Financial and Tax Accounting: Transparency and "Truth"

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In the USA there have been calls for greater conformity between the rules producing tax accounts and those used for financial reporting purposes. A number of benefits are claimed for this so-called "book-tax conformity", including reduced compliance costs and better opportunities for monitoring. In Europe, the debate around use of the financial accounts for tax purposes has arisen from a different conceptual starting point as well as differences in surrounding circumstances. Linkage between tax and financial accounts is common in Europe, although it takes varying forms. This does not result in complete book-tax conformity, however, and recent developments in accounting may be increasing divergence rather than reducing it. Despite the strong arguments in favor of conformity, there are also good reasons for some divergences, meaning that the most likely outcome in any system, whatever the starting point, is partial convergence. The problem with a hybrid outcome of this kind is that, at the point of divergence, there can be conceptual confusion and difficulties in integrating and managing two conceptually very different rule systems. Clarity of the relationship between the rules and improved accounting disclosure requirements might be more important than convergence, and might be achieved with less distortion to either tax or financial accounting. The current U.K. position is used to illustrate these points.

1. Introduction: Key Issues

It may seem logical to argue that having separate systems for financial accounting and for tax accounting leads to obfuscation and confusion and thus detracts from good corporate governance. Total convergence of accounting methods for both purposes might seem to promise an increase of transparency and to simplify compliance. There is a persuasive argument that, if there were a single method of accounting for tax and financial reporting, pressures to increase reportable profits for the markets on the one hand, and to minimize taxation on the other, might balance each other to create a healthy equilibrium in listed companies and produce a set of figures closer to "true" profits than results from separated systems.

Prima facie this is convincing, but there is a flaw. If total conformity could be achieved then some benefits might accrue, although other problems would arise as

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explained below. Most important, however, is the point that the most likely consequence of attempting to introduce book-tax conformity is partial rather than complete convergence. There is a danger that purported convergence with exceptions could be confusing. Separate rules could be preferable to a system that purports to integrate two sets of rules but does so without clarity. Far from removing opportunities for manipulation, the interaction of two systems based on very different concepts and cultures could increase the available opportunities for obfuscation. There might be issues about the scope of a specific tax rule and of the corresponding accounting practice, or concerning the applicability or interpretation of an accounting rule in a tax context. Each system might use "different criteria of validity, different forms of authority and different codes for deriving meaning from and assessing the value of information."[1]

Moreover, in the European context it is misleading to see the options and contrasts as being simply between financial accounting and tax accounts. This is because many jurisdictions have both national accounting standards and International Financial Accounting Standards (IFRS).[2] In other words, there may be divergence between different types of accounting standard as well as between tax accounting and financial accounting. There are always several possible ways of calculating a profit and the method adopted by the relevant standard will reflect policy choices made by the standard setters.[3] The differences in accounting standards have come to the forefront in the debate in Europe, due to the adoption of IFRS by the EU.[4] The result is that the U.S. and the European debates have a very different flavor. While a key issue in the USA is whether book-tax conformity would be an aid to improved corporate governance,[5] in most European countries the debate on the use

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1 KING/THORNHILL, Niklas Luhmann's Theory of Politics and Law (2003).

2 IFRS as used here should be taken to include International Accounting Standards (IAS). The International Accounting Standards Board (IASB) publishes its Standards in a series of pronouncements called IFRSs. It has also adopted the body of Standards issued by its predecessor, the Board of the International Accounting Standards Committee (IASC). Those pronouncements continue to be designated "International Accounting Standards" (IASs).

3 MILLER, Accounting as Social and Institutional Practice: an Introduction, in: HOPWOOD/MILLER (eds.), Accounting as Social and Institutional Practice, 13 (1994).

4 The IAS Regulation (EC)1606/2002 was adopted on July 19, 2002 by the European Parliament and the Council (*see* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002R1606:EN:NOT). It sets out a procedure for the adoption of IAS by the Commission and sets out the purposes for which the standards are to be used by companies in the Member States.

5 For some of the literature on this debate *see* KNOTT/ROSENFELD, Book and Tax: A Selective Exploration of Two Parallel Universes, pts 1 & 2, 99 Tax Notes 865 and 1043 (2003); DESAI, The Degradation of Reported Corporate Profits, SSRN working paper (2005) (available at http://ssrn.com/abstract=758144) and DESAI/DHARMAPALA, Tax and Corporate Governance: An Economic Approach, in this volume, at 13; HANLON/SHEVLIN, Book-Tax Conformity for Corporate Income: An Introduction to the Issues, NBER Working Paper No 11067 (2005); PLESKO/MILLS, Bridging the Reporting Gap: A Proposal for more Informative Reconciling of Book and Tax Income, 56 National Tax Journal 4 (2003); JOINT COMMITTEE ON TAXATION, Staff Report, Present Law and Background Relating to Corporate Tax Reform: Issues of Conforming Book and Tax Income (2006) (available at www.house.gov/jct/x-16-06.pdf#search=%22staff%20of%20joint%20committee%20on%20taxation%20book%20tax%20conformity%22); WALKER, Financial Accounting and Corporate Behavior, Boston Univ. School of Law Working Paper No. 06-05 (2006) (available at SSRN: http://ssrn.com/abstract=894002).

of accounting standards for tax purposes centers on the suitability of accounting standards as a method of defining the tax base; perhaps even as a mode of harmonizing the computation of taxable profits across Europe.[6]

In the U.K. there is considerable degree of conformity between tax and financial accounts but there are major exceptions, so that the ultimate position is one of partial conformity.[7] This gives scope for a gap between the profits stated for financial reporting purposes and the amount of tax actually paid. Whether and to what extent this is an indicator of avoidance activity is tied up with the vexing question of what amounts to tax avoidance and the extent to which tax avoidance (as opposed to illegal evasion) is undesirable and "unacceptable".[8] There are no official published figures in the U.K. on this "gap". The Tax Justice Network (TJN) reports that the U.K.'s fifty largest companies have paid an average of 5.7% less corporation tax than "expected rates" from 2000 to 2004, but much depends upon what is "expected" and some of the assumptions made are questionable. In particular the TJN refer to "excessive corporate tax allowances given to encourage investment in plant and machinery, resulting in high levels of deferred taxation".[9] Capital allowances (accelerated depreciation) are an example of the various express tax reliefs and incentives which are considered by most governments to be desirable in the context of their economic policies. Similarly, a recent report of the National Audit Office that around 220 of the U.K.'s 700 largest companies paid no tax at all in 2005-6 led to concerns expressed in the media that there were high levels of corporate tax avoidance.[10] Whilst this has some substance, the reasons for this might be, in part at least, that the companies concerned were benefiting from intentional reliefs and incentives. If some of the gaps arise from deliberate differences between the tax base and the definition of profit for financial accounting purposes, care must be taken in using this gap in too crude a way as a proxy for tax avoidance activity. The U.S. literature adopts more sophisticated methods for arriving at the book-tax gap, making adjustments for differences caused by differential treatment of depreciation, for example, but care is still needed in making assumptions about the reasons for any differences.[11]

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[6] *See* SCHÖN, International Accounting Standards – A "Starting Point" for a Common European Tax Base?, 44 European Taxation 426 (2004); SCHÖN, The Odd Couple: A Common Future for Financial and Tax Accounting?, 58 Tax Law Review 111 (2005); FREEDMAN, Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges, 2 eJournal Tax Research 71 (2004). *See* also the debate on a Common Consolidated Corporate Tax Base, discussed below.

