Woman C.P.A.

Volume 50 | Issue 4 Article 6

10-1988

Theory & Practice: Accounting for Income Taxes — The Last Fifty Years By

Linda M. Plunkett

Deborah H. Turner

Follow this and additional works at: https://egrove.olemiss.edu/wcpa

Part of the Accounting Commons, Taxation Commons, and the Women's Studies Commons

Recommended Citation

Plunkett, Linda M. and Turner, Deborah H. (1988) "Theory & Practice: Accounting for Income Taxes — The Last Fifty Years By," *Woman C.P.A.*: Vol. 50 : Iss. 4 , Article 6.
Available at: https://egrove.olemiss.edu/wcpa/vol50/iss4/6

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Accounting for Income Taxes — The Last Fifty Years

By Linda M. Plunkett and Deborah H. Turner

Editor: Karen Hooks, University of South Florida, Tampa, FL 33620

The last fifty years have been revolutionary in accounting history as nearly every aspect of the profession has changed. The body of accounting theory has evolved in conjunction with vastly complex business organizations, technological advancements, and governmental imperatives. Many improvements in accounting principles have resulted, but one area — the accounting for income taxes — has had minimal theoretical growth despite numerous accounting pronouncements.

Linda M. Plunkett, Ph.D., CPA, *is an associate professor of business administration at the College of Charleston in Charleston, S.C. She is a member of various professional organizations including AWSCPA, AAA, and the South Carolina Association of CPAs.*

Deborah H. Turner, Ph.D., CPA, *is an assistant professor of accounting at the Georgia Institute of Technology. She serves on the Board of Directors of the Georgia affiliate of AWSCPA and is also a member of AICPA, AAA, and Georgia Society of CPAs.*

After nearly six years of research and discussion, the FASB issued Statement No. 96, *Accounting for Income Taxes* (SFAS 96) in December 1987. The accounting profession is just beginning to understand the implications of comprehensive tax allocation using the liability method required by this pronouncement. To better understand the significance of SFAS 96, it is useful to examine the historical development that preceded its passage.

The history of accounting for income taxes can be divided into three periods: pre-1967 — the years prior to the passage of Accounting Principles Board (APB) Opinion No. 11 (APBO 11); 1967-1987 — the years involving APBO 11; and the present situation under SFAS 96. This article provides an overview of each of these three periods considering both the income tax laws and the accounting practices involved.

Pre-1967: Whether to Allocate and How Much to Allocate

The accounting treatment of income taxes prior to World War II was inconsistent. For the most part, taxes were treated as distributions of net income, rather than as expenses. The bottom line in an income statement was net income before taxes; income taxes paid were deducted from retained earnings.

> ***It was not until the passage of the Internal Revenue Code (IRC) of 1954 that accounting for income taxes became a widespread accounting issue affecting most businesses.***

This treatment was chiefly due to the fact that federal income taxation was not a dominant part of the U.S. tax system before World War II [Sommerfeld and Easton, 1987, p. 169]. Local governments, rather than the federal government, raised most of the tax revenues in the U.S., mainly through property taxes. However, during the war years, there was a rapid expansion in both the corporate and individual taxpaying population, and the top marginal rates increased significantly

(corporate rates doubled to 39 percent). Even though many income tax provisions and modifications have occurred since the second World War, the dominance of the federal income tax still exists.

Initially, income taxes paid to the federal authorities were generally equal to the tax rates applied to accounting income as reported in the income statement. Few timing differences existed between taxable income and accounting income, and the effects of any differences in tax and accounting bases were diluted to an immaterial level by relatively low tax rates.

In 1942, the first sign of interperiod tax allocation appeared in an authoritative accounting pronouncement, Accounting Research Bulletin (ARB) No. 18 issued by the Committee on Accounting Procedure. The statement concerned a rather esoteric problem, accounting for the tax effects of extraordinary charges arising from unamortized discounts on refunded bonds. Nevertheless, the accounting profession recognized that a problem area existed in accounting for income taxes.

Two years later when ARB No. 23 was issued, the profession had its first extensive exposure to accounting for income taxes. The statement introduced a broad concept of timing differences and concluded that income taxes should be treated as expenses requiring allocation, although it exempted long-term timing differences from this treatment. (It is interesting that ARB No. 23 presented an occasion for an early skirmish between the accounting profession and the SEC, which objected to the conclusions of the pronouncement. The SEC stated that "the amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws" [Accounting Series Release No. 53, 1945].)

