whose benefit the financial statements are prepared. For Zeff [1961, pp. 211-215], however, it is the common stockholders, not all the stockholders, who are

As a result, when applied correctly to the corporation, the proprietary and entity theories coalesce into the same theory of the accounting entity. The corporation is the subject being accounted for and the stockholders are the principal party for whose benefit the financial statements are prepared. Within the context of this coalesced proprietary-entity theory, the corporate income tax is not an income distribution; rather, it should be deducted from revenues and gains to derive net income attributable to the stockholders.[25]

As to whether the corporate income tax deduction is an expense, a loss, or an anomalous item, the issue is best addressed within the context of some generally accepted definition of these items, such as the FASB's conceptual framework.

Within that context, corporate income taxes clearly fit the definition of an expense as an outflow of net assets resulting from an entity's central or peripheral operations. This conclusion presupposes several aspects of the FASB conceptual framework: (1) the financial statements should articulate with one another; (2) a major objective of financial accounting is measuring periodic net income; (3) periodic net income comprises the sum of the revenues and gains less the sum of the expenses and losses; and (4) the 1985 FASB definitions of assets, liabilities, comprehensive income, revenues, expenses, gains, and losses are not only self-evident but also fully consistent with the coalesced proprietary-entity theory of the accounting entity.[26]

Consistent with the FASB conceptual framework, the statement of financial position reports assets, liabilities, and stockholders' equity as of a moment in time, while the income statement reports revenues, expenses, gains, and losses for a period of time. The statement of financial position reflects the fundamental accounting equation, Assets – Liabilities = Owners'

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the principal party for whose benefit the financial statements are prepared. As such, his fused proprietary-entity theory evolves into the residual equity theory. Kam [1990, pp. 318-320] also suggests that elements of the proprietary and entity theories might be fused.

[25] This paper purposely slights over whether the principal party for whom financial statements are prepared should be all the stockholders or just the common stockholders. Either way, the corporate income tax should be deducted from revenues and gains to derive net income attributable to all the stockholders under the fused proprietary-entity theory or just the common stockholders under the residual equity theory.

[26] Presently, the FASB and IASB are jointly developing a common conceptual framework to replace their separate conceptual frameworks. However, significant differences between the jointly developed common conceptual framework and the extant FASB conceptual framework are not anticipated.

Equity under the proprietary theory, or Assets = Equities, where equities are either liabilities or owners' equity under the entity theory. Because revenues, expenses, gains, and losses are defined in terms of changes in assets and liabilities, the financial statements articulate with one another.

Under the FASB conceptual framework, comprehensive income has four basic categories. There are no anomalous deductions from revenues and gains to derive comprehensive income or any intermediate component of comprehensive income. Conceivably, another two categories could be added to derive comprehensive income, namely, anomalous additions and anomalous deductions. However, adding two such anomalous "what-you-may-call-its" categories, to use Sprouse's [1966] terminology in a different context, would make the conceptualization of periodic net income more complicated than it already is, involving six categories rather than four. Indeed, adding two anomalous categories might make comprehensive income itself anomalous.

The FASB conceptual framework does not encompass anomalous items. Although the deduction or addition of income taxes is often captioned a "provision" and reported apart from the other expenses, it should be understood that said provision is in the nature of an expense or, if a refund, an expense reduction, not an anomalous item. Characterizing the income tax deduction as a provision does not change its conceptual nature from expense to anomalous item anymore than characterizing bad debts or warranty costs as provisions changes their conceptual nature from an expense to an anomalous item.

Manifestly, the FASB's definition of expense as an outflow or the using up of net assets resulting from an entity's central operations subsumes the definition of expense as "a cost of services consumed to obtain revenue" or, more simply, as "a cost incurred to generate revenue."[27] Thus, the above definition of expense reflects a coalesced proprietary-entity theory. Moreover, the FASB definition of expense explicitly includes income taxes. SFAS No. 109 [1992, para. 16] refers to deferred tax expense or benefit and total tax expense or benefit, not to deferred tax

[27] Chatfield [1974, p. 225] notes how the definition of expense differs under the proprietary and entity theories. Whereas expense is simply a decrease in stockholder's equity or net assets under the proprietary theory, it is a cost of services consumed to obtain revenue under the entity theory. The FASB definition subsumes the definitions under both the proprietary and entity theories.

provision and total tax provision.[28] Similarly, in the October 16, 2008 *Preliminary Views* [FASB, 2008a, p. 71] document on financial statement presentation, the illustrative statement of comprehensive income includes a deduction captioned income tax expense, not income tax provision or just income taxes.