[7] The U.K. system is described further below.

[8] For further discussion of this problem *see* FREEDMAN, The Tax Avoidance Culture: Who is Responsible?, in: HOLDER/O'CINNEIDE (eds.), Current Legal Problems 2006 (2007).

[9] TAX JUSTICE NETWORK, Mind the Tax Gap (2006).

[10] NATIONAL AUDIT OFFICE, HM Revenue & Customs Management of large business Corporation Tax, HC 614 Session 2006-2007, (The Stationery Office) July 2007; HOULDER, "One-third of biggest U.K. businesses pay no tax", Financial Times, August 28, 2007.

[11] For a much more sophisticated use of the book-tax gap to construct a proxy for tax avoidance in the USA, which attempts to isolate only that part of the book-tax gap not attributable to accounting accruals *see* DESAI/DHARMAPALA, Corporate Tax Avoidance and High Powered Incentives, 79 Journal of Financial Economics 145 (2006); DESAI/DHARMAPALA, *supra* note 5. The difficulties involved in producing these figures are discussed in depth in HANLON/SHEVLIN, *supra* note 5.

There may be good reasons why complete book-tax conformity cannot, and even should not, be achieved, as discussed below. Stronger disclosure requirements and better education of those who analyze accounts, so that any differences can be properly understood, might be a more fruitful way forward than arguing for greater conformity in the USA as well as in Europe.

2. Conformity of Financial and Commercial Accounts: In Search of "True Profit"

2.1 Conformity – The Issues

There are arguments in favor of alignment, based on simplicity and convenience. If there was only one profit figure and no adjustments were needed, compliance costs would be saved. These benefits would be significantly reduced if complete conformity could not be achieved, since some adjustments would then be needed and the simplicity of one figure would disappear immediately. There could be reductions in compliance costs in some areas if only one set of records was needed, and in relation to certain types of transaction where very complex records are required this may be an overriding consideration.[12] Overall, however, if there are good reasons for divergence of financial and tax accounts, arguments based on convenience should not be allowed to distort the tax base so that problems of another kind are produced, such as lack of equity or impracticality of collection.

The more fundamental arguments are those relating to the nature of profits and their definition. Underlying the views of those who would conform book and tax accounts is the notion that we can achieve an optimal definition of profit: one which brings us closer to "true economic profit" than other definitions. This is a questionable assumption, since the proper definition of profit depends to some extent on the purpose for which it is to be used.[13] Does the profit figure need to be historical or forward-looking? Is the business continuing as a going concern or is the issue its break-up value? In each case valuations will need to be carried out differently.

The objectives of commercial accounts and of tax accounts may well differ. Tax must raise revenue and do so equitably and efficiently as between taxpayers. These requirements point to the need for reasonably objective rules that take account of taxable capacity and administrative efficiency and provide a workable set of rules on the basis of which tax can be calculated and – importantly – collected. For example, to operate fairly and efficiently, it is often argued that a tax system must recognize ability to pay and subject the taxpayer to tax when it is most convenient to pay the

[12] In the U.K., many financial institutions have chosen to follow accounts for tax purposes in relation to hedging transactions even though they have been given a choice by the legislation to deviate from that treatment since it was thought by many to result in volatility which was not appropriate for taxation purposes. *See* text to note 64 below.

[13] *See* MILLER, *supra* note 3; HICKS, Maintaining capital intact: a further suggestion, Economica IX 174-79 (1942), cited in: MACDONALD, *HMRC v William Grant & Sons Distillers Ltd and Small (Inspector of Taxes) v Mars U.K. Ltd*: accountancy practice and the computation of profit, 2007 British Tax Review 366.

tax.[14] These concepts are linked to the realization principle, since without liquid assets there is an obvious difficulty in paying taxes. Whilst in a perfect market this problem of liquidity might be met by borrowing by the taxpayer against unrealized profits, in practice financing taxes in this way not only creates transaction costs but can also be risky as the value of the security for the borrowing may fall. For this reason, the realization principle seems more important for tax purposes than it is for accounting purposes, particularly as we move towards fair value accounting, as discussed below.[15] The volatility inherent in fair value accounting reflects volatility in the market and so, arguably,[16] should be reflected in the commercial accounts. It is less clear, both from the point of view of the taxpayer and the government, that it is sensible to tax on the basis of volatile accounts. In addition, tax accounts are affected by the facts that tax avoidance opportunities must be blocked and that governments may want to use the tax system to deter or incentivize certain behavior and for public policy purposes, for example in disallowing certain expenses.

Financial accounts, on the other hand, need to give a range of relevant and reliable figures to a variety of stakeholders. To achieve this, accounting standards often give guidance rather than detailed rules and make available a range of options to be applied according to the judgment of the company directors (advised by their auditors). Figures in accounts may be augmented by notes; a method which cannot assist in the case of taxation, where a definitive figure is required. IFRSs/IASs give primacy to the balance sheet rather than the profit and loss account: the profit and loss account looks set to disappear altogether.[17] This contrasts with the obvious needs of any tax system based on profit[18] to have a profit and loss account, which is charged on a periodic basis. It may be possible to carry losses or other allowances forwards and back from one period to another, but essentially each period is taken in isolation because taxation needs to operate in this way to be manageable. This means that tax accounts take an historical perspective and are concerned with the profits and losses in an (artificial but important) period.

In each case the differing objectives are perfectly valid, but the functions performed by the accounts for these two purposes dictate some differences, despite a central core of similarity. Further, in addition to the need to keep each system true to its objectives, it needs to be robust against any pollution by considerations more relevant to the other system. At present, international and U.S. accounting standard set-

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[14] Adam Smith’s Canons of Taxation, SMITH, The Nature & Causes of the Wealth of Nations, Book V, Chap. 11, Part II “Of Taxes”, paras. 1-7.

[15] Deborah Schenk argues that the justifications for the realization rule are not as persuasive as has been thought, but even she agrees that there are valuation and political difficulties in taxing paper gains, making it difficult to abandon realization as a basis for taxation; SCHENK, A Positive Account of the Realization Rule, 57 Tax Law Review 355 (2004).

[16] Though some would argue not, *see* below.

[17] *See* WILSON, Financial Reporting and taxation: marriage is out of the question, 2001 British Tax Review 86; PATERSON, A taxing problem, 130 Accountancy Magazine 94 (11/2002).

