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Aligning Taxable Profits and Accounting Profits: Accounting standards, legislators and judges

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Abstract
There has been an uneasy relationship between taxable business profits and accounting profits for many years. The radical changes currently taking place in the content and objectives of accounting standards, spurred on by the move towards International Accounting Standards, could be seen as an impetus for reviewing the tax positi

The differences are significant and generally lead to lower taxable profits in those dependence countries where commercial accounts follow tax rules, although the tax collected need not be lower, of course, since the rates may be higher to compensate.

Although systems vary, it is important not to draw too sharp a dividing line between different approaches or to be over-simplistic in the characterisation of these systems. 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.[3] Even in Germany, considered to be home to a strong form of dependence[4], there has been a recent tendency towards special tax rules which deviate from commercial accounts, for example on valuation, often in an effort to increase revenue.[5] At the same time, in the UK, frequently described as a prime example of a jurisdiction where the approach is one of independence, there has always been some element of alignment, recently strengthened through judicial and legislative developments. In truth, the stereotypes do not seem ever to have been entirely accurate and are becoming less so.

It seems likely that the complexity of accountings standards, and their globalisation, will lead to an appraisal of the appropriateness of dependence in many jurisdictions, whatever their starting point. In countries where there is strong culture of dependence there may well be a temptation to limit the adoption of the new accounting standards to consolidated accounts so that single company accounts, which are used for tax purposes, remain unaffected. At the same time, the work that is being done by the accounting bodies to achieve agreement in especially difficult areas may tempt tax policy makers to 'piggy-back' on these efforts both at domestic and international levels by using accounting standards as a basis for taxation. In which direction these conflicting pressures will lead us for tax purposes is not yet entirely clear.

Some argue that globalisation of accounting standards is the cue to *disassociate* tax and accounting. Not only will governments be reluctant to hand over control of their tax base to the International Accounting Standards Board (IASB)[6] but, crucially, the theory behind International Accounting Standards (IAS), and particularly its emphasis on fair value accounting, is departing from the central principles that have always been

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Tax Bulletin May/June 2002 (Special issue on the Relationship between Accounting and Taxation Principles).

[3] Hoogendoorn (1996), ibid.

[4] The German *Massgeblichkeitprinzip* is conveniently described in English by N. Herzig (1996), 'Tax versus Commercial Accounting in Germany' in IFA 50th Congress Seminar Proceedings, *The Influence of Corporate Law and Accounting Principles in Determining Taxable Income*, Kluwer, The Hague.

[5] K. Ebling (ed) *Blumich Kommentar* (2003) (76th edn) Verlag Franz Vahlen Munich, § 5. The author is grateful to Oktavia Weidmann, Oxford University BCL student, for this reference. These moves are also a reaction to pressure to change accounting standards and to adjudicate on them at a European level: see W. Schoen, 'International Accounting Standards- a 'Starting Point' for a Common European Tax Base?', Presentation given to the Annual Conference of the European Association of Tax Law Professors, Paris, 5th June 2004.

[6] Alvin D. Knott and Jacob D. Rosenfeld (2003) 'Book and Tax: A Selective Exploration of Two Parallel Universes' (Parts I and II) *Tax Notes* May 12 and May 19th. The IASB is a not for profit Delaware corporation, not under any governmental control. Constitutional concerns are also a problem for many European jurisdictions as became clear at the conference of the European Association of Tax Law Professor, Paris, 5th June 2004.

thought of as suitable for taxation purposes in the past, the key one of which is the traditional concept of realisation.[7]

So, in an EU Commission staff working paper in 2001, globalisation of accounting standards is seen as a catalyst for the development of harmonised, but independent, tax accounting principles. The paper states[8]

> 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

In Part II of this article the debate on the relationship between taxable and accounting profits is outlined. Part III discusses the way in which this relationship is changing and being managed in the UK. In Part IV the role of the judiciary in this relationship is scrutinised and it is suggested that, contrary to some views expressed, there is a continuing role for the courts and this role will remain despite increasingly detailed and comprehensive accounting standards. Part V comments briefly on the interaction between the tax and accounting systems in this

able to tax the same profit as is enjoyed by the owners. There is no need to have two sets of rules and no justification for it. At an international level, the expert work done to harmonise accounting standards could be utilised in the tax field without having to duplicate effort. Accountants have expertise in defining profit that lawyers do not have and this should be recognised.