The conceptual distinction between revenue versus gain and expense versus loss relates to whether the item results from an entity's ongoing major or peripheral operations, not its gross or net presentation [FASB, 1985, para. 84]. Revenue and expense are conventionally reported gross, whereas gain and loss are conventionally reported net. For example, sales revenue is reported gross, excluding the related cost of goods sold. Cost of goods sold is also reported gross, excluding the related sales revenue. On the other hand, gain or loss on the sale of plant assets is reported net of the depreciated cost of the plant assets sold. Conceivably, the sale of plant assets could be reported gross, i.e., both the selling price and the cost of the assets sold could be reported separately as non-operating revenue and non-operating expense respectively. Income taxes are incurred as a result of generating revenue, a major or peripheral activity of a business enterprise. Accordingly income taxes are an expense because they are a cost of generating that revenue, whether from operating revenue reported gross or from non-operating revenue reported net. Income taxes remain in nature an expense, whether reported gross as income tax expense when resulting from major or peripheral activities, or reported net when resulting from discontinued operations, extraordinary items, other comprehensive income, or prior period adjustments subject to intraperiod income tax allocation.

Besides being defined explicitly by the FASB as an expense, corporate income tax is an expense because it is an inevitable outflow or using up of net assets from major or peripheral activities. Expressed more succinctly, the income tax is an expense because it is a cost of generating operating or non-operating revenue. Although the amount of income tax is not proportional to any benefits received from the government, neither is the amount of certain other costs proportional to the benefits received from payees. Yet, these other costs are unambiguously ex-

[28] SFAS No. 109 [1992, para. 16] defines deferred tax expense or benefit as "the change during the year in an enterprise's deferred tax liabilities and assets," excluding changes in deferred tax liabilities and assets due to business acquisition or dispositions during the year. It defines total income tax expense or benefit for the year as "the sum of deferred tax expense or benefit and income taxes currently payable or refundable."

penses, not distributions of income, losses, or anomalous items. Examples include fixed franchise fees, property taxes, and trade association membership fees.

Additionally, although not proportional in amount to revenues, under interperiod income tax allocation, reported income tax expense is roughly proportional to pretax book income, ignoring permanent differences and graduated rates, etc. Accordingly, application of interperiod income tax allocation bolsters the argument that corporate income tax is an expense because its recognition is roughly proportional to the benefits received in the form of pretax book income.[29] Consistent with this observation, perhaps the method of accounting for the income tax determines its conceptual nature rather than vice versa, illogical as this conclusion might appear.

These FASB definitions might conceivably be wrong or at least subject to revision in a new jointly developed FASB-IASB common conceptual framework. However, substantial changes in these definitions are not anticipated in any new common conceptual framework. More important, as accounting is the language of business, some authoritative body should develop definitions of the elements of the financial statements so that accounting communicates effectively. Presently, that job rests with the FASB. Moreover, these definitions are essentially correct and fully consistent with the coalesced proprietary-entity theory of the accounting entity.

Equally important, because the objective of financial reporting is to provide information that is useful in credit and investment decisions [SFAC-1, 1978, paras. 30-32], financial statements should provide information needed for credit and investment decision models. Many of these decision models are specified in the finance literature. These models invariably treat income taxes as an expense, not as an income distribution, loss, or anomalous deduction. For example, Palepu et al. [2004, pp.

[29] Consistent with interperiod income tax allocation, when net income before income taxes is positive, income tax expense is usually positive, absent permanent differences, tax credits, and other items. When net income before income taxes is negative, income tax expense is usually negative and is often described as income tax benefit. Importantly, income tax benefit represents a reduction of positive income tax expense, not a revenue or gain. The same is true of negative bad debt expense due to favorable adjustments to offset overestimates of bad debt expense of prior periods, and negative professional service expense due to favorable adjustments resulting from the overestimates of professional service expense of prior periods or refunded amounts due to dissatisfaction with the quality of professional services received.

5-12], Brigham and Ehrhardt [2005, pp. 385-395], Scholes et al. [2005, pp. 3, 394], and Penman [2007, pp. 312-315] call for including income taxes, along with other expenses, in analyzing cash flows, rates of return, and/or net present values in credit and investment decisions. The usefulness of financial statements should be enhanced by treating income taxes as expense, consistent with the way they are treated in credit and investment decision models.