During the decade after the IRC of 1954 was passed, the differences between accounting income and taxable income widened as income tax provisions rapidly became more complex.

Only minor accounting pronouncements involving income taxes were made in the next decade (see Table 1). It was not until the passage of the Internal Revenue Code (IRC) of 1954 that accounting for income taxes became a widespread accounting issue affecting most businesses. The allowance of accelerated depreciation methods in the IRC of 1954 resulted in frequent and significant timing differences, and the profession responded with ARB No. 44, *Declining Balance Depreciation*. It was then that the debate began on the appropriate extent of interperiod tax allocation —comprehensive versus partial.

> The idea of comprehensive allocation drew increased support, and in 1958 the Committee issued ARB 44 (Revised). It required companies to record deferred taxes for all depreciation timing differences and permitted the net-of-tax method of presentation for timing differences expected to continue indefinitely. [Beresford, et al., 1983, p. 137].

This time the SEC concurred with the Committee. The SEC reinforced the concept of interperiod tax allocation by stating in Accounting Series Release No. 85 that deferred taxes should be recognized in all cases where there is a tax reduction resulting from deducting costs at faster rates for tax purposes than for financial statement purposes.

During the decade after the IRC of 1954 was passed, the differences between accounting income and taxable income widened as income tax provisions rapidly became more complex. Tax policies were developed in reaction to economic, social, and political influences and objectives; taxable income and deductions were no longer consistent with accounting income and expenses. By the mid-1960s, the accounting profession recognized the crucial need to undertake a thorough analysis of the rapidly increasing differences between accounting and taxable income.

The analysis culminated in the issuance of Accounting Research Study No. 9 (ARS 9), *Interperiod Allocation of Corporate Income Taxes*, authored by Homer Black in 1966 for the Accounting Research Division of the AICPA. The two basic premises of the study were that (1) income taxes are expenses, not distributions of income; and (2) income taxes should be allocated to applicable periods, not merely disclosed as timing differences in footnotes. The conclusions of ARS 9 are recognizable as some of the same principles being argued in SFAS 96 over twenty years later:

a. Interperiod tax allocation should be applied to all material timing differences (comprehensive allocation).
b. Deferred tax debits should be recorded under the deferred

TABLE 1
Chronological Listing of Authoritative Pronouncements Related to the Accounting for Income Taxes

Year	Pronouncement	Title of Pronouncement
1942	*ARB No. 18	Unamortized Discount and Redemption Premium of Bonds Refunded (Supplement)
1944	*ARB No. 23	Accounting for Income Taxes
1946	*ARB No. 27	Emergency Facilities
1952	*ARB No. 42	Emergency Facilities — Depreciation, Amortization, and Income Taxes
1953	*ARB No. 43	Restatement and Revision of Accounting Research Bulletins (Chapters 9C, 10B, 11B, and 15)
1954	*ARB No. 44	Declining Balance Depreciation
1958	*ARB No. 44 (Rev.)	Declining Balance Depreciation (Paragraphs 4, 5, 7, and 10)
1959	*ARB No. 51	Consolidated Financial Statements (Paragraph 17)
1962	*APBO No. 1	New Depreciation Guidelines (Paragraphs 1, 5, and 6)
1962	APBO No. 2	Accounting for the "Investment Credit"
1962	APBO No. 4	Accounting for the "Investment Credit" (Amending APB No. 2)
1965	*APBO No. 6	Status of Accounting Research Bulletins (Paragraph 21)
1966	APBO No. 10	Omnibus Opinion — 1966 (Paragraph 6)
1967	*APBO No. 11	Accounting for Income Taxes
1972	APBO No. 23	Accounting for Income Taxes — Special Areas
1972	*APBO No. 24	Accounting for Income Taxes —Investments in Common Stock Accounted for by the Equity Method (other than Subsidiaries and Corporate Joint Ventures)
1977	FASB Int. 18	Accounting for Income Taxes in Interim Periods
1978	*FASB Int. 22	Applicability of Indefinite Reversal Criteria to Timing Differences
1978	*FASB Int. 25	Accounting for an Unused Investment Tax Credit
1979	*FASB Int. 29	Reporting Tax Benefits Realized on Disposition of Investments in Certain Subsidiaries and Other Investees
1979	*SFAS No. 31	Accounting for Tax Benefits Related to U.K. Tax Legislation Concerning Stock Relief
1980	*FASB Int. 32	Application of Percentage Limitations in Recognizing Investment Tax Credit
1980	*SFAS No. 37	Balance Sheet Classification of Deferred Income Taxes
1987	SFAS No. 96	Accounting for Income Taxes

*Section of pronouncement related to accounting for income taxes superseded by later pronouncement.

