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The Case for Noncomprehensive Interperiod Tax Allocation

The Controversy Continues

By David P. Donnelly and Eugene J. Laughlin

Editor's Note: *In August 1983, the Financial Accounting Standards Board issued a discussion memorandum on accounting for income taxes. During subsequent deliberations, the Board decided that comprehensive interperiod tax allocation should be required based on an asset/liability approach. This article presents an opposing view. An exposure draft, scheduled for issuance in the third quarter 1986, and perhaps already distributed by the publication date of this journal, will undoubtedly require comprehensive interperiod tax allocation. Whether the positions taken in the exposure draft will be incorporated into a Statement of Financial Accounting Standards will depend, in part, upon the nature of the comments received by the Board in response to the exposure draft.*

In December 1967, the Accounting Principles Board (APB) issued *Opinion No. 11,* "Accounting for Income Taxes," and concluded that

a. Interperiod tax allocation is an integral part of the determination of income tax expense, and income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income.
b. Interperiod tax allocation procedures should follow the deferred method, both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods.
c. The tax effects of operating loss carrybacks should be allocated to the loss periods. The tax effects of operating loss carryforwards usually should not be recognized until the periods of realization.[1]

Although *Opinion No. 11* eliminated the diversity in reporting income taxes, the controversy surrounding accounting for those taxes continues. Failure to agree on whether income tax is an expense or a distribution of residual profit has much to do with this controversy. Understanding the nature of tax in relation to the nature of accounting is an essential first step in determining the proper accounting treatment of income tax.

Income Tax Laws and Accounting Principles

The federal income tax system's legal base is found in the 16th Amendment, which provides Congress with the power to levy and collect taxes on incomes from whatever source desired. Broadly, that power is directed toward providing funds for the operation of the government, serving as a means of redirecting the economy, and attaining desired social goals.

The body of tax laws relies on the general rule of taxing all revenue, unless specifically exempted, and allowing deductions only for specified expenses. The law does not attempt to define net income, assets, liabilities, and so on. To do so would place severe restrictions on the flexibility and ease with which change can occur as well as increase the difficulty of enforcement. Congress is a body of change, both in membership and interests, and the tax law reflects the complexity and changeability of this political body. As a result, tax regulations lack continuity and are subject to frequent changes.

Financial accounting, on the other hand, is largely dependent upon definitions and broad principles rather than specification of individual items. The authority inherent in financial accounting is not legal, but rather it is based on general consensus. As a result, change is slower and results from an evolutionary process. Income calculations for financial reporting purposes rely on the broad dictum that the data be reliable and relevant.

The differences created by the specificity of the tax laws and the broad dictums and definitions of accounting make it virtually impossible to resolve the question of whether or not income tax is an expense by reference to definitions. Expense, as such, is left undefined in the tax law, but the Financial Accounting Standards Board (FASB) defines expense as

> outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.[2]

If the tax can be construed as a result of a firm's normal buying, producing, and selling activities, it is endogenous to the operations and, thus, an expense of operations. If, on the other hand, the tax is unilaterally imposed by a body exogenous to the firm and in disregard of the firm's major operations, it is an "outflow or other using up of assets or incurrences of liabilities" disassociated with those "activities that constitute the entity's ongoing or central operations." In such a case, it is not an expense within the FASB definition cited above from *Statement of Financial Accounting Concepts (SFAC) No. 3.*

The difference in the nature of income tax is also reflected in its placement in financial statements. On the income statement, income

tax is not treated as an operating expense or as any other business-related expense; it is listed separately at the bottom of the statement simply as income tax.

Although it may be impossible to resolve the question of whether income tax is an expense or a distribution of residual income, there are areas in which agreement can be reached. First, income tax certainly has a nature quite different from other expenses, and this difference should be considered in determining its proper recording treatment. Secondly, while there is disagreement as to the amount and manner of disclosure of income tax, there is agreement that it must be disclosed in the financial statements.

Nature of Deferred Tax

Difficulty in establishing the amount of income tax arises because items used in determining income reflected in the tax return differ from those reported in the financial statements. These differences are of two types: permanent differences and timing differences.

Since permanent differences are defined as those that do not affect future tax calculations, it is generally agreed that they have no impact on the amount of the income tax to be disclosed. But in reference to timing differences, *APB Opinion No. 11* states that

> The tax effects of those transactions which enter into the determination of pretax accounting income either earlier or later than they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and the periods in which the differences reverse.[3]

Proponents of disclosing the tax effects of all timing differences support their position by the matching principle. However, to apply the matching principle requires a relationship between the accounting income recorded in the period and the income taxes shown. This relationship does not exist. Income tax results from earning net taxable income, not net accounting income. The effect that a timing difference has on future taxes cannot be determined without knowing all other components of the future period. The changing nature of tax laws also negates the relationship between taxable income and accounting income. Changes take place in both tax rates and items taxed. Although changes are certain, the type and magnitude of those changes are not. Applying the matching principle to income tax without regard to its difference from other expenses results in an asset or liability, which, as discussed below, does not fit within the current definition of those items.