[18] Of course it could be argued that a tax system based on expenditure or some other base would be preferable to one based on profit, particularly in view of the difficulties experienced in defining profit and locating it. Clearly then this issue of alignment would be seen very differently, but this is outside the scope of this article.

ters pay little regard to tax implications. They would be unlikely to take kindly to the suggestion that they needed to add this issue to the list of considerations and pressures they must take on board already.[19] Commercial accounting considerations could be distorted by tax pressures and this might have the perverse effect that even less information was released to the markets because those fearing tax consequences would oppose the establishment of standards that suited commercial purposes but that would result in a higher tax payment. A similar point is made by Hanlon and Shevlin.[20] They argue that in a U.S. context, conformity would result in greater control by Congress rather than the independent Financial Accounting Standards Board (FASB),[21] and that the conformed measure would be closer to the current measure of taxable income than the financial reporting measure, thus depriving the markets of information. This relates to an important constitutional point that will be discussed further later. Who is to control the tax base, the legislature or the accounting standard setters?

2.2 The Nature of Profits

The idea that a gap between taxable profits and book profits reveals tax avoidance activity, as discussed in the introduction above, suggests that book profits are somehow closer to the economic profits upon which tax should be paid than are the taxable profits. This is a questionable assumption given that the special rules for computing taxable profits have been devised to reflect policy decisions about what ought to be taxed. It is true that the U.S. literature on the implications of the book-tax gap has attempted to allow for that by removing certain differences such as depreciation, and still finds a residual difference, but it is very hard to be sure that that is not also the result, at least in part, of deliberate policy decisions about the tax base rather than exploitation of technical loopholes.[22]

It may also be the case that there are some areas where accounting standards can result in figures which are less reliable than tax figures. So, in a U.S. context, following the WorldCom and Enron scandals, the Wall Street Journal of January 29, 2003 stated that "Profits reported to the IRS, where firms have less discretion in making calculations, are considered to be closer to the truth [than financial accounting profits] …"[23]

Developments in accounting standards both in Europe and in the USA are attracting serious questions about the reliability of the figures being produced under new standards. Fair value accounting is particularly problematic and continues to be the subject of heated debate in the accounting world.[24] IFRSs require fair value account-

[19] WILSON, *supra* note 17; NOBES, A Conceptual Framework for the Taxable Income of Businesses, and How to Apply it under the IFRS, 38 (2003).
[20] HANLON/SHEVLIN, *supra* note 5.
[21] For details of the U.S. standard setting structure *see* KNOTT/ROSENFELD, *supra* note 5.
[22] *See* material cited *supra* note 11.
[23] Cited in PLESKO/MILLS, *supra* note 5.
[24] HUGHES, "What do users really want from 'fair value' accounting?", Financial Times, September 13, 2007.

ing, as opposed to historic cost accounting, in a number of areas, especially in relation to financial instruments, as do standards recently introduced in the USA.[25] Further work is under way, led by the IASB, to improve guidance and disclosures on fair value and for IASB and the Financial Accounting Standards Board in the U.S. to produce converged standards and so modifications may occur.[26] At present, however, the critics of the standards argue that fair value accounting leads to difficulties in measurement (where there is no market) and to volatility of profits.[27] Fair value accounting also has other curious consequences; for example, if the creditworthiness of a company falls, the market price of its bonds drops, so that these are written down in the balance sheet with a resulting profit in the profit and loss account, despite the fact that the company is still liable on the full amount of the bond.[28] Sir Michael Rake, the former head of KPMG and now Chairman of BT has urged standard setters to slow the pace of change and to be careful about rushing into fair value accounting, saying that

> "Moving to fair value is going to require a high degree of subjectivity, which will mean less direct comparability [between companies]."[29]

So, although the accounting profession has expertise in defining profit, it does not necessarily lead to universally agreed figures. Indeed in a report in November 2006 the Chief Executive Officers of the major auditor networks stated that "Today's rules can produce financial statements that virtually no-one understands."[30]

The fact that there is not one definitive set of figures representing "true" profit does not entirely deal with the argument that having one set of figures would be better than having two. It is arguable that some kind of middle way might be achieved through the balance of the competing pressures to ensure that financial accounts show high earnings and healthy balance sheets whilst tax accounts take a very prudent view of taxable profits. The hope would be that this would reduce avoidance opportunities[31] but the problem might be that the resulting composite set of accounts

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[25] IAS 39; Statement on Financial Accounting Standards (SFAS) 157 and SFAS 159, effective for fiscal years beginning after November 15, 2007.

[26] IASB, Fair Value Measurements Discussion Paper (2006) (available at www.iasb.org/Current+Projects/IASB+Projects/Fair+Value+Measurements/Fair+Value+Measurements.htm).

[27] There was strong resistance to IAS 39 in Europe for this reason, spearheaded by French banks: MURRAY/CLARK, IAS 39, cash flow hedges and tax, 8 Financial Instruments Tax and Accounting Review 1 (2003); PARKER, "Compliance costs soar for new IAS rules", Financial Times, November 24, 2003. This forced an amendment of IAS 39 by the IASB to enable the European Commission to adopt the standard.

[28] HUGHES, *supra* note 24.

[29] HUGHES, "Former KPMG head calls for fix in system", Financial Times, October 11, 2007.

[30] *See* Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks (2006) (available at www.deloitte.com/dtt/cda/doc/content/dtt_CEO Vision110806(2).pdf).

[31] This seems to be the assumption of the U.K. Government in their consultation papers on Corporation Tax Reform, supporting alignment: Inland Revenue and H.M. Treasury (2002) Reform of Corporation Tax (London); Inland Revenue and H.M. Treasury (2003) Reform of Corporation Tax, London.

might lose some of its efficacy both for tax and for financial accounting purposes. The resulting lack of information to the market and obfuscation of detail might actually open up avoidance opportunities instead of removing them.[32]

This is not to say that tax and financial accounting should operate in isolation from each other. The financial accounts will always be the starting point for taxable profits. There are justifiable differences, however, reflecting government policy and differences between the nature of the tax base and the informational purposes of financial accounting. Rather than arguing for conformity, which would then be the subject of exceptions so leaving the position unclear, it would be better to accept that there are differences and to make these explicit and rooted in established principles.

3. Trends and Developments: National Jurisdictions, the EU and IFRS

The financial accounts are a starting point when drawing up the tax accounts in any jurisdiction. Although systems vary, it is important not to draw too sharp a dividing line between different approaches or to be over-simplistic in the characterization of these systems. It is customary to divide European jurisdictions between those where there is dependence and those where there is independence.[33] In 1996, in a comparative study, Hoogendoorn reported a "clear recent development towards more independence between accounting and taxation" especially in Scandinavian and Eastern European countries.[34] At the same time, there have been some apparent movements towards greater dependence, in the U.K. for example. The overall movement seem to be towards partial alignment. The stereotypical extreme cases do not seem ever to have been entirely accurate and are becoming less so.

Given this move towards a middle way, three key questions arise. First, how and to what extent are the financial accounts modified for tax purposes? Secondly, which financial accounting standards are relevant for tax purposes and what difference is made by the adoption of IFRS? Thirdly, what are the constitutional implications of following accounting standards for tax purposes, whether they be national or international standards? These questions are distinct and yet intricately related.