NOTE: Some pronouncements not identified as having been superseded have been *amended* by subsequent pronouncements.

method. Deferred tax credits should be recorded under the liability method. The net-of-tax method should not be used.

c. Long-term deferred tax liabilities should be discounted using the enterprise's internal rate of return.

d. The benefit of an NOL carryforward should be recognized in the loss year only if realization is substantially assured [Beresford, et al., 1983, p. 138].

1967-1987: How Much to Allocate and How to Allocate

In issuing APBO 11 in 1967, the APB deviated from some of the recommendations of ARS 9. Comprehensive interperiod tax allocation was required, but only the deferred method could be used. The tax effects of operating loss carrybacks were required to be allocated to the loss periods, while tax effects of loss carryforwards were not usually recognized until the periods of realization. Financial statement presentations of income tax expense and related deferred taxes required disclosure of income tax expense currently payable and deferred, and the deferred portion was to be separated into a net current and a net noncurrent amount. Discounting was not advised.

Under the deferred method of APBO 11, income tax **expense** was based on pretax accounting income. Tax rates currently in effect were used to measure income tax **expense** as if pretax financial income were reported on the tax return. The difference between income tax **expense** and income tax actually **payable** was reported on the balance sheet as deferred taxes. Theoretically, deferred taxes

would reverse as the timing differences causing the deferrals reversed.

In APBO 11, the Board was trying to establish the guidelines needed to handle the tax effects of the increasing number of timing differences between net income determined for financial accounting purposes and net taxable income. Timing differences were not the only problem areas. Operating losses, investment tax credits, and similar items presented a proliferation of reconciliations between accounting and taxable income.

APBO 11 might have been a fairly serviceable standard if the tax laws had remained constant instead of becoming more voluminous and complicated. However, another major obstacle to the long-term usefulness of APBO 11 was the significant decrease in the statutory tax rates during this time. In 1964, the maximum corporate tax rate was 50 percent. It dropped to 48 percent in 1965, then to 46 percent in 1979. (Now the top marginal rate for corporate taxpayers is only 34 percent.) The deferred tax accounts which had been determined using historical (higher) rates were not reduced until the timing differences began to reverse, sometimes years after they originated. Thus, the annual reporting of the deferred tax accounts reflected amounts that were out of proportion to the reporting year's statutory (lower) tax rates.

Studies of corporate deferred tax accounts have shown that deferred tax credits continually increased in balance sheets from 1954 to 1973. "These . . . studies suggest that under normal economic circumstances (e.g., inflation, stable or expanding production facilities) a going concern may never have to pay the balance on deferred taxes" [Hoshower and Ferrara, 1985, p. 57]. Thus the deferred tax credits arising under APBO 11 were not true liabilities that would affect cash flow, yet they represented a growing sum on the credit side of the balance sheet that were not really equities either. As a compromise, the large deferred tax credits were reported as a separate item in the balance sheet between liabilities and equities in "no man's land." Such an ambiguous presentation created interpretation problems and confusion for financial statement users.

By the mid-1960's, the accounting profession recognized the crucial need to undertake a thorough analysis of the rapidly increasing differences between accounting and taxable income.

By 1982, the FASB had called for a reconsideration of accounting for income taxes. In addition to being extremely difficult to comprehend and interpret, APBO 11 (along with eight additional APB opinions, four FASB statements, and almost fifty interpretations, releases, and bulletins from the APB, FASB, AICPA, and SEC) was criticized as being too costly to apply in view of the benefits derived, as well as being internally inconsistent [Beresford, et al., 1983, p. 3]. One of the letters to the FASB stated a view shared by many:

> It is now so clear that the deferred tax account is such a hodgepodge that we need to start over. The deferred method of tax allocation has nothing to say for it except that it is a mechanical process . . . The countless hours that are spent arguing over the way to calculate deferred income taxes under Opinions 11, 23, 24, and the various interpretations thereto just are not worth the informational benefit to users of financial statements. We know that the business world is complex, but for accountants to heap accounting complexity on business complexity when there is no benefit to the user — and when he does not understand it — is nonsense [Peat, Marwick, Mitchell & Co., Letter to the FASB, May 12, 1980, in Beresford, et al., p. 4].