Deferred Taxes as an Asset. Under current practice, the deferred income tax balance is the amount of timing differences times a prior or current tax rate. If the account has a debit balance, it is classified as a current or noncurrent asset. Some accountants question the propriety of this classification. *SFAC No. 3* states "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[4] "Probable" in this context "refers to that which can reasonably be expected or believed on the basis of available evidence or logic."[5]

The only justification for an asset classification is found in the probable effect of future cash flows.

Since it is clear that deferred income taxes will not be exchanged directly for cash or other assets, the only justification for an asset classification is found in the probable effect on future cash flows. Unlike other prepaid items, such as rent or insurance that involve rights to services or use of resources, deferred tax conveys no rights. While it is argued that the deferral represents a reduction in future tax liabilities, such an argument ignores the uncertainty of both the timing and the amount of the reduction. Proponents argue that certainty is not required, but rather that it be only a probable reduction. But it is interesting to note that the Accounting Principles Board disregards the notion of probable for the tax effects of a loss carryforward when it states in *Opinion No. 11* that

> . . . the Board has concluded that the tax benefits of loss carryforwards should not be recognized until they are actually realized, except in unusual circumstances when realization is *assured beyond any reasonable doubt* at the time the loss carryforwards arise.[6] (emphasis in the original)

Deferred Taxes as a Liability. When the deferred tax account has a credit balance, it is classified as a liability. *SFAC No. 3* defines liabilities as

> probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.[7]

"Probable" is used here in the same context as used in defining an asset and results in the same disagreement among accountants as to whether deferred taxes meet this criterion. "Obligations" is used in a broader sense than legal obligations. It refers to "that which one is bound to do by contract, promise, moral responsibility, etc."[8] In discussing liabilities, *SFAC No. 3* further specifies that

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer of use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular enterprise, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the enterprise has already happened.[9]

The first characteristic necessitates a present obligation; but under the tax law, taxes are determined on a period-by-period basis. Each tax year is separate and distinct, and taxes are assessed only on the current period. A taxpayer has no responsibility to the government for taxes on transactions not required to be included in the entity's tax return for that taxable year. The fact that an item is included on the financial statement in a particular period does not create the responsibility; rather, it is the inclusion of the item under the tax law that creates the obligation.

The second characteristic of a liability is that the responsibility obligates the enterprise, leaving it little or no discretion to avoid the future sacrifice. To say that deferred taxes has this characteristic is to deny the existence of tax planning. The ability of the corporation to avoid future sacrifice is reflected in the increase in size of the deferred tax account on most large corporate financial statements. The deferred tax account is not so much a measure of responsibility to make a future payment as it is a measure of planning to avoid future obligations on timing differences.

At best, classification of deferred taxes as a liability may be based on the definition of a contingency.

The third and final characteristic of a liability is that the transaction obligating the enterprise has already happened. In the sense that the timing difference has been reflected in the entity's statements, the event has occurred. Future obligations result only if the timing differences occur in the future.

At best, classification of deferred taxes as a liability may be based on the definition of a contingency. *FASB Statement of Financial Accounting Standards (SFAS) No. 5* specifies the essential characteristics of a contingency as (1) an *existing* condition (2) involving *uncertainty* about an outcome (3) that should be resolved by the occurrence or nonoccurrence of some *future* event.[10]

As currently determined, much confusion exists about what the deferred tax account represents. For many companies, the account balance continues to increase in size, reflecting the impact of recurring differences. The account balance does not truly represent the future cash outlay for income taxes, which is what the financial statement user perceives it to measure. According to the FASB in its *Discussion Memorandum,* "Accounting for Income Taxes," under comprehensive allocation

> the tax effects of timing differences that might originate in the future . . . are not anticipated and accounted for as offsets of the reversals of present period differences.[11]

Even though past experience suggests that some differences are not expected to result in future cash outlays, these differences are nevertheless recorded as if they will. This decreases representational faithfulness since the amount purported to represent a future cash outlay cannot be expected to materialize.

Asset/Liability View vs. Revenue/Expense View

The FASB Concepts Statements have initiated a return to the asset/liability (balance sheet) view. Under this viewpoint, an expense results from using up assets or incurring liabilities. While the revenue/expense view directly determines the amount of the tax to be shown on the income statement and the deferral on the balance sheet is a residual, the asset/liability view is exactly the opposite. The amount of the balance sheet deferral is the dominant factor determined directly and the income statement is a residual. On a much larger scale, it is essentially the same as the differences in approach found in determining bad debts as a percentage of sales (revenue/expense view) or as a percentage of accounts receivable (asset/liability view).

Under the asset/liability view, the argument over whether income taxes are an expense or a distribution of income is less important. Although

As currently determined, much confusion exists about what the deferred tax account represents.

both views involve matching, Sprouse believes the role of matching has changed.