3.1 To What Extent are Financial Accounts Modified for Tax Purposes and How?

Most countries, even the USA, which has the "most advanced separation between different sets of books",[35] have a residual rule that the commercial accounts will be followed if there is not a rule of some kind to the contrary.[36] Sometimes the modi-

[32] *See* HANLON/SHEVLIN, *supra* note 5.
[33] HOOGENDOORN, Accounting and Taxation in Europe- A Comparative Overview, 5 The European Accounting Review, Supplement 783 (1996).
[34] HOOGENDOORN, *id.*
[35] *See* SCHÖN, The Odd Couple, *supra* note 6.
[36] IRC § 446(a).

fying rule has to be statutory but in other jurisdictions, such as the USA, it can arise from the case law.[37]

In the past the U.K. was sometimes seen as an example of a jurisdiction where the approach was one of independence, but this was never the case and, arguably the element of alignment has recently been strengthened by statute and case law.[38] As discussed further below, the interesting issue in the U.K. now is to what extent, if at all, the commercial accounts are subject to principles of law *not* derived from statute. There have always been statutory differences between tax and commercial accounts in the U.K., but it was at one time thought that there might also be general principles of tax law to which commercial accounting was subject. There are some judicial statements to support this but also many which do not.[39] The starting point is certainly generally accepted accounting practice, which includes IAS/IFRS where these standards are being used.[40] There are, however, various statutory modifications. These range from fundamental differences in regime, as in the areas of depreciation and capital gains, to adjustments, as in the areas of financial instruments taxation or finance leasing.

In Germany, generally seen to be at the other extreme from the USA as a jurisdiction where there is a strong linkage, the close connection between commercial or financial accounts and tax accounts is manifested not only in the *"Maßgeblichkeitsprinzip"* which means that commercial accounting rues are binding for tax purposes but perhaps even more importantly on the *"umgekehrte Maßgeblichkeit"* principle, or reverse conformity, which allows tax rules to influence commercial accounts and results in very conservative profit figures for all purposes.[41]

Even in Germany, however, there has never been total conformity and Schön comments that the number of adjustments since the late 1990s has been increasing, often in an effort to increase revenue.[42] Similarly, in Sweden, which is sometimes classified as having strong linkage, certain types of asset, that is financial instruments and real estate, are taxed on a realization basis on capital gains tax principles, whilst other types of asset such as stock in trade, construction contracts, machines and equipment are covered by special tax rules.[43] In the Netherlands, on the other hand, where there is no formal link between tax accounts and financial accounts, the

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37 *Thor Power Tool Co. v Commissioner*, 439 US 522 (1979) and *see* SCHÖN, The Odd Couple, *supra* note 6.

38 Discussed below.

39 For some cases where the courts have not followed accounting practice in assessing taxable income *see Minister of National Revenue v Anaconda*, [1956] AC 85; *Sharkey v Wernher*, [1956] AC 58; *BSC Footwear Ltd v Ridgway*, 1971 2All ER 534 (HL); *Willingale v International Commercial Bank Ltd.*, [1978] 1 All ER 754; however there is debate about the rationale for some of these decisions.

40 Section 42 Finance Act 1998 as amended by section 103 (5) 2002 Finance Act, section 50 of the Finance Act 2004 and section 25 of the Income Tax (Trading and Other Income) Act 2005.

41 HERZIG, Tax versus Commercial Accounting in Germany, in: THORELL (ed.), The Influence of Corporate Law and Accounting principles in determining Taxable Income, IFA Congress 1996, Vol. 21b (1996).

42 SCHÖN, International Accounting Standards, *supra* note 6; and SCHÖN, The Odd Couple, *supra* note 6.

43 NORBERG, Kari Tikka Memorial Lecture, EATLP Helsinki, June 2007.

Supreme Court ruled many years ago that commercially accepted methods of calculating profits are acceptable as methods of calculating taxable profit unless the spirit of the tax legislation suggests otherwise.[44] Once again this results in partial conformity. Here, as elsewhere, not only are there legislative modifications to financial accounts for tax purposes but also the courts play a role in interpreting the requirements of financial accounting and their relationship to the objectives of the taxable concept of "profit" or "income".

3.2 Which Accounting Standards?

In some jurisdictions the answer to the question of which accounting standards are to be used for tax purposes is straightforward. There may be only one set of applicable accounting standards, as in the USA, or it may be that IFRS are applicable only to consolidated accounts which are not used for tax purposes. In the EU, use of IAS has been mandatory for the consolidated accounts of all listed companies since 2005[45] but various options are in use in respect of unlisted companies and single company accounts.[46] In the U.K. and the Netherlands, to take two examples, all companies are permitted to use IAS for not only their consolidated accounts but also their individual accounts. Moreover in the U.K. there is a reducing difference between IFRS and domestic standards. A convergence program is under way and it is anticipated that IFRS based U.K. standards will be operative for the financial year commencing January 2009, although for small and medium sized companies there would be a simplified Financial Reporting Standard for Smaller Entities.[47]

In a very different mode, Sweden allows IAS to be used only for consolidated accounts. Germany permits the use of IAS for individual company accounts but only for the purposes of information, and national accounting standards continue to apply for tax law and profit distribution purposes. Clearly these different approaches mean that the impact of new accounting developments has differential effects. In the U.K. there is a need to confront the new approaches and consider whether they are appropriate for tax purposes,[48] whereas in dependence countries like Sweden, as Norberg points out, the consequence of new developments in IFRS is that the differences between consolidated accounts and annual accounts are increasing.[49]

This has the curious result in corporate governance terms that the accounts used for investor purposes are becoming *more* detached from those used for tax purposes in so-called dependence countries than they are in the U.K. The remaining focus on

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[44] H.R May 8, 1957, BNB 1957/208; information taken from a questionnaire prepared by Dr. R. Russo of Tilburg University.

[45] *See supra* note 4.

[46] EUROPEAN COMMISSION: Table on use of IAS in the EU (2006) (*see* http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf).

[47] ASB, Convergence of U.K. standards with IFRS (2006) (*see* www.frc.org.uk/asb/technical/projects/project0072.html).

[48] The U.K. revenue authority (Her Majesty's Revenue and Customs (HMRC)) has published guidance: "U.K. tax implications of international accounting standards" (*see* www.hmrc.gov.uk/practitioners/int_accounting.htm).

[49] NORBERG, *supra* note 43.

dependence in the former countries is not a form of alignment that would satisfy the U.S. critics of book-tax divergence. It simply produces single level company accounts that deviate from the consolidated accounts. This explains why the problem of dealing with new accounting standards may be seen as greater in the U.K. than in the so-called dependence countries and may also be a partial explanation of the wariness in the U.K. about the Common Consolidated Corporate Tax Base (CCCTB) proposed by the EU Commission.[50]

3.3 Constitutional Issues

In most of Europe and in the USA, one major concern about using accounting standard as a tax base relates to constitutional issues. This is not an issue which has caused major concerns in the U.K., where in its normal pragmatic way, the tax community and government seem to be largely unworried about the constitutional issues and the legislature has happily incorporated references to generally accepted accounting standards in the tax legislation, making it clear that this refers to international accounting standards where these are being used.[51] In the USA, the issue is one of significance, however. Knott and Rosenfeld write,

> "An aligned book-tax system would require one body to be the ultimate rulemaking authority. Raising revenue through taxation is such a fundamental governmental function that granting principal authority on measurement of taxable income to a private sector body such as FASB seems untenable".[52]

In many European jurisdictions likewise, the fact that the IASC is a private organization formed by the International Accounting Standards Committee Foundation, a not-for-profit Delaware corporation, not under any governmental control,[53] has raised concerns about the status of IFRS/IAS even for accounting purposes, despite the fact that there is a procedure to be followed before the EU adopts these standards. For tax purposes, it would seem impossible in many jurisdictions to follow these international accounting standards without approval by national parliaments.[54]

3.4 CCCTB

Views emanating from the European Commission on the use of international accounting standards as a means to achieve tax harmonization have shown some interesting twists over the past few years. In 2001 an EU Commission staff working paper saw globalization of accounting standards as a catalyst for the development of harmonized, but independent, tax accounting principles, stating that[55]

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[50] That is not to argue that this is the only reason for U.K. opposition to the CCCTB.

[51] *See supra* note 40.

[52] KNOTT/ROSENFELD, *supra* note 5, at 1060.

[53] *See* IASB, About Us (available at www.iasb.org/About+Us/About+Us.htm).

[54] *See supra* note 4, and SCHÖN, International Accounting Standards, *supra* note 6.

[55] EU COMMISSION STAFF, working paper, Company Taxation in the Internal Market, SEC(2001) 1681, 322-324 (2001) (available at http://ec.europa.eu/taxation_customs/resources/documents/company_tax_study_en.pdf).

> "Generally, it is clear that there is no prospect of fully matching tax and financial accounting in the future… To the extent that tax accounting will develop independently from financial accounting, Member States will be obliged to find autonomous rules for tax accounting purposes. In looking for such rules there is an opening for co-ordination and co-operation to start with common base rules, instead of each of the Member States trying to pursue individual solutions."

Subsequently, however, the EU Commission formed the contrary view that globalization of accounting standards might be an opportunity for finding a common base for tax across the EU, with a starting point in accounting profits, but it always recognized that this was only a starting point and that some deviation was likely to be necessary.[56] In 2004, it proposed the use of IAS as a tool for designing a common consolidated tax base but stressed that the discussions should be guided by "appropriate tax principles" and that any such base, once established, would not be systematically linked to accounting standards as any further development would need to be driven by tax and not accounting needs.[57]

The Commission has now accepted that there can be no formal link between the proposed new CCCTB and IAS/IFRS. This is because, as explained above, many Member States do not permit the use of these international accounting standards for tax purposes. Thus companies would start from accounts prepared in accordance with a number of different national generally accepted accounting principles and then make adjustments towards the tax base as defined by the European Directive. This European base would make some references to IFRS/IAS but with many tax adjustments, so in each case the company concerned would need to adjust its individual company accounts to arrive at this base.[58] Thus we can see that, whether or not the CCCTB is a worthwhile experiment in the use of accounting ideas to move towards a harmonized tax base in Europe, it is not going to produce one set of accounts for all purposes. In fact in some jurisdictions the move will be towards three sets of accounts: consolidated accounts based on IAS/IFRS; individual company accounts based on national generally accepted accounting practice, and the CCCTB accounts. It is hard to see how this will improve simplicity or transparency, unless the hope is that it will result in modification to national generally accepted

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[56] For example the European Commission in its proposals for a consolidated tax base: *see* European Commission Consultation Document, The application of International Accounting Standards in 2005 and the implications for the introduction of a consolidated tax base for companies' EU-wide activities (2003) and EUROPEAN COMMISSION, Summary report on results of consultation (2003) (both to be found on www.europa.eu.int/comm/taxation_customs/taxation/consultations/ias.htm); Communication from EU Commission (2003) (COM 2003 726 final) An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges (*see* http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0726en01.pdf).

[57] Commission Non-Paper to informal Ecofin Council, September 10 and 11, 2004, A Common Consolidated EU Corporate Tax Base (*see* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCTBWPNon_Paper.pdf).

[58] European Commission CCCTB Working Group, Possible Elements of a Technical Outline, CCCTB/WP057\doc\en, July 26, 2007 (available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP057_en.pdf).

accounting practices. It should be noted that the individual company accounts will have uses in some jurisdictions related to distributions as well as to taxation. Thus the comment by Desai in his testimony to a U.S. Senate Committee that the European Union is contemplating "aggressive conformity of tax and accounting rules" perhaps oversimplifies the position.[59]

4. The U.K. – Problems with Partial Conformity

4.1 Current Position

There is now a considerable degree of conformity between tax and financial accounting in the U.K., but there are many instances of statutory divergence. The U.K. has a separate system entirely from income tax for capital gains and this is governed by special statutory rules rather than accounting practice.[60] Depreciation is also dealt with by completely separate tax provisions.[61]

For corporations there has been some movement away from the capital/revenue divide and towards accounting practice, especially in the area of loan relationships, derivatives and intangible fixed assets, but the fundamental distinction remains.[62] Even where there is legislation based on accounting practice there are some deviations from accounting practice for tax purposes; for example if the accounting practice is not considered to be sufficiently robust to prevent tax avoidance.[63] Thus new divergences are created from a starting point of conformity.

Alternatively the legislation may require conformity with accounting standards but it may then be decided to permit deviations because conformity turns out to be inappropriate. For example, IFRS hedge accounting has proved to be unsuitable for tax purposes because IFRS follows a mixed model; using fair value for some assets and some not. There can be an accounts mismatch despite the existence of a commercial hedge and the hedge accounting rules in IFRS do not cover every case. Since the changes go to the profit and loss account, this can prove problematic. Therefore, tax rules were introduced to reduce tax volatility by disregarding fair value move-

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59 Testimony of Mihir A. Desai before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, June 5, 2007 (*see* www.people.hbs.edu/mdesai/DesaiTestimony060507.pdf).

60 The Taxation of Chargeable Gains Act 1992.

61 Capital Allowances Act 2001. Accounting standards are also irrelevant to tax deductions for share based payments as these are governed by specific legislation in Schedule 23 Finance Act 2003.

62 Corporate debt and currency accounting (Finance Act 1996 as amended by Finance Act 2002); derivatives (Schedule 26 Finance Act 2002); intangibles (Schedule 29 Finance Act 2002). *See* MACDONALD/MARTIN, Taxing Corporate Gains: Proposals for Reform, 2005 British Tax Review 628, for proposals to further align capital gains taxation with corporation tax. These proposals have not been adopted to date.

63 For an example *see* the Finance Act 2006 definition of funding leases which goes beyond the accounting definition of finance lease: CARSON, Traditional Equipment Leasing, The Tax Journal, October 23, 2006, 11.

ments on certain contracts for tax purposes.[64] However it was then found that these special tax rules created compliance costs for some taxpayers, who preferred to use IAS despite its flaws rather than keeping special records and so these taxpayers were then permitted to elect out of the special tax rules. Hence, from a position of conformity, a very complex situation arose in which taxable profits might or might not diverge from financial profits, depending upon a taxpayer election. Despite the appearance of greater conformity, neither full alignment nor simplicity has been achieved.

