SPRINGER NATURE Link

Log in

Financial and Tax Accounting: Transparency and “Truth”

Conference paper

pp 71–92 | Cite this conference paper



Tax and Corporate Governance

Judith Freedman

Part of the book series: MPI Studies on Intellectual Property, Competition and Tax Law ((MSIP,volume 3))

3881 Accesses **14** Citations

Abstract

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.

The author thanks the organizers and participants of the Symposium on Tax and Corporate Governance at the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich for the helpful discussion. She has also benefited from the Kari Tikka Memorial Lecture delivered by Professor Claes Norberg at the University of Helsinki in June 2007 and the debate which followed.

This is a preview of subscription content, log in via an institution to check access.

Access this chapter

Log in via an institution →

Institutional subscriptions →

Preview

Unable to display preview. Download preview PDF.

Explore related subjects

Discover the latest articles, books and news in related subjects, suggested using machine learning.

Business Taxation and Tax Law | Accounting | Financial Accounting | Financial Law | Public Accounting | Fiscal Law | Valuation and Accounting Implications of Deferred Taxes

References

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

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

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).

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.

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.

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.

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).

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).

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.

23 Cited in PLESKO/MILLS, *supra* note 5.

24 HUGHES, “What do users really want from ‘fair value’ accounting?”, Financial Times, September 13, 2007.

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_CEOVision110806(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.

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.

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

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.

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.

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

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).

49 NORBERG, *supra* note 43.

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

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).

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).

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).

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.

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

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.

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).

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

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).

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.

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. 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*.

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

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).

103 NATIONAL AUDIT OFFICE, *supra* note 10.

Author information

Authors and Affiliations

Taxation Law in the Law Faculty, Oxford University, Oxford
Judith Freedman (KPMG Professor)

Editor information

Editors and Affiliations

Max Planck Institute for Intellectual Property, Competition and Tax Law, Marstallplatz 1, 80539, Munich, Germany
Wolfgang Schön

Rights and permissions

Reprints and permissions

Copyright information

© 2008 Springer-Verlag Berlin Heidelberg

About this paper

Cite this paper

Freedman, J. (2008). Financial and Tax Accounting: Transparency and “Truth”. In: Schön, W. (eds) Tax and Corporate Governance. MPI Studies on Intellectual Property, Competition and Tax Law, vol 3. Springer, Berlin, Heidelberg. https://doi.org/10.1007/978-3-540-77276-7_6

.RIS .ENW .BIB

DOI
https://doi.org/10.1007/978-3-540-77276-7_6

Publisher Name
Springer, Berlin, Heidelberg

Print ISBN
978-3-540-77275-0

Online ISBN
978-3-540-77276-7

eBook Packages
Business and Economics
Business and Management (R0)
Springer Nature Proceedings
excluding Computer Science

Keywords

Supra Note
Accounting Standard
Financial Account
Accounting Practice
Financial Account Standard Board

These keywords were added by machine and not by the authors. This process is experimental and the keywords may be updated as the learning algorithm improves.

Publish with us

Policies and ethics

Search

Search by keyword or author

Navigation

Find a journal

Publish with us

Track your research