> Under the asset/liability view, revenues and expenses are matched as a consequence of recognizing changes in assets and liabilities in the period in which those changes take place . . . Under the revenue/expense view, however, what constitutes "proper matching" and "nondistortion" is very much in the eyes of the beholder.[12]

Partial Allocation

As stated earlier, the nature of interperiod tax allocation is such that it is not clear if deferred taxes meets the definition of assets or that of liabilities. Criticism of the classification of deferred taxes concerns the probable future effects of the allocations. Under a partial allocation approach, only the effects of nonrecurring timing differences are recorded, thus increasing the likelihood that differences will reverse in the future and cash flows will be as expected. Nevertheless, to make the approach more operational while at the same time increase the probability of expected future cash flows, the partial allocation method should be modified to include only material nonrecurring timing differences that reverse in a relatively short period of time, for instance, three to five years.

A further problem of definition

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concerns the enterprise's ability to avoid the future sacrifice in the case of a liability. This criticism is largely nullifed by eliminating recurring timing differences and by the short horizon period of the nonrecurring differences.

Finally, the debate rests on whether or not the deferred tax amount represents a present responsibility to the

The nature of interperiod tax allocation is such that it is not clear if deferred taxes meet the definition of assets or that of liabilities.

government. As stated earlier, the nature of the tax law is such that a strict interpretation would suggest that such a responsibility does not exist. Although the nonrecurring tax allocations are not legal liabilities, they are almost certain to be paid in the near future. As stated by Sands

> . . . accountants have long since recognized that they can not rely entirely on legal concepts in the measurement of economic phenomena . . . There could be no objection to distinguishing between legal and economic liabilities by describing the non-legal type by some other name . . . as long as it was generally understood what the term meant.[13]

This broader interpretation of liabilities appears to be held by the majority of practitioners and standard setters. Deferred tax does meet a broader interpretation of liabilities and may properly be presented in the financial statement under a partial allocation method. This is the approach the authors prefer.

Summary and Conclusion

SFAC No. 1 states that

> The primary objective of financial reporting is to provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective cash inflows to the related enterprise.[14]

For most companies, income tax represents a major cash outflow that needs to be disclosed. Deferred tax, unlike the current amount of income tax payable, represents an uncertain but potential effect on future cash flows. The question centers on the degree to which the uncertainty surrounding deferred tax affects its informational value.

Under current practice, deferred tax is recorded using comprehensive interperiod tax allocation. This approach is based upon the revenue/expense view under which the tax effects of all timing differences occurring in prior and current periods are recorded. This view, however, fails to consider the difference in nature between income tax and other expenses and results in recording assets and liabilities which do not meet the definitions of either classification. It has resulted in recording an amount for deferred tax that does not represent future cash flows. Finally, it has resulted in misunderstanding and confusion in practice.

This paper suggests that partial interperiod tax allocation be adopted. This approach is justified from an asset/liability point of view. By recording only nonrecurring timing differences, much of the uncertainty surrounding the deferred tax amount is eliminated, and the resulting amount represents assets or liabilities as currently defined. Furthermore, the deferred tax amount under this method represents expected future cash flows and thus increases the understanding of users as well as meets the objectives of financial statements. If the profession is serious about using the recent concepts statements as a framework for accounting pronouncements, then a change from comprehensive to partial interperiod tax allocation is a logical step. Ω

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NOTES

[1]*Accounting Principles Board Opinion No. 11,* "Accounting For Income Taxes," (New York: AICPA, 1967), para. 12.

[2]*FASB Statement of Financial Accounting Concepts No. 3,* "Elements of Financial Statements of Business Enterprises," (Stamford: FASB, 1980), para. 65.

[3]*Accounting Principles Board Opinion No. 11, op. cit.,* para. 34.

[4]*FASB Statement of Financial Accounting Concepts No. 3, op. cit.,* para. 19.

[5]*Ibid.,* fn. 9.

[6]*Accounting Principles Board Opinion No. 11, op. cit.,* para. 45.

[7]*FASB Statement of Financial Accounting Concepts No. 3, op. cit.,* para. 28.

[8]*Ibid.,* fn. 9.

[9]*Ibid.,* para. 29.

[10]*FASB Statement of Financial Accounting Standards No. 5,* "Accounting for Contingencies," (Stamford: FASB, 1975), para. 1.

[11]*FASB Discussion Memorandum,* "Accounting For Income Taxes," (Stamford: FASB, 1983), para. 119.

[12]Robert T. Sprouse, "The Importance of Earnings in the Conceptual Framework," *Journal of Accountancy* (January 1978), p. 69.

[13]J. E. Sands, "Deferred Tax Credits are Liabilities," *The Accounting Review* (October 1959), p. 589.

[14]*FASB Statement of Financial Accounting Concepts No. 1,* "Objectives of Financial Reporting by Business Enterprises," (Stamford: FASB, 1978), para. 37.