In the case of statutory deviations, the position may be complex but at least the rules are stated. The situation is more complex where case law is concerned. Most of the text books will now take their starting point on the question of conformity as being section 42 of the Finance Act 1998 as amended. This states that

> "…the profits of a trade, profession of vocation must be computed in accordance with generally accepted accounting practice, subject to any adjustment required of authorized by law in computing profits for those purposes".[65]

Generally accepted accounting practice is defined to mean IFRS/IAS, where a company is making up its accounts in accordance with IAS, and U.K. generally accepted accounting practice (GAAP) in other cases[66] but, as explained above, these standards are converging in any case.

Clearly the provision permits statutory modification of accounting standards for tax purposes, but the extent to which case law can provide such modifications is unclear. Section 42 was not supposed to alter the law,[67] but even before it was introduced the evidential value of formally decided accounting standards was becoming increasingly persuasive[68] and the statutory statement of the position has supported the view held by many that the U.K. had reached a position in which accounting standards would always be followed, subject only to statute. To many commentators this position now seems to have been confirmed by the decision of the House of Lords in *Her Majesty's Revenue and Customs* (*HMRC) v William Grant & Sons* and *Small v Mars U.K. Limited* (here together called the *Mars* case), but even a strong supporter of the view that there are no general principles of tax law with the power to modify accounting standards has expressed his doubts about the solidity of this position in the long term.[69] Thus, Graeme MacDonald in a note on the *Mars* case states

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[64] The Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256) as amended.

[65] For a more detailed history of the introduction of this provision *see* FREEDMAN, *supra* note 6.

[66] Finance Act 2005 s. 50.

[67] Explanatory Notes to clause 42 Finance (No 2) Bill 1998 (but note that this is unlikely to be taken into account by the U.K. Courts under the rules of statutory interpretation).

[68] *See Gallagher v Jones* [1993] STC 537; other cases discussed in FREEDMAN, *supra* note 6. For a contrary view *see* FREEDMAN, Ordinary Principles of Commercial Accounting – Clear Guidance or a Mystery Tour?, 1993 British Tax Review 468.

[69] [2007] UKHL 15.

> "…it does seem from both Lord Hoffmann's interpretation of section 42 and from the dicta that it is said to codify, that intervention in GAAP profit computation can only be justified by statute. Nevertheless, can we really conclude from this that the Courts will never develop constraints on the application of GAAP in computing taxable profits?"[70]

It is noteworthy that the case of *Mars* was only decided after a lengthy progression through the courts and that, although the court of first instance (the Special Commissioners) found for the taxpayers,[71] the distinguished judges in the High Court in *Mars* (an English case)[72] and the Court of Session in *William Grant* (a Scottish case)[73] found for HMRC. It was HMRC which was arguing that accounting practice should not be followed in this instance. Ultimately they lost when the cases were rejoined in the highest court, the House of Lords, but the lack of a common view amongst distinguished members of the judiciary does suggest that there is still going to be scope for argument over the application of accounting standards. It will be hard for the judiciary to deny themselves a jurisdiction, especially when the issue is one of statutory interpretation or interpretation of a contract, or the characterization of a relationship or the nature of an asset – whether it is capital or revenue for example.[74] Thus although the courts may state that they will follow accounting practice, it will continue to be for them to decide what amounts to a correct application of such practice within a tax context.

To understand this debate it is necessary to look back at some previous case law.[75] The suggestion that there might be some general principles of tax law reached their height in the 1970s. So, according to Lord Reid in the House of Lords in *BSC Footwear v Ridgeway*[76]

> "The application of the principles of commercial accounting is, however, subject to one well established though non-statutory principle. Neither profit nor loss may be anticipated... But it is admitted that this matter is not governed by any rigid rule of law. It depends on general principles which have been elaborated by the courts for the purpose of ensuring that so far as practicable profits shall be attributed to the year in which they were truly earned."

Note that even this statement of a principle denied the existence of rigid rules of law, so that if there was a principle it was one susceptible to change. Nevertheless the

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70 MACDONALD, *supra* note 13.

71 [2004] STC (SCD) 253.

72 [2005] STC 958.

73 [2006] STC 69.

74 For some examples of such cases *see* FREEDMAN, *supra* note 6. On the question of the capital/revenue divide being a question of law *see* the unequivocal statement of Lord Denning in *Heather v P E Consulting Group Ltd*, [1972] 48TC293: "The courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the courts. They are not to be deflected from their true course by the evidence of accountants, however eminent".

75 For a detailed account of the older cases *see* FREEDMAN, Profit and Prophets – Law and Accountancy on the Timing of Receipts, two parts, 1987 British Tax Review 61 and 104.

76 (1972) 47 TC 495 (Lord Reid, dissenting, but not on principles).

House of Lords in *BSC Footwear* (although not in the end Lord Reid, who dissented) did refuse to follow accounting evidence. They supported a system of stock valuation which they saw as being less artificial and unreal than the one used by the taxpayer for financial accounting purposes, but this was before the days of fully formulated and institutionalized accounting standards. It is interesting to note also that the House of Lords in *BSC Footwear*, sitting in May 1971, did not have put to them a comment that has been made in the High Court (a lower court in the hierarchy) in November 1970 in *Odeon Associated Theatres Ltd v Jones*[77] by Pennycuick VC. This judge is often quoted as stating that

> "The concern of the court in this connection is to ascertain the true profit of the taxpayer... In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy... At the end of the day the court must determine what is the correct principle to be applied."

Pennycuick VC also stated, however, that he was unable to accept the suggestion that the Court must ascertain the profit of a trade on some theoretical basis divorced from the principles of commercial accountancy, which he said was an entirely novel contention. Unfortunately the House of Lords did not get the chance to comment on that point in *BSC Footwear*, but Lord Hoffmann revived it with his approval in the *Mars* case in the House of Lords. Relying on this, he roundly rejected the view that there have ever been fundamental principles of accounting additional to the best practice of accountants.[78] Nevertheless he did not go so far as to say that the courts will always follow an accounting standard. For those who were hoping for a thorough analysis of the legal position, the *Mars* case is a disappointing one, dealing briefly with the issue and not commenting upon the older cases.[79] It must be doubted now whether cases such as *BSC Footwear* and *Minister of National Revenue v Anaconda*[80] (where the courts rejected the use of LIFO for tax purposes in the U.K.) *would* be decided in the same way today.[81] Almost certainly greater weight would be placed on the accounting practice now, since it would be more formalized and sophisticated. Nevertheless we do not have certainty on this point and it seems highly likely that professional advisers and HMRC will continue to argue for deviations where that suits their case.

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[77] [1973] Ch 288, 48 TC 257 (Pennycuick VC at first instance).

[78] Lord Hoffmann at para. 15.

[79] As J. Collins and D. Dixon commented in COLLINS/DIXON, Open and Shut case?, The Tax Journal, April 9, 2007, 6, their Lordships made the case seem so simple that they left us with a real problem to understand why it ever got as far as it did; this suggests some over-simplification of the issues.

[80] [1956] AC 85.

[81] Following this decision, LIFO was rarely considered to be good accounting practice either: contrast the U.S. where LIFO appears to have been used for tax reasons and attempts to limit this by a statutory conformity requirement failed because everyone accepted that this figure would be tax driven and accounts provided additional information in other ways; *see* SHAVIRO, The Optimal Relationship between Taxable Income and Financial Accounting Income: Analysis and a Proposal, NYU Law & Economics Working Paper No. 07-38 (2007) (available at http://ssrn.com/abstract =1017073).