1987-1988: How to Allocate

By 1982, the FASB began a project to re-examine all aspects of accounting for income taxes after numerous requests for reconsideration, amendment, and interpretation. Finally SFAS 96 was issued in December 1987. The standard was hailed by some as being a notable improvement over its predecessors, but some controversies that existed prior to APBO 11 still have not been resolved.

As most accountants now know, the new standard includes the following principles related to recognition and measurement:

a. A current or deferred tax liability or asset is recognized for the current or deferred tax consequences of all events that have been recognized in the financial statements.
b. The current or deferred tax consequences of an event are

measured by applying the provisions of enacted tax laws to determine the amount of taxes payable or refundable currently or in future years.

c. The tax consequences of earning income or incurring losses or expenses in future years of the future enactment of a change in tax laws or rates are not anticipated for purposes of recognition and measurement of a deferred tax liability or asset [SFAS 96, p. i].

The new statement, by adopting the liability method, has shifted from an income statement orientation to a balance sheet emphasis. At each balance sheet date, the amount of deferred taxes is calculated using statutory rates that will be in effect when timing (temporary) differences are expected to reverse. In this manner, a credit balance in deferred taxes represents a true liability, since that balance reflects probable future sacrifices — taxes that are expected to be paid in the future (based on events already recognized in the financial statements). On the other hand, a debit balance in deferred taxes is not always considered to be an asset. It is recognized as an asset only to the extent that in future years the deductible amounts that resulted in the debit balance will offset taxable amounts from other temporary differences that **already exist.** If there are no other existing temporary differences that will be taxable amounts in future years, then the debit balance in deferred taxes cannot be recognized as an asset.

This asymmetrical treatment of deferred tax liabilities (**always** recognized for temporary differences that will result in net taxable amounts) and deferred tax

The new statement, by adopting the liability method, has shifted from an income statement orientation to a balance sheet emphasis.

assets (**only** recognized for temporary differences that will result in deductible amounts that will reduce taxes otherwise paid or payable) has not been justified on the theoretical grounds of conservatism as might be expected. Instead, the FASB has defended the asymmetry as being "an accurate reflection of U.S. tax law . . . [which] is not evenhanded" [SFAS 96, p. iv]. This may be the most blatant evidence that SFAS 96 is not based so much on pure accounting theory as on expediency.

Another criticism of the theoretical foundation of SFAS 96 concerns the accrual accounting model and the matching principle. Under SFAS 96, the amount of income tax expense to be reported on the income statement is basically a forced (plugged) reconciliation between taxes payable and deferred taxes calculated at year end. No longer can income tax expense be interpreted as being the result of the current tax rates applied to reported accounting income and, thus, as being in conformity with the matching principle.

The income statement effect of the new standard may be a major weakness, but it will likely be the most attractive aspect of adopting SFAS 96 as well. It is significant that the liability method of accounting for income taxes was released so soon after the passage of the Tax Reform Act of 1986, whereby nominal corporate tax rates were pruned to 34 percent. Since the liability method requires that any existing deferred tax amounts on the balance sheet be adjusted for subsequent changes in the tax laws, deferred tax credits originating prior to SFAS 96 will be reduced, causing an increase in net income. A recent study suggested that the impact of adopting SFAS 96 will be a dramatic increase in reported earnings for many industries [Epaves and Smith, 1988, p. 5].

In other words, application of the liability method could result in fluctuations in earnings, but these fluctuations may be due entirely to the frequent, and seemingly continual, changes in the tax laws. Presently, the corporate tax rates have been reduced, and it is understandable that many in the business community now favor the change to the liability method and the resulting increase in earnings. "[But] if tax rates increase, substantial write-ups of deferred tax liabilities with concomitant decreases in reported earnings will result under the liability method. In these circumstances, it is likely that many in the business community will be disenchanted with the liability method" [Nurnberg, 1987, p. 64].

Conclusions

Whether SFAS 96 represents an improvement over prior GAAP remains a question that can only be answered after the profession gains experience in applying the standard. What is known now is that:

(continued on page 37)

(continued)

Burckel, Daryl V., and Swindle, Bruce. *Church Accounting*, July, p. 27.

INTERNATIONAL

Foran, Nancy, and Gray, Dahli. *Florida's Sales and Use Tax: Implications for Multinational Corporations*, January, p. 20.

MANUSCRIPT GUIDELINES

January, p. 32, April, p. 32, July, p. 32.

MISCELLANEOUS

Gibson, Charles H., and Schroeder, Nicholas W. *Improving Annual Reports by Improving the Readability of Footnotes*, April, p. 13.