Arguments for divergence of accounting and taxable profits

The counter arguments are less immediately obvious but are nevertheless well known. It is argued here that they are stronger than the arguments for alignment. This view is based on the differing objectives of calculating taxable profits on the one hand and presenting financial accounts on the other and the need to keep each system true to its objectives and robust against any pollution by considerations more relevant to the other system.

Alignment is only helpful if it simplifies the process of preparing accounts, thus reducing compliance costs. Major simplification may not be possible because in practice complete alignment is neither achievable nor desirable. Commercial accounts and tax accounts have different objectives. Tax must raise revenue and do so equitably and efficiently as between taxpayers. This points to reasonably objective rules that take account of taxable capacity and administrative efficiency. Tax avoidance opportunities must be blocked. Financial accounts must give relevant and reliable information and prevent businesses from hiding the substance of their position. In each case these objectives are perfectly valid, but the functions performed by the

pay the tax.[18] These concepts are sometimes linked to the realisation principle, since without liquid assets there is an obvious difficulty in paying taxes. Whilst in a perfect

whom the idea of public disclosure of tax accounts was put, doubted 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. Rather more useful is specific information that can be requested by the SEC if necessary. There does seem to be a consensus, however, that the book-tax reconciliation information already required should be improved upon.[25] It should also be noted that one of the characteristics that makes a transaction in the USA subject to stringent tax rules on disclosure is a large difference between book and tax results.[26] The use of book- tax differences in this targeted way seems likely to be a more valuable way of tackling abuses than does conformity, with all the problems and disadvantages that would entail.

III. MANAGING DIVERGENCE- AN

In order to discuss this further, the current UK position will be examined. The positions in Australia and the UK are not identical[28] but there are significant parallels and interesting distinctions in the debate. [29]

Superficially, the position in the UK now seems to be clearer than it has been in the past. In part this is said to be due to case law developments, notably the case of *Gallagher v Jones*,[30] seen by many as cementing the trend towards dependence of taxable profits on account profits. Sir Thomas Bingham MR stated in that case that he found it

> hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business.[31]

This was followed by legislative codification of this case law in section 42 of the Finance Act 1998. Section 42 stated that

> …the profits of a trade, profession or vocation must be computed *on an accounting basis which gives a true and fair view*, subject to any adjustment required or authorised by law in computing profits for those purposes.3.7(ew)]T trendx7uid40hw[(This

> correct principles of commercial accountancy...At the end of the day the court must determine what is the correct principle to be applied.

In modern conditions, where accounting standards have been hammered out and agreed nationally and now even internationally so as to eliminate many disputes between accountants on different approaches, the first part of this process as described by Pennycuick VC, seems to have been elevated over the second as Bingham MR suggested in *Gallagher v Jones*. Accounting standards are so much more formalised and rigorous now than when the older cases were decided that the position is now In m3(od27.8(

of the capital/income distinction. In the capital/income area, Lord Denning's famous dictum in *Heather v PE Consulting Group*[44] expresses a widely shared view.[45]

> The Courts have always been greatly assisted by the evidence of accountants. Their practice should be given due weight: but the Courts have never regarded themselves as being bound by it... The question of what is capital and what is revenue is a question of law for the Courts.

The revenue/capital distinction was one where the judges felt comfortable, having encountered it in various guises in the realm of property law and trusts, and where they would impose their own views. More recent cases have stressed the importance of the facts in cases where the capital/income distinction falls to be decided but the judges have nevertheless proceeded on the basis that they must apply precedent and identify indicia of capital payments, which appears to elevate this to a question of at least mixed law and fact.[46]

Profit definition - the role of the legislature

In the UK there have always been areas of profit definition covered entirely by legislation, most notably depreciation, where a comprehensive legislative capital allowances regime continues to govern the position despite arguments from accountants for many years that commercial depreciation methods would be preferable.[47] There are further areas where the UK government has legislated, notably in the case of financial instruments, foreign exchange and intangibles, where the legislation is in each case largely based on accounting standards, but with some important deviations.[48] This legislation moves away from the traditional common law distinction between capital and income.

