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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 position. These developments might be seen by some as an opportunity to use global accounting standards as a step towards harmonising the tax base, especially within the European Union. It is argued here, however, that the objectives of accounting standards are moving away from those of the tax system, making complete alignment between taxable and accounting profits inappropriate and identification of tax principles all the more important. It is widely agreed that, whilst the commercial accounts are a starting point for calculating taxable profits, there is a continuing role for tax legislation in providing for modifications in some cases to meet specific tax objectives. This article argues that, contrary to the views of many in the UK at present, there is also a multi-layered and ongoing role for the courts in the process of defining taxable profits.

I. INTRODUCTION

In Australia, as in the UK, there has been a longstanding debate about the wisdom and extent of alignment of taxable business profits and accounting profits.¹ Systems differ markedly across jurisdictions. In Europe, countries have tended to divide between those where there is dependence (meaning either that the commercial accounts follow the tax rules or that tax follows the commercial accounts) and those where there is independence (where there are different rules for accounting and tax).²

⁺ The author would like to thank the participants at conferences organised by the Cambridge Centre for Tax Law in January 2004, the Anton Philips Fund Center for Company Law at Tilburg University in April 2004 and the European Association of Tax Law Professors at the Sorbonne in June 2004 for their comments on earlier versions of this paper and general discussions of this topic. She also thanks the anonymous referee, Maurice Parry-Wingfield and Edwin Simpson for their comments on this article. Any errors and the views expressed remain hers alone.

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¹ On Australia see Aldrin De Silva (2003) 'The Alignment of Tax and Financial Accounting Rules: Is it Feasible?' 18 *Australian Tax Forum* 264. On the UK, for just some examples see Judith Freedman (1995) 'Defining Taxable Profit in a Changing Environment' [1995] *British Tax Review* 434 and the many earlier articles cited at footnote 1 thereof; Geoffrey Whittington, 'Tax Policy and Accounting Standards' [1995] *British Tax Review* 452; Graeme Macdonald (2002) *The Taxation of Business Income: Aligning Taxable Income with Accounting Income*, TLRC Discussion Paper No. 2, Institute for Fiscal Studies, London (hereafter Macdonald (2002)); Christopher Nobes (2003) *A Conceptual Framework for the Taxable Income of Businesses, and How to Apply it under the IFRS*, ACCA, London (hereafter Nobes (2003)).

² Martin N. Hoogendoorn (1996) 'Accounting and Taxation in Europe- A Comparative Overview', *The European Accounting Review Vol.5 Supplement* 783 (hereafter Hoogendoorn (1996)). The importance of the relationship between accounting and tax principles outside Europe has been underlined recently by the publication of a special issue of the Asia-Pacific Tax Bulletin on the topic *IBFD 8 Asia-Pacific*

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 dependence⁴, 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

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

³ Hoogendoorn (1996), *ibid*.

⁴ The German *Massgeblichkeitsprinzip* 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 states⁸

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.

The EU Commission has, however, subsequently developed a modified view, that globalisation of accounting standards is an opportunity for finding a common base for tax across the EU, with a starting point in accounting profits.⁹ This is no doubt in part on pragmatic grounds in the hope of reaching some measure of agreement within a reasonable time. Even so, the Commission recognises that this is only a starting point and that some deviation is likely to be necessary. What is important is to define those areas of deviation.¹⁰ It is necessary to focus on whether there are any tax principles that can be agreed as a basis for the variations from accounting standards, both at a domestic and European level. In Europe, Australia and elsewhere, many companies are preparing to adopt IAS by 2005. Thus this is a debate which is topical and urgent, both in jurisdictions where there is currently alignment between accounting standards and tax accounts and those where the relationship is weaker, since that relationship needs re-examination in the light of the introduction of IAS.¹¹

⁷ Allister Wilson (2001) 'Financial Reporting and taxation: marriage is out of the question' *British Tax Review* 86; Ron Paterson, 'A taxing problem', (2002) *Accountancy* November 94.

⁸ EU Commission staff working paper (2001) *Company Taxation in the Internal Market* http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip1468/company_tax_study_en.pdf at p.324.

⁹ 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 http://www.europa.eu.int/comm/taxation_customs/taxation/consultations/ias.htm.