Gurganus, Frankie, and Holley, Charles L. *Risk Management: Balancing the Costs*, April, p. 8.

Parrish, Lillian C. *Updates*, July, p. 2.

Parrish, Lillian C. *Pages from the Past*, October, p. 2.

STRESS

Campbell, Michael C., Sheridan, Joanne B., and Campbell, Kathleen Q., *How Do Accountants Cope with Stress?* July, p. 4.

Piccoli, Linda, Emig, James R., and Hiltebeitel, Kenneth M. *Why is Public Accounting Stressful?* July, p. 8.

Senatra, Phillip. *What are the Sources and Consequences of Stress?* July, p. 13.

TAX

Marcum, Sue, and Williamson, Donald T. *Taxpayer Record Retention Requirements*, April, p. 29.

Theisen, Barbara A. *Tax Reform to Increase Cost of Higher Education*, January, p. 23.

White, III, Thomas C., and Plunkett, Linda M. *TRPs: Definition, Responsibilities, Penalties*, July, p. 17.

THEORY AND PRACTICE

Plunkett, Linda M., and Turner, Deborah H. *Accounting for Income Taxes: The Last Fifty Years*, October, p. 28.

THE WOMAN CPA

Audit Report — *The Woman CPA*, October, p. 38.

Vol. I - Vol. 50, October, p. 16.

WOMEN IN ACCOUNTING

Jancura, Elise G. *A Profile of Women Accountants — 1988*, October, p. 7.

Marquette, R. Penny, and Lieberman, Alvin. *Future Women Accountants: The Best and the Brightest or the Most Naive?* October, p. 12.

Meredith, Vicki, and Brown, Betty. *Women at the Partner Level: What Does the Future Hold?* October, p. 3.

Parrish, Lillian C. *Upward Mobility of Women in Accounting*, January, p. 2.

(continued from page 32)

a. Implementation of SFAS 96 will be at least as complex as APBO 11, if not more so.

b. The liability method of accounting for deferred tax credits may represent a treatment more consistent with the definitions within the conceptual framework; however, the treatment of a net deferred tax debit is not as well seated in accounting theory.

c. The discounting of deferred tax liabilities advocated by ARS 9 over twenty years ago is by no means a defunct issue. [See Rayburn, 1987, and Stepp, 1985].

d. The U.S. tax laws appear to have a more powerful effect on the development of accounting theory than in the past.

This last observation — the effect of tax laws on accounting theory — is especially troubling given the frequent and significant tax law changes over the last decade.

The history of accounting for income taxes over the last fifty years, as presented here, provides an example of what might be described as regressive accounting theory. Given this historical experience, it seems likely that users of financial statements will continue to be confused rather than enlightened by the profession's current approach to the accounting for income taxes.

. . . another major obstacle to the long-term usefulness of APBO 11 was the significant decrease in the statutory tax rates during this time.

REFERENCES

Beresford, Dennis R., Lawrence C. Best, Paul W. Craig, and Joseph V. Weber, *Accounting for Income Taxes: A Review of Alternatives*, Financial Accounting Standards Board (1983).

Epaves, Richard A. and Ephraim P. Smith, "Deferred Income Taxes: A Financial Windfall?" *The Woman CPA* (April 1988), pp. 3-7.

Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 96: Accounting for Income Taxes* (December 1987).

Hoshower, Leon B. and William L. Ferrara, "Deferred Taxes and Consolidations — A Case for Change," *Management Accounting* (December 1985), pp. 57-60.

Nurnberg, Hugo, "Changes in Tax Rates Under the Deferred and Liability Methods of Interperiod Tax Allocation," *Accounting Horizons* (September 1987), pp. 59-65.

Rayburn, Frank R., "Discounting of Deferred Income Taxes: An Argument for Reconsideration," *Accounting Horizons* (March 1987), pp. 43-49.

Sommerfeld, Ray and John E. Easton, "The CPA's Tax Practice Today — and How It Got That Way," *Journal of Accountancy* (May 1987), pp. 166-179.

Stepp, James O., "Deferred Taxes: The Discounting Controversy," *Journal of Accountancy* (November 1985), pp. 98-103.

U.S. Securities and Exchange Commission, *Accounting Series Release No. 53: In the Matter of "Charges in Lieu of Taxes" — Statement of the Commission's Opinion Regarding Charges in Lieu of Income Taxes" and "Provisions for Income Taxes" in the Profit and Loss Statement* (1968).