4.2 The Problems with Partial Conformity

In the long run, the importance of *Mars* may lie not in the apparent statement of conformity by their Lordships but in the way it reveals the difficulties inherent in *partial conformity*. One of the difficulties in the case can be seen to be the problems experienced by the courts in understanding the intricacies of accounting and by those giving accounting evidence in understanding the way a lawyer would look at the facts.[82] The simplified way in which the House of Lords eventually dealt with the decision is a reflection of this and was an entirely predictable outcome according to systems theory. The accounting evidence needed to be internalized into a form of legal methodology, which follows what the courts understand as good accounting practice.[83] The analysis of the accounting standards derives from the accounting evidence but is translated into a narrative which interweaves statutes, cases and accounting standards and is transformed into a version of accounting practice understood from a legal perspective.

What was not brought out in the case at any level of the hearings, or in the commentary so far, is the fact that this was not a case about achieving conformity at overall. It was about the management of non-conformity, or partial conformity. The case related to depreciation in the financial accounts and it was agreed by all that this had to be added back into the tax accounts at some point, so conformity overall was not the aim. Allowances for capital expenditure for tax purposes are available under the Capital Allowances Act 2001 which is completely separate from accounting depreciation. The question was when the accounting depreciation should be added back in for tax purposes (or perhaps when it should be treated as having been deducted), so the issue was one of timing only and not *whether* an amount was taxable or not in the long run. In the end this may be seen as the central reason why the taxpayer won. The problem was one of the interaction of the statutory prohibition of deduction of depreciation for tax law purposes with accounting practice.

It was accepted by both sides in the case that U.K. GAAP provides for the inclusion of depreciation as an overhead cost in valuing stock. Thus, applying proper accounting practice, stock was valued at a cost figure which included an element derived from depreciation and this was the cost carried forward in the financial accounts.[84] To accountants (and ultimately to the House of Lords) it seemed obvious that the part of the depreciation cost carried forward as cost of stock had not been deducted in the year of the expenditure and so did not need to be added back in until the stock was sold and the deduction made. To HMRC, however, it seemed that the whole depreciation figure should have been added back in immediately. In their view, the part carried forward took on a different character as income once included

[82] The attempts of the lower courts to introduce their own analysis were subject to a considerable amount of criticism from accountants in the professional press but it was mainly accountants who commented and, arguably, they did not understand the legal perspective. *See* TRUMAN, Mars barred, Taxation, June 30, 2005; Accounts don't contain whisky, Taxation, October 27, 2005; WINGFIELD in The Tax Journal, April 12 and 19, 2004 and April 25, 2005.

[83] KING/THORNHILL, *supra* note 1, and *see* the discussion of systems theory in FREEDMAN, *supra* note 6, at 96 and below.

[84] Statement of Standard Accounting Practice 9 and 12 and Financial Reporting Statement 15.

in the cost of stock.[85] The view of the High Court judge in the U.K. and the majority of the Court of Session in Scotland was that the statutory prohibition on deduction overrode accounting practice. As Lightman J put it

> "It is not to be expected that Parliament intended that (save as expressly provided) any sum deducted in respect of depreciation should avoid being added back merely because it was reflected as an item of cost in the figure shown for stock."[86]

To Lightman J this was a question of statutory construction and therefore one of law and not accounting, as was the conversion of the depreciation cost into an income cost, issues of capital and income being clearly a question for the courts,[87] but to the accountants[88] and eventually to the House of Lords, the decision as to what had actually been deducted was a question of accounting principle. To them the amount carried forward had not been deducted and so could not be added back. The lawyer representing HMRC in the *Mars* case argued that it was relevant to consider the capital allowances legislation. Capital allowances were given without any reduction for depreciation carried to stock and so the add back should be for the full amount of the depreciation.[89] This argument, which attempted to look at the accounts and tax legislation as a whole, was not remarked upon by the House of Lords. In one sense this was understandable, because the capital allowances legislation is quite separate from the question of stock valuation. The outcome in the House of Lords is widely considered to be correct on the facts. On the other hand, the decision to follow the financial accounts for tax purposes in one respect whilst it does not govern depreciation more generally results in difficulties at the point of interaction as shown by this case and does not produce conformity or a simple relationship between the tax accounts and the financial accounts.[90]

This phenomenon can also be seen in other cases also involving the capital/ income divide. In *Gallagher v Jones*,[91] although the court purported to be following the accounting standard for finance leasing, part of that standard – the element which regarded a proportion of rental payments to be capital rather than income – was ignored. This was accepted without argument so that the relevant standard (SSAP 21) apparently applied in so far as it applied to timing, but not in relation to the recharacterization of a revenue payment as capital.[92] A fuller (although still not

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[85] As explained by Lightman J [2005] STC 958 at para. 39.

[86] [2005] STC 958 at para. 36.

[87] *See supra* note 74.

[88] *See* TRUMAN, *supra* note 82.

[89] [2004] STC (SCD) 253 at para. 267.

[90] Similarly in the case of *Gallagher v Jones*, accounting standards were in fact followed only in part – *see* FREEDMAN, *supra* note 68.

[91] *See supra* note 68.

[92] *Id.*, at 544, line h. In another case dealing with the conversion of rental payments into a capital lump sum by way of assignment, the entire question was treated as one of law, to the surprise of the dissenting judge in the Court of Appeal, Arden LJ, who thought that the accountancy treatment was a relevant consideration: *IRC v John Lewis Properties*, [2003] STC 117. Legislation has not introduced a solution to the issue addressed in that case which comes close to the accounting treatment.

complete) alignment with accounting practice had to be achieved subsequently by legislation to produce a coherent solution.[93]

The consequence of this partial conformity with accounting standards is that there is no certainty about when the courts will decide that a matter falls within their jurisdiction and when they will follow accounting practice, as we can see from the very different views of the judges at different levels in the *Mars* case as just one recent example. The direction from Lord Hoffmann in the House of Lords suggests that only legislative qualifications of accounting practice are likely to be considered valid, yet this was not fully explored and the older cases may yet be raised up by taxpayers or HMRC in the future. Even if a legislative provision stated expressly that only statutory deviations from accounting practice would be permitted, this would be unlikely to bring an end to the uncertainty, since issues of interpretation and scope would still arise and the courts would still be inclined to find points of law on which they could opine. As now though this would be a partial exercise resulting in a hybrid system. Thus there would be a tendency for the courts to seize back jurisdiction by finding that the accounting standard was not applicable to the situation or by converting the issues into ones with which they were familiar, such as the capital/income divide, as discussed above, or a contractual or legal ownership question. This might be done by finding that there was an issue as to the nature of a payment for tax purposes which must be decided as a pre-requisite to deciding whether or not the accounting standard applies at all.[94]

5. Conclusion and Issues for the Future

It has been argued here that full convergence of commercial and tax accounts will not be achieved and should not be the aim. Convergence with adaptations to take account of necessary differences might seem to be a sensible compromise, but this will bring with it its own difficulties as systems which have apparently similar objectives and use similar language in fact are based on different principles, making interaction problematic. In particular, any notion that there is one true "profit" figure will be an unhelpful over-simplification. Systems theory suggests that integration of the tax and accounting systems is not possible; they are separate "closed" systems which inevitably see things differently and this needs to be recognized in policy formulation.[95] "All that one system is able to achieve is an internalization according to its own 'way of seeing' of what it understands from the communications of the other system".[96] As can be seen from the decided cases, the interaction of two very different systems will result in a tendency for the courts to simplify accounting principles in order to absorb them into a legal decision making process.