¹⁰ Communication from EU Commission (2003) (COM 2003 726 final) *An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges*, http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0726en01.pdf. See also Matthias Mors of the European Commission, unpublished paper at the European Association of Tax Law Professors Conference, Paris June 5th 2004. As this article was being finalised, the Commission published a 'non-paper' for the informal Ecofin Council to be held on 10th and 11th September, proposing the use of IAS as a tool for designing a common consolidated tax base but stressing 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: see http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/Non-Paper_CCBT_EN.pdf.

¹¹ Use of IAS will be mandatory for the consolidated accounts of all listed companies in Europe by 2005: see *Regulation (EC) No 1606/2002 on the application of international accounting standards* (July 2002). In the UK, publicly traded companies and others will be permitted to use IAS for not only their consolidated accounts but also their individual accounts from the same date: DTI Press Release P/2003/406, 17th July 2003; DTI- *Modernisation of Accounting Directive/IAS Infrastructure*, March 2004. Australia plans to adopt IAS by 2005 (Bulletin of the Financial Reporting Council 2002/4 - 3 July

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 context, and Part VI concludes that a role will remain for the judiciary.

II. THE ESSENCE OF THE DEBATE

The essence of the debate is whether the taxable profits of a business, or more specifically in a UK context, a trade or profession, should deviate from accounting profits.¹² Since TVM has now been rejected, Australians can return to the more general debate. Clearly, there are strong arguments for a move away from profit as the tax base altogether and the discussion about alignment of taxable and accounting profit only serves to show profit to be an artificial and problematic concept.¹³ Since the taxation of business profits is pervasive and unlikely to disappear in the near future, however, this article will not examine alternative tax bases, but will focus on the need under current systems of business tax worldwide to find a sensible and workable definition of the concept of business profit which is fit for tax purposes.

Arguments for alignment of taxable profits and accounting profits

The case for alignment is simple and *prima facie* attractive. It is based on the view that alignment would bring simplicity, cut compliance costs and reduce avoidance. The argument runs as follows. Companies must all make up commercial accounts following accounting standards so why not use these for tax purposes also? This simplification would save compliance costs, since only one set of accounts would be needed. It would also help to increase transparency and prevent avoidance. Since most companies, at least quoted companies, want to keep their commercial profits high, they would not wish to enter into tax schemes that reduce these profits if the same figure had to be used for both purposes. Transactions should be entered into for commercial and not for tax reasons and consistency in the accounts might help to achieve this.¹⁴ Both those setting accounting standards and the tax authorities are aiming at the same figure - the 'true' economic profit.¹⁵ The tax authorities should be

2002). Japan has decided to follow this trend (*Japan Today*, February 17th 2004). It is also likely that domestic standards will be heavily influenced by IAS and that ultimately there will be convergence, as is proposed in the UK: DTI (2004) *Modernisation of Accounting Directive/IAS Infrastructure*, Department of Trade and Industry, London.

¹² In Australia this debate seems to have been side-tracked for a while due to discussions about a move to the Tax Value Method (TVM). De Zilva has explained why the TVM proposal is entirely different from the question of the extent of alignment of tax and accounting profits under a standard tax on business profits: see De Zilva above, Appendix 1.

¹³ There are many discussions of alternative bases, such as a cash flow or expenditure tax approach. For a leading UK example, see the Meade Committee Report (1978) *The Structure and Reform of Direct Taxation*, Institute for Fiscal Studies, London and for an excellent overview of cash flow taxes see David F. Bradford, (1986) *Untangling the Income Tax*, Harvard University Press, Cambridge, Mass.

¹⁴ This seems to be the assumption of the UK 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.

¹⁵ This assumes an ideal of a comprehensive income tax, rarely achieved in practice but accepted as a goal in most tax literature (the Haig-Simons model: R.M. Haig (1921) *The Federal Income Tax*, New York:

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 accounts for these two purposes may dictate some differences although there will be a central core of similarity. In addition to the above objectives of a tax system, governments wish to use the tax system to provide economic incentives and disincentives. Whilst many economists would argue against such a use of taxation, it appears to be inevitable and universal, making complete alignment an illusory goal.

Accountants would agree that there is no one true profit figure but that a range of figures is necessary to paint a picture of what is happening in a company.¹⁶ The application of accounting standards requires the use of discretion. Commercial accounts cater for many stakeholders, although primarily for the shareholders. What are needed for this purpose are forward looking figures involving judgment and valuations. The single figure in the accounts will often be backed up or explained by notