

Accounting Standards and Tax Law¹

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Basis of Tax Laws

Profits model:

taxable income = business profits (with some adjustments)

Income/expenses model:

taxable income = gross income minus allowable deductions

Accounting → Taxable Income

- BOTH profits and income/expense jurisdictions start with financial accounts for large companies and then adjust back
- smaller businesses may not have audited financial accounts;
- very small may have:
 - no financial accounts at all, only bookkeeping records
 - or no records and only receipts
 - or no receipts

Who sets accounting standards?

- until recently, most countries applied national standards
- standards in many former colonies were based on former colonial powers' standards
- serious problems in socialist countries which had no standards
- following the European lead; much of the world moving to IFRS (IASB)

Whose standards?

- standards are set by national accounting bodies NOT government
- exception: China Accounting Standards Committee (CASC) under MoF prepared Chinese Accounting Standards (CASs)
- many countries with IFRS use national standards for unlisted businesses
- U.S. and some others did not adopt IFRS
- gradual convergence with Canada, India, Japan; slower with U.S.

Socialist market economy standards

CASs deviate from IFRS because

- government controls price of many assets (no fmV valuation possible)
- "related-party" disclosure provisions can not apply
- concern over "impairment of assets" rules

Using standards for tax

- extremely rare to explicitly use IFRS for tax (Slovakia a notable exception)
- even profits systems that start with standards tend to have deviations

Why not use standards?

- political concern: hand base to outside body
- legislature loses control of base changes
- insufficient certainty (accounting offers leeway)
- accounting and tax may differ in their approaches to corrections to past entries
- legislature uses tax to achieve various social, political, and economic objectives

Different objectives of accounting and tax

- accounting: measure performance for creditors and investors
- tax: measure economic gains in terms of ability to pay
- accounting: looking forward to future profitability – alerts to creditors, owners, potential investors
- tax: looking back to past gains

Legislative intervention

- negative externalities
- positive externalities
- address market failure
- discourage anti-social behaviour
- “simplify” rules
- integrity of tax system

Negative externalities

- price of goods does not reflect full social costs
- excise tax is normally used to increase price
- but sometimes income tax is used (e.g., no deduction for some inputs)

Positive externalities

(government knows better than the market)

- subsidies (tax expenditures) to encourage certain types of consumption
- e.g., deductions for personal expenses
- tax system used to avoid transparency
- e.g., accelerated depreciation, exemptions, holidays

Address market failure

- market failure results from imperfect access to information or government interference with the market
- example is tax system that does not refund tax on losses – could lead to tax subsidies for R&D

Discourage anti-social behaviour

- increase tax burden on persons engaging in unwanted behaviour
- example: no deduction for fines, bribes, expenses incurred in the course of illegal activities
- [some countries encourage anti-social behaviour by exempting income from illegal activities or exempting products from excise taxes]

“Simplifying” tax rules

- (sometimes misguided) attempts to simplify tax rules
- example is depreciation pooling

Integrity measures

- accounting indifferent to income shifting from high bracket to low bracket or taxable entity to loss entity (ignore common interests of owners) or use of alternative structures or transactions
- tax has many integrity measures at odds with accounting measurement

Integrity measures (2)

- rules ignore income shift between related persons (family, related companies, etc.), including transfer pricing
- quarantine rules to prevent abuse of realisation recognition of capital gains and offshore income
- surrogate taxation, e.g., tax fringe benefits by denying deductions

Integrity measures (3)

- recharacterisation to take advantage of different tax treatments
- examples:
 - “debt dividend” rules treat some inter-corporate dividends as interest
 - “thin capitalisation” rules treat some interest as dividends

Further divergences

Two areas in which there are further and significant differences:

- in Anglo jurisdictions courts read down “profits” or “income” to exclude “capital gains” in the trust law sense
- tax laws based on income and deduction rules cannot provide offsetting assets or liabilities

Flows Alone vs Flows and Assets

- accounting can offset expenses with assets and receipts with liabilities
- example: prepayments, acquisition of assets
- tax systems based on income and deductions need complex statutory regimes to accomplish the same thing

Where you might want to differ

- warranty expenses
- accrued leave expenses
- appreciation formula rather than mark-to-market

Special rules might be needed

- pre-payments
- subject to discount: e.g., 100 subject to 5% discount if paid within 30 days
- price uncertainty: e.g., price based on spot price over a period determine after end of the year
- amount uncertainty: e.g., gas meter checked after the end of the year; vending machine checked after the end of the year

Embedded debt

- finance lease
- installment sale (cost 100, sold for 500 payable over 10 years)
- annuity vs blended payment loan

Dealings in debt

- debt dissection and debt defeasance; e.g.
 - lend 100 @ 10% for 10 years and lender sells right to 100 principal in 10 years for 40 or right to 10 each year for 10 yrs income stream for 60; or
 - borrower pays someone to take over principal repayment obligation or interest repayment obligation
- repo transaction