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93 Finance Act 2006, Schedule 8 amending Capital Allowances Act 2001.

94 For examples of such a response under the present system, *see*, in addition to *Gallagher v Jones*, the cases on "judicial gap filling" discussed in FREEDMAN, *supra* note 6, at 87 *et seq.*

95 KING/THORNHILL, *supra* note 1, at 26-27; NOBLES/SCHIFF, A Sociology of Jurisprudence (2006).

96 KING/THORNHILL, *id.*

A judicial decision needs to give a definitive, one figure answer to questions that in accounting terms may be dealt with in a more nuanced way by use of a package of figures and notes to the accounts. In picking and choosing issues on which they will follow accounting practice as they see it, the courts may fragment the overall picture, and this process, combined with statutory modifications to the commercial accounts for tax purposes, is highly unlikely to produce conformity, transparency or simplicity.

Despite a starting point of conformity in many European countries, in practice there is considerable statutory divergence and this is likely to increase rather than decrease if national accounting standards used for tax purposes follow the path of IAS/IFRS in the use of fair value accounting and other developments that are not easily applicable to taxation. Countries in which individual company accounts as used for tax and company law purposes vary from IAS/IFRS may not experience this difficulty, but their individual company accounts will then not be aligned with their consolidated accounts which, at least in the case of listed companies, will be made up according to IAS/IFRS. In the U.K., where use of IAS/IFR is already permitted for individual company accounts and where U.K. accounting standards are converging with IAS/IFRS in any event we see a starting point of convergence but many examples of divergence. Issues are arising about the point at which questions of law about the nature of receipts and expenses might interact with the application of accounting standards. Yet further complexities will arise should issues of interpretation of IAS/IFRS reach the European Court of Justice, as well they might now these have been adopted at European level. Should the CCCTB be implemented, there will be yet another layer of accounts which will follow IAS/IFRS in part but not completely and further issues of interpretation for the ECJ.[97] There is little evidence that Europe is moving towards a simpler system.

In the United States, as we have seen, there are calls by some for greater conformity in order to prevent tax avoidance and the manipulation of financial accounting income. Desai and Dharmapala suggest that there exists a relationship between aggressive tax sheltering activity and diversion of corporate profits from shareholders and that the opportunities for this could be decreased by book-tax conformity and greater transparency.[98] For the reasons explained here, it is not clear that a sufficient degree of conformity could be achieved to ensure the lack of divergence that would be necessary to remove these opportunities and it is very unlikely that the degree of simplicity these writers hope for would be attained; at least this has not been the result in the U.K., where complexity remains and there

[97] It has been suggested that a specialist court at EC level might be needed to deal with interpretations of accounting standards: Philip Baker QC at the CCCTB Conference organized by the German Federal Ministry of Finance in cooperation with the ZEW Centre for European Economic Research and the Max Planck Institute for Intellectual Property, Competition and Tax Law in May 2007.

[98] DESAI/DHARMAPALA, *supra* note 5; DESAI, *supra* note 59.

still seems to be a gap between taxable and financial accounting profits that is not always easy to explain.[99]

If the standards regulating financial accounts are designed to bring as much information to the market as possible then this must be good for corporate governance and it is not desirable to muddy the waters by insisting on conformity with the tax accounts. Nevertheless, if there are large differences between book and tax accounts which cannot be explained in terms of deliberate divergences in the rules there are governance concerns of the type described by Desai and Dharmapala. Greater disclosure of information from the tax accounts might be necessary to enable the authorities, analysts and researchers to investigate this.

There are various routes to achieving this.[100] There could be greater or better disclosure to the tax authorities (in the USA through improvements to the Schedule M-3),[101] there could be increased disclosure of tax information to the public or to agencies regulating the securities markets or there could be inclusion of increased disclosure in financial reports with respect to book-tax differences.[102] The Securities and Exchange Committee (SEC) and the U.S. Treasury have expressed doubts about the value of disclosure of the entire voluminous tax accounts, largely on the grounds that the complexity and length of them made them of limited value to the authorities, although potentially useful to competitors. They believe that specific information is more useful and this can be requested by the SEC if necessary.

Elsewhere, the effective tax rate is sometimes used by revenue authorities as one measure of tax compliance and this requires examination of the relationship between the tax and financial accounts, the effective tax rate of corporations being the corporation tax liability declared as a percentage of pre-tax company profit. This measure is already used in Australia and Canada and the U.K. National Audit Office has recommended that HMRC should

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[99] *See* SHAVIRO, *supra* note 81, who considers the difficulties created by conformity make it inferior to partial conformity. By this he means, however, a form of partial conformity, this would not be based on altering the detailed rules for profit computation but would take the form of an adjustment of the final figures. This is a practical proposal to address the tax avoidance problem although the rationale is not entirely clear. If it is reasonable to have a tax base which differs from the financial accounting base, why should it be justifiable to have an adjustment? *See* also MCCLELLAND/MILLS, Weighing Benefits and Risks of Taxing Book Income, 2007 TNT 35-61, Special Reports.

[100] HUBBARD (panel member), Presentation on Tax Accounting versus Commercial Accounting, IFA Congress 2006.

[101] KNOTT/ROSENFELD, *supra* note 5, Part II, discuss the issues of publication of tax returns and the Schedule M-1 reconciliation of book and tax accounts. *See* also MANZON/PLESKO, The Relation Between Financial and Tax Reporting Measures of Income, 55 Tax Law Review 175 (2002); LENTER/SLEMROD/SHACKLEFORD, Public Disclosure of Corporate Tax Return Information: Accounting, Economics and Legal Perspectives, 56 National Tax Journal 803 (2003).

[102] There are already requirements to account for uncertainty in relation to tax positions under FIN 48.

> "assess the usefulness of monitoring businesses' effective tax rates over time, as an indicator of potential compliance risk behaviour and to develop better understanding of the drivers behind those rates."[103]

The differences between the financial accounts and the tax accounts may be based on a good rationale. If so, any cost resulting from having two separate figures is likely to be outweighed by the benefits of providing appropriate information and figures for the different stakeholders in question. If the differences in the accounts are not based on reason but on some form of manipulation, the answer seems to lie in ascertaining the causes of this and changing whichever set of rules is inappropriate for its purpose. The best way to discover why the differences are arising is by improving transparency and disclosure. The existence of two systems side by side will result in complexities and issues of interaction. It should not be assumed that this interaction can be managed without legislation, nor that it will be simple, even where there is an initial presumption of convergence.

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[103] NATIONAL AUDIT OFFICE, *supra* note 10.