To this point, our discussion of income taxes has focused primarily on how timing dif-
ferences result in deferred tax assets and liabilities. In this section of the chapter, we
introduce the concept of intraperiod income tax allocation. This concept involves
allocating income tax expense between income from continuing operations and
below-the-line items such as extraordinary items, discontinued operations, and
changes in accounting principles.

**INTRAPERIOD TAX ALLOCATION**

As discussed in Chapter 4, when a company reports irregular or extraordinary items
(below-the-line items) on its income statement or when a prior-period adjustment affects
retained earnings, intraperiod tax allocation is appropriate. Under this approach, the
income tax effect of each of these special items is reported with the individual item
rather than being included with the income tax expense related to current operations. It
was assumed in Chapter 4 that a single rate was applied to each category of income and
that no special tax limitations were present for any of the income categories. With this
assumption, intraperiod income tax allocation is not difficult.

When this simplifying assumption is not realistic and different levels of income are
taxed at varying rates, decision rules must be developed to make the allocation among
the various categories of income. Paragraph 38 of FASB Statement No. 109 establishes the
priority for intraperiod tax allocation.

In summary, a “with and without” approach is applied as follows:

1. Income taxes are computed for current operations without any of the irregular or
   extraordinary items.
2. Income taxes are computed with all income items considered. The difference
   between (1) and (2) is the total tax allocation to irregular and extraordinary items.
3. Income taxes are computed on total income without irregular and extraor-
   dinary losses considered to determine the tax effect of all losses. If there are
   several losses, the incremental tax effect of each loss category is considered,
   and the total tax impact of all loss categories is allocated among the separate
   losses in the ratio of their separate incremental impacts.
4. The difference between the income tax benefit allocated to all losses and
   the total irregular and extraordinary allocation (2) is attributed to irregular
   and extraordinary gains. If there are several gains, the incremental tax effect
   of all gain categories is considered, and further allocation to gain items is
   made in the same manner as losses.

An example will illustrate the application of these decision rules. Assume Marble
Corp. reports the following pretax income components on its income statement.

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$100,000</td>
</tr>
<tr>
<td>Extraordinary items</td>
<td>$20,000</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

**FYI:** Most tax rate structures are graduated. When a company’s income from operations is in one tax rate level and the below-the-line items are at another level, the allocations described here apply.

18 To simplify the discussion of intraperiod income tax allocation, it is assumed that financial reporting income and taxable income are equal; thus, there are no deferred taxes. In many actual situations, deferred taxes may apply both to current operations and to irregular categories of income such as discontinued operations. The interplay of deferred taxes with intraperiod tax allocation adds another dimension of complexity not considered in this introductory presentation of accounting for income taxes.
Income from continuing operations ................................................................................................... $75,600
Loss on disposal of business segment ............................................................................................ (19,000)
Extraordinary gain on early extinguishment of debt ....................................................................... 30,000
Extraordinary loss on litigation claim ........................................................................................... (16,000)
Cumulative effect of change in depreciation method ....................................................................... 15,000
Total income before considering income taxes ................................................................................. $85,600

Assume the tax department has applied the current tax regulations and rates to Marble’s various income categories and computed the following tax information using the with-and-without concepts required for intraperiod tax allocation.

Tax on total income ($85,600) .......................................................................................................... $30,200
Tax on income from continuing operations ($75,600)..................................................................... 26,750
Tax on total income before considering all irregular and extraordinary losses
($85,600 + $19,000 + $16,000 = $120,600)......................................................................... 42,500

Based on this assumed tax information, the net income for the year is $55,400 ($85,600 – $30,200). The total intraperiod tax allocation is $3,450 tax expense ($30,200 – $26,750). The total tax benefit allocated to the two loss categories is $12,300 ($42,500 – $30,200), and the total tax expense allocated to the two gain categories is $15,750 ($12,300 + $3,450). This allocation can be shown graphically as follows:

```
Tax on income from continuing operations $26,750
Tax on total income before considering all irregular and extraordinary losses $42,500
Tax on total income $30,200 $ 3,450 (Net tax allocated to irregular and extraordinary items)
```

The loss and gain tax effects are further allocated to the specific gain and loss categories using the following assumed information also provided by the tax department. The incremental tax benefit or expense is determined by considering each component separately.

```
Incremental tax benefit—disposal loss ................................................................................................. $ 9,000
Incremental tax benefit—extraordinary loss ........................................................................................ 6,000
Total tax benefits from losses ........................................................................................................... $15,000

Incremental tax expense—extraordinary gain ..................................................................................... $10,200
Incremental tax expense—cumulative change ..................................................................................... 3,800
Total tax expense on gains ................................................................................................................. $14,000
```

Allocation of the $12,300 tax benefit to loss categories would be as follows:

```
Disposal loss ($9,000 ÷ $15,000) × $12,300 ................................................................................... $ 7,380
Extraordinary loss ($6,000 ÷ $15,000) × $12,300 .......................................................................... 4,920
Total tax benefit ............................................................................................................................... $12,300
```

Allocation of the $15,750 tax expense to gain categories would be as follows:

```
Extraordinary gain ($10,200 ÷ $14,000) × $15,750 ....................................................................... $11,475
Cumulative change ($3,800 ÷ $14,000) × $15,750 ........................................................................ 4,275
Total tax expense ............................................................................................................................. $15,750
```

The bottom portion of Marble Corp.’s income statement would be reported as follows:
Income from continuing operations before income taxes ............................................................... $75,600
Income taxes ......................................................................................................................................... 26,750
Income from continuing operations ..................................................................................................... $48,850
Loss on disposal of business segment (net of income tax benefit of $7,380).................................... (11,620)
Extraordinary gain from early extinguishment of debt (net of income taxes of $11,475)............... 18,525
Extraordinary loss on litigation claim (net of income tax benefit of $4,920)................................... (11,080)
Cumulative effect of change in depreciation method (net of income taxes of $4,275).................... 10,725
Net income ..................................................................................................................................... $55,400

If there are taxable direct entries to owners’ equity accounts, the incremental approach is used to allocate tax benefits or tax expense to the equity accounts. For example, prior-period adjustments usually are affected by income taxes and must be shown in the statement of retained earnings net of the tax effect.