There is also some empirical evidence that viewing the corporate tax as an income distribution rather than an expense enjoys little acceptance among practicing accountants. In a survey of 500 American CPAs, Ricchiute [1977, p. 134] reports that 191 of 234 respondents view the tax as an expense whereas only 43 view it as an income distribution. On an overall basis, Ricchiute [1979, pp. 70, 72] reports that most of the respondents subscribe to the proprietary theory, not the entity theory. Additionally, he found no differences among surveyed CPAs in public accounting contrasted to those in industry, government, or education.[30]

According to SFAC No. 2 [1980, paras. 40-41], understandability is an essential qualitative characteristic of accounting information. Presumably, using the prevailing view of income taxes as an expense enhances user understanding of financial statements by minimizing dissonance between preparers and users.

In conclusion, the corporate income tax is best viewed as an expense rather than as a loss, an income distribution, or an anomalous item. But to paraphrase van Hoepen [1981, p. 11], it is an expense with some remarkable characteristics.

RELEVANCE OF THE CONCEPTUAL NATURE OF INCOME TAX TO INCOME STATEMENT AND CASH FLOW STATEMENT REPORTING

The controversy over the conceptual nature of the corporate

[30] Kam [1990, p. 318] disagrees with Ricchiute's findings. He argues that the attitudes of stockholders, managers, and the public confirm the entity theory. Kam appears to base his views in part on the findings of an Australian study by Moores and Steadman [1986, pp. 23-24, 30], which found that "most practicing Australian accountants currently subscribe to what has been called a 'middle position,' that is, they exhibit a propensity to oscillate between the proprietary and entity viewpoints [theories]." Somewhat inconsistently, however, Moores and Steadman found that "corporate accountants were slightly more disposed to middle positions and overall appeared more inclined towards proprietary viewpoints. But when the total responses are considered, this group clustered on middle ground while public accountants were skewed slightly to proprietary viewpoints."

income tax continues to impact its reporting on the income statement and cash flow statement.

Income Statement Reporting: One secondary effect of this controversy is the location of income tax expense on the income statement. At one time, some companies reported the income tax among other expenses, whereas other companies reported it separately as a separate deduction from pretax income to derive post-tax income [AICPA, 1966, pp. 203-204; Hasselback, 1976, p. 275]. Presently, however, almost all companies [e.g., the 2007 annual reports of Ford, p. 55; General Motors, p. 82; Procter & Gamble, p. 49] report income taxes as a separate deduction from pretax income from continuing operations to derive post-tax income from continuing operations.

This presentation may well reflect the carryover to the corporate annual report of the SEC's requirement to report income taxes separately in income statements included in annual Form 10-K reports [see Regulation S-X, 1966, section 4.08(h)]. McLaren [1947, pp. 156, 163] notes that reporting income before income taxes pursuant to SEC requirements suggests that the SEC views the income tax as an income distribution:

> It is perfectly natural for a Federal agency to view income taxes … as a profit-sharing arrangement in which the government is a participant … in keeping with … basic New Deal theories concerning the relationship … between government and business.

However, the separate presentation of the income tax does not make it a distribution or an anomalous item; it is still an expense. Deducting income tax separately from expenses merely facilitates user analysis of operations on a pre- and post-tax basis. In a multiple-step income statement, cost of goods sold is also deducted separately to facilitate analysis of gross margin; it is still an expense.

Another secondary effect of the controversy as to the conceptual nature of the corporate income tax is the lingering controversy over interperiod income tax allocation. Some theorists [e.g., May, 1945, p. 125; Moonitz, 1957, p. 175; Sprouse, 1957, p. 377; Davidson, 1958, p. 174; Dewhirst, 1972, p. 42; Van Hoepen, 1981, p. 12; Beechy, 1983, p. 17] suggest that interperiod income tax allocation would not be appropriate if the corporate income tax was really an income distribution rather than an expense. Other theorists [e.g., Hendriksen, 1958, p. 216; Jaedicke and Nelson, 1960, p. 278, fn. 4; Keller, 1961, pp. 29-30] argue that interperiod allocation should be required even if income taxes are an income distribution in order to determine income available for distribution as dividends to stockholders without impairing capital.

Cash Flow Statement Reporting: Questions concerning the conceptual nature of the corporate income tax may also impact its classification in the cash flow statement. Current U.S. GAAP classifies all income taxes as an operating flow [SFAS No. 95, 1987, paras. 91-92], except for the tax benefits from the "windfall" stock option deduction, which are classified as a financing flow [SFAS No. 123 (Revised), 2004, para. 68].

Some theorists [e.g., Nurnberg, 1993, pp. 67-69, 2003, pp. 48-54; Turpen and Slaubaugh, 1994, pp. 35-36; Waxman, 2003, pp.18-19] call for intraperiod income tax allocation within the cash flow statement for the income tax effects of all investing and financing activities in order to sharpen the distinction between operating, investing, and financing flows.

Presently, the FASB [2008a, paras. 2.21, 2.74, 2.75] proposes to report income taxes in a separate category apart from business activities on the cash flow statement. It reasons that allocating income taxes among operating, investing, and financing activities in those statements "would require complex and arbitrary allocations that are unlikely to provide useful information." Such a presentation would implicitly treat the income tax cash flows differently from cash flows for expenses, losses, or income distributions.

RELEVANCE OF THE CONTROVERSY OVER THE CONCEPTUAL NATURE OF CORPORATE INCOME TAX TO THE DEVELOPMENT OF ACCOUNTING THEORY

Unless current accounting theory is understood within a historical context, no amount of correctness, originality, rigor, or elegance will prevent those studying it from sensing a lack of direction and meaning [cf., Schumpeter, 1954, pp. 4-5]. By studying the history of accounting thought, we learn about both the fruitfulness and the fruitlessness of theory controversies, about how we advance and how we regress, and about why we are as far as we actually are but also why we are not further. Hopefully, a better understanding of the controversy over the conceptual nature of the corporate income tax will preclude fruitless controversies over other issues currently troubling accountants and accounting standard setters.

For example, a current FASB project is the conceptual distinction between liabilities and equities [FASB, 2007a]. In some ways, this controversy is similar to the one over the conceptual nature of the corporate income tax, which in turn relates to the conceptual distinctions between expenses and distributions. Despite an extensive literature extending over almost a century, the controversy over the conceptual nature of the corporate income tax remains unresolved, largely because the conceptual distinctions between expenses and income distributions are not always unambiguous. Perhaps there is little reason to expect the FASB to be more successful in distinguishing between liabilities and equities, judging by its recent somewhat unsuccessful efforts at ascertaining the conceptual nature of mandatorily redeemable preferred stock.

Another example is the current FASB project on the reporting entity, including its associated theories. Perhaps there is little reason to expect the FASB to be more successful in developing a more workable concept of the reporting entity, judging by its somewhat unsuccessful and incomplete efforts over more than 23 years to develop a more workable concept of the consolidated entity.

Still another example is the current efforts of the FASB and IASB to make accounting more consistent by developing and refining a common conceptual framework. The FASB commenced initial efforts on developing a conceptual framework in 1972. Although some of its members suggest that its extant conceptual framework is helpful in its own deliberations on new accounting standards, to date the framework is far from complete, far from internally consistent, and far from conceptual throughout, as is the joint FASB-IASB proposed common conceptual framework. Perhaps the world of accounting and business would be better off by following Boulding's [1962, p. 54] suggestion to educate report users and the public as to what accountants do rather than developing new and potentially more complex and more obtuse conceptual frameworks.

SUMMARY AND CONCLUSION

This paper examines a long-standing controversy about the conceptual nature of the corporate income tax. This controversy remains unresolved, despite several authoritative pronouncements stating or assuming that the corporate income tax is an expense, and despite an extensive discussion in the literature over more than one hundred years. This controversy in part reflects different theories of the accounting entity.

Within the context of a coalesced proprietary-entity theory of the accounting entity, the examination of this controversy leads to the unsurprising conclusion that the corporate income tax is an expense, but an expense with some remarkable characteristics. However, the benefits from examining this controversy extend beyond the conclusion that the income tax is an expense. The examination provides a historical context in which other theory controversies can be examined to greater advantage. It shows how the development of accounting thought has progressed and regressed. It teaches us much about the ways of the human mind. Perhaps a better understanding of this controversy may preclude fruitless controversies over other accounting theory issues currently troubling accountants and accounting standard setters.

Additionally, the controversy as to the conceptual nature of the corporate income tax impacts its reporting on the income statement and cash flow statement. One manifestation of this controversy is the lingering controversy over interperiod tax allocation. Another manifestation of this controversy is how to report income taxes on the income and cash flow statements.

No doubt some readers will disagree with the conclusion that the corporate income tax is an expense. To some readers, the tax defies conceptualization. Perhaps the same is true of other conceptual issues currently troubling accounting standard setters. For decades, standard setters have called for the development of a conceptual framework to help facilitate the development of financial accounting standards. But, as indicated by the controversy over the corporate income tax, some things are not easily conceptualized in the real world.

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