In recent reviews of the Corporation Tax regime,[49] the UK Government has expressed a desire to align commercial and tax accounts to a greater degree, for example by moving away from the capital/income distinction to follow accounting treatment for the taxation of profits and losses on capital assets, and using accounting depreciation instead of a capital allowances regime. On both these proposals there has been retrenchment in the light of comments and further consideration. The 2003 consultation document reiterates rather more strongly than before that it may not be appropriate for the tax base to follow the accounts in all respects. It is accepted that adjustments to the accounts may be needed for policy reasons, to provide incentives to address market failures, to ensure that the tax system is fair and to take account of practical issues.

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made it clear in *Gallagher v Jones* (n. 30 above) that the Courts will seek guidance from accounting practice as to whether or not a loss is anticipated.

[44] [1973] 1 All E.R. 843.

[45] Apparently also held in Australia, see Hill, n. 28 above.

[46] See the analysis of Dyson LJ *in IRC v John Lewis Properties* [2003] STC 117, for example, where he decided, based on careful consideration of the case law that a lump sum prepayment of rent was capital in nature. Contrast Arden LJ, dissenting in that case, who relied upon dicta of Lord Hoffmann's in *MacNiven v Westmoreland* [2001] STC 237 to the effect that income and capital are commercial and not juristic concepts and thought that the payments must take their capital/income colour from the rentals they represented, and were therefore income. See also Macdonald, n.1 above, at para. 4.12.

[47] Discussed in Lamb, n. 41 above.

[48] For example, 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).

[49] Consultation documents on Corporation Tax Reform, 2002 and 2003, n. 14 above.

In the first category, provision of incen

not be referred to by the courts in interpreting the legislation, so there is some speculation about this matter.

It is interesting to note that this 'tidying up exercise' had first been mooted by the Tax Law Rewrite Team[57] and the phrase 'generally accepted accounting practice' originally suggested by them for inclusion had met with some opposition. According to the summary of responses to the first consultation on this part of the rewrite, a substantial majority of respondents were in favour but, the team said,

> we recognise that a significant number were opposed. They felt that profits could not be sufficiently defined or that references to accounting principles were not helpful- many of those who supported the change had reservations about the way the clause is currently framed.[58]

The question was then transferred from the rewrite team to be dealt with within the less restricted bounds of the Finance Act 1998. Nevertheless, presumably due to the comments from consultees, the 1998 legislation referred to a true and fair view, rather than generally accepted accounting practice (GAAP), to be quietly replaced by the reference to GAAP in 2002. In this way (GAAP) appeared in UK tax legislation for the first time without full consultation and somewhat by stealth, although arguably the reference to a 'true and fair view' came to

> Gains from transactions shall be recognised in the accounting period in which they are regarded as realised in accordance with normal accounting practice.[67]

This is a suggestion that might well require further consideration, given the way in which accounting practice is moving away from realisation as a trigger for recognition. To some extent this is being achieved by a redefinition by accountants of realisation to include, for example, the results of marking to market as realised profits.[68] It is not clear how long the concept of realisation will continue to be important at all in financial accounting terms. In the UK it has been retained in Financial Reporting Standard (FRS) 18, *Accounting Policies*,[69] but only under sufferance because of protests from those concerned about the company law implications of the concept disappearing, whilst distributions are dependent on having realised profits.[70] In practice the UK Accounting Standards Board (ASB) considers the linking of prudence to realisation to be out of date and prefers to discuss the concept of prudence in terms of revenue recognition only where there is reasonable certainty that a gain exists and if it can be measured reliably.[71] IAS do not address the issue of realisation and the fact that a gain must be reported to accord with IAS does not necessarily imply that a gain would be realised or distributable under UK or any other national law.[72] It is not by reference to realisation, therefore, that we can expect to see the accounting rules on profit recognition evolving.

Given this, Macdonald's proposed provision may require modification. It may not be appropriate to try to use normal accounting practice to determine the time of realisation: some form of tax realisation principle may be required, possibly more closely linked to legal rights than revenue recognition will be in the future under accounting practice. So, discussion is needed on the appropriate legislative tax principles but it can be agreed that some sort of guidance is desirable. If there were to be legislation on such principles, the courts could examine the accounting standard in question and decide whether, as a matter of statutory construction, the application of the accounting standard would give a 'correct' result under the tax realisation principle.

If no such legislation is forthcoming, it may be necessary for the courts to evolve a concept of realisation of their own, based on earlier accounting approaches that were

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[67] Macdonald (2002) n 1 above at p 50.

[68] See Inland Revenue Guidance 2004, n. 42 above, citing the ICAEW Technical Release 7/03 on Realised Profits.

[69] Accounting Standards Board (December 2000).

[70] Article 31 of the EC Fourth Directive on Company Accounts, implemented in the UK by Schedule 4 to the Companies Act 1985, paragraph 12. Sections 262(3) of the Companies Act 1985 provides that references to realised profits are to be construed in accordance with GAAP so that this fundamental principle of company law is, arguably, in the hands of the accountants. See Judith Freedman (1996) 'The Role of Realisation: Accounting, Company Law and Taxation' in IFA 50th Congress Seminar Proceedings, *The Influence of Corporate Law and Accounting Principles in Determining Taxable Income* , Kluwer, The Hague. Within the EU there are now calls for the test for distributability to be a solvency test rather than one based on realised profits: see Jonathan Rickford (ed) (2004*) Reforming Capital,* Provisional Report of the Interdisciplinary Group on Capital Maintenance, (British Institute of International and Comparative Law, London); Communication of 21 May 2003, COM (2003) 284 final, *Modernising Company Law and Enhancing Corporate Governance- A Plan to Move Forward.*

[71] Appendix IV to FRS 18.

[72] Allister Wilson, Mike Davies, Matthew Curtis and Greg Wilkinson-Riddle (2001), *UK & International GAAP*, (7th ed.) Ernst & Young/Butterworths Tolley, London.

more suitable for tax purposes than those now developing (and thus taking in some of the old case law). This is not stultification of development but a proper application of the traditional two-stage process described in the *Odeon* case. There will remain a role for the courts in applying any relevant legislation and, whether there is legislation or not, in determining the correct accounting principles to be applied for tax purposes.

There will be those who argue that the courts are not equipped for this role. This is to confuse the proper *determination* of accounting standards on the one hand with their *interpretation* and *application* for tax purposes. *Determining* the content of accounting standards is of course beyond the expertise of the judiciary and this is a question for accountants and business owners and managers, as are many, though not all, questions of interpretation of standards. When it comes to *interpretation*, there has to be some adjudication process in case of dispute and the courts must provide that service, although always in the light of expert evidence. Although this will be a question of fact, it is one that could lead to the determination of general principles regarding the meaning of accounting standards that could become used as precedents and thus emerge as questions of law. Given this, it could be argued that it would be desirable for the manner in which accounting evidence is brought to the court to be formalised somewhat, since at present the court is dependent upon whatever accounting evidence is brought before it by the parties.[73] If a court's decision on the meaning of accounting standards may acquire status as a precedent then it is important for all issues to be aired. This is particularly so if a decision in a tax case could have implications in other areas of law such as company law, a problem which would be reduced by having distinct legislative tax principles. Furthermore, the accounting standards to be examined in future may be international accounting standards and it is desirable to have uniform interpretation of these across jurisdictions.

One solution to this might be for the courts to seek guidance from the Accounting Standards Board or International Accounting Standards Committee in cases of dispute over the correct interpretation of accounting standards. In Sweden, for example, the Supreme Administrative Court may consult the Swedish Accounting Standards Board. It is not bound to follow its interpretation but in recent years normally has done so.[74] It seems unlikely, however, that it would be practical to call upon the interpretation committee of the IASC to perform this role and they may well not welcome the additional burden.[75] The issue of different interpretations in different jurisdictions will be a general problem of interpretation of accounting standards at an international level and not merely a tax problem. Once IAS is a European standard, the relevant court to decide on interpretation in Europe will ultimately be the European Court of Justice (ECJ), raising further issues for domestic courts in a tax context.

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[73] Sometimes taxpayers can find it hard to find adequate expert evidence or choose not to do so as was the case in *Gallagher v Jones* (see Freedman n.31 above).

[74] Kristina Artsberg (1996) 'The link between commercial accounting and tax accounting in Sweden' *The pean standard698(m)7e IASx ac21421 TD0.001om*

Whilst it is right that the courts should look to expert evidence on the meaning of accounting standards, their *application* for tax purposes is bound to raise questions upon which the courts must and will adjudicate. In addition, where the interpretation relies on legal concepts it is proper for the courts to have a role. Further, they may have to choose between accounting practices where more than one is applicable. The courts can thus be seen to have a role in dealing with four categories of questions as follows.

1) Does the accounting standard apply to the transaction at all?
2) Does the accounting standard itself introduce questions of law?
3) Are there two or more accounting practices which could properly be applied, or no specific standard but only general accounting principles? If so, which practice or principles are preferable for tax purposes?
4) Is the accounting standard proposed by the accounting evidence applicable in a tax context?

These questions, which are explored in more detail below, are similar, although not identical, to the questions posed by Sir Thomas Bingham in

reason.[79] If, as a matter of law, a receipt is not a trading receipt then it will not be included in the calculation of profit for income or corporation tax purposes, although it may be taxable as a capital gain.

As the Special Commissioners put it in *Tapemaze v Melluish*

> …accountancy principles may tell us how big a sum ought to be, and in what year it should appear in the accounts, and whereabouts in those accounts it should appear, and what accountancy label should be attached to it. What those principles cannot tell us is what the sum, in income tax terms, actually is.[80]

A recent example of this approach can be seen in a case that came before the Special Commissioners, *Anise v Hammond*,[81] in which excess payments were received by banker's order from customers by the taxpayer in payment for brochures and booklets containing their advertising. These overpayments were retained[82] and written to the profit and loss account. Initially they were included in the taxable profits but subsequently the taxpayer companies changed their views and, although still including the sums in the profit and loss account, argued that they were not trading receipts and thus not taxable receipts. The sums were shown in both the commercial and corporation tax accounts as non-trading receipts. The taxpayers succeeded in their claim that the sums were not taxable trading profits. The Special Commissioners held that the sums were not received as trading receipts: seeking overpayments was not part of the trading activities of the company. Transferring them to the profit and loss account was purely an internal transaction and no trading asset was created.

The Special Commissioners, in their decision in *Anise*, kept closely to previous case law and did not discuss the case on the basis of accounting standards or accounting principles.[83] The whole case was argued 'as an old fashioned tax appeal concerned with basic principles' as the Commissioners put it themselves. The Commissioners relied on *Morley v Tatersall*,[84] a case in which it was decided that unclaimed balances of sale proceeds of racehorses were not trading receipts and did not become such as a result of being transferred to the partners of the firm. The Commissioners in *Anise* agreed that *Morley* established that it must be determined whether payments are or are not trading receipts at the time they are received. The overpayments were not trading receipts when received and did not become so as a result of internal transactions. Another case, *Jay's the Jewellers*,[85] was distinguished. Here, surpluses retained by a pawnbroker became his property after a certain time under a special statutory regime and were held taxable at that time, was distinguished. In the case of *Jays*, the accounting treatment had been to put the whole surplus into the profit and loss account on receipt and then debit two-fifths as a reserve for the amount that would be claimed, based on past experience. That this was good accounting practice was not questioned,

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[79] *Morley v Tattersall* [1938] 3 All ER 296, discussed further below.
[80] *Tapemaze Ltd v Melluish* [2000] STC 189 at 197h.
[81] [2003] STC (SCD) 258.
[82] No comment is made in the case or here on the propriety of these sums being retained in this way.
[83] The accountants took the view that these were non-trading receipts and so non-taxable, despite being in the profit and loss account. This was, of course, a tax judgment made by the accountants and not justified by reference to accounting standards, which do not appear to have been discussed in the case at all.
[84] (1937) 22 TC 51.
[85] (1947) 29 TC 274.

What is more, the fact that the issue arises in a tax case rather than, say, a company law case, could colour the outcome since the court will be considering the tax implications of its decision in the context of overall tax concepts such as realisability and taxable capacity, avoidance and objectivity. Whether a decision in a tax case

the unclaimed deposit account, in order to assess whether a balancing liability should be recognised.[98]

In practice the statement quoted from Treitel in the application note is merely a preface to an entire chapter discussing the issues around performance in more detail and many questions of law are involved which might be relevant to whether a contractual right to consideration has arisen. For example, certain contracts - entire

It may be that the courts will refuse to enter into any debate over this and see it as a matter of accounting practice. Indeed we have already seen them take this approach in *Symons v Weeks*[100], where the court accepted the application of a work in progress formula consistent with SSAP 9 in relation to recognition of profit by architects under a long-term contract. On the other hand, the contractual language of the Application Note does much to invite judicial intervention. The equivalent IAS, which deals with construction contracts, is rather less dependent on contractual terms, referring to contract revenue, which can be measured reliably, but the question of reliable estimates depends upon nevertheless judgments on various matters such as the enforceability of contracts. Thus we can see that many accounting standards will have legal elements which continue to require adjudication by the courts.

Are there two or more accounting practices that could properly be applied, or no specific standard but only general accounting principles? If so, which practice or principles are preferable for tax purposes?

It is well established, and was reiterated in *Gallagher v Jones*[101], that where there are two or more rules which could be applied to a situation it will be for the court to chose between them for tax purposes.[102]

Sometimes where accounting standards have not given a clear answer the courts have chosen an approach which has been subsequently upheld by accounting developments, [103] whilst at other times judicial decisions have been effectively reversed by subsequent accounting standards, as in *Johnston v Britannia Airways Ltd.*[104] The increasingly comprehensive coverage by standards at a national and international level is likely to remove some of this choice from the courts, although the principles basis of standards will mean that detailed choices remain to be made by those applying the standards. At other times the accounting will give a very detailed answer, requiring a range of information and notes in the accounts,[105] whereas what is needed for tax law purposes is a more straightforward or binary answer: is this sum taxable or is it not?

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[100] [1983] STC 195; see Freedman n 35 above for a detailed discussion of this case.

[101] n. 30 above.

[102] Where unlisted and individual UK companies will have a choice between IAS and UK GAAP after 2005 their tax treatment will follow whichever of these sets of standards they use (clause 50, Finance Bill 2004).

[103] *Herbert Smith v Honour* [1999] STC 173, consistent with the subsequently agreed FRS 12.

[104] [1994] STC 763

[105] See the comments of Lord Millet NPJ in *Commissioners v Inland Revenue v Secan Ltd.* 74 TC 1 at p

counteract the mischief being attacked in that case,[114] we may never learn the fate of this particular rule.

How the case law will develop more genera

recharacterises the revenue payment as capital. The accounting standard is only partially applicable.

Whether the courts will ever intervene in timing issues in the future is a more difficult question. It seems more likely that legislation will be used to counter the more extreme effects of fair value accounting but, if fair value accounting is introduced without legislative variations, it is not impossible that the courts will revive the notion of the importance of realisation for tax purposes and endeavour to examine for themselves whether an accounting treatment amounts to anticipation of profits, especially if the accounting profession finally removes all references to realisation as we have known it previously from its standards.[120] This will truly raise the question of whether any tax principles remain which can override accounting standards.

As this analysis of decided cases has shown, though the courts will sometimes be content simply to follow accounting standards, this will not always resolve the issues. If there is a prior question concerning the legal character of a receipt or expenses, or if the courts perceive that a legal concept is relied upon for the propose of the application of a standard, they will have a tendency to adjudicate: that, after all, is the function of courts. Much will depend upon the way cases are presented and the confidence of the judiciary in their comprehension of standards but, as they become more used to dealing with accounting evidence under the formalised systems of standards now evolving, this confidence will grow. Taxpayers and their advisers will also begin to press issues relating to accounting standards before the courts when these are seen to involve important issues with a good deal of tax at stake and will become increasingly expert at arguing the case for analysing the legal aspects of standards when it suits their case.

It is contended here that the judiciary will be willing to decide whether a standard is applicable at all, to provide interpretations of legal concepts embodied in standards, and to choose between competing standards or practices where both are presented as acceptable but one has to be chosen for tax purposes. In some cases, for example where there is a long established legal rule such as the capital/income distinction or the rule in *Sharkey v Wernher,* they may even decide that a tax principle exists which means that an accounting standard is not the correct principle to be applied, either in whole or in part, for tax purposes. In sum, then, it cannot be stated that the advent of detailed and formally agreed accounting standards removes the judicial role completely in this area.

V. THE INTERACTION OF SYSTEMS

The extent to which the courts will be prepared to go in interpreting accounting standards, and even deciding that they should not apply accounting standards for tax purposes, remains to be seen. It seems inevitable, however, that there will be a complex relationship between these two systems of law and accounting in this context, as in others.[121] Tax law will make reference to accounting standards, and in so doing will transform them into part of the legal system. In this process, there will be a tendency towards simplification of the accounting material to make it practical to use

[120] See text to ns. 68- 72 above.

[121] The complexities of this interaction are discussed in Peter Miller and Michael Power (1992) 'Accounting, law and economic calculation' in *Accounting and the Law*, Michael Bromwich and Anthony Hopwood (eds) Prentice Hall/ICAEW, London.

it in legal decision-making, as we have seen in a number of decided cases.[122] Tax law requires binary decisions- is an amount taxable or is it not?- rather than disclosure of an array of information as is required for accounting. Similar problems are encountered when the law attempts to inter

and make it much more difficult for them to be tax driven. If this occurs, the pressure to increase the number of exceptions from the old dependence principle will continue to mount. The absorption of IAS will be seen as unconstitutional, too difficult to control and as having objectives too remote from those of the tax system which earlier governed the formulation of accounting standards. Dependence was a product of tax dominance and once this has gone, the arguments for dependence will follow.

At a European level, the Commission continues to argue for the use of IAS as a starting point for discussion of a common consolidated tax base, even if only for want of anything better. There are, however, many Member States opposed to the concept of such a common base. Most Member States are still considering the impact of IAS and are not at the stage of moving forward on this basis. There are also those who would raise constitutional objections to the use of IAS to determine tax policy and so a sophisticated and political process would be needed at Commission level for the adoption of such standards for tax purposes. Much work remains to be done to reach agreement on this within the EU.

Underlying all these debates there is a concern about the interpretation of accounting standards for tax purposes. At a European level, the relevant court would ultimately be the ECJ, already embroiled in many controversial tax decisions. The interaction between the ECJ and the IASB would almost certainly be dynamic and difficult to predict. This problem of interpretation also exists more generally in relation to accounting standards in a wider context than tax.

Even if IAS are to be the starting point for taxable profits, governments at a domestic and European level will need to consider the pragmatic and policy reasons for departure from the accounting standards.[125] It is suggested here that these focus largely around issues of realisation, certainty and volatility. Legal transactions may be easier to manipulate than other tests of economic substance, but they do have a basis in reality and there may be good reasons to use transactions based evidence and legal rights as opposed to estimates in a tax context. Legal concepts of capital and income may seem outdated but sometimes reflect common understandings that underlie consensus about tax systems. Neutrality of taxation may be a desideratum but Governments will not wish to give up the ability to use tax as an economic tool, however ineffective a tool it may be.

All these considerations need to be taken into account in formulating policy on the relationship between taxable and accounting profits. Preferably these differences should be embodied in legislation to give guidance. As the European Commission working paper put it,[126] to the extent that tax accounting is to develop independently from financial accounting, autonomous tax rules (or principles) are needed. But legislation will not, and probably cannot, provide all the answers across the range of issues that may arise. Given this it will not be entirely unexpected if the courts intervene where a residual possibility to do so remains, either by means of interpreting standards, by finding them not to be applicable, or even by deciding that they are not the correct accounting principles to be applied in a certain situation. Just how far the courts will be prepared to go in the face of sophisticated accounting standards remains

[125] As the European Commission agrees: see the Commission non-paper referred to at n. 10 above.
[126] See n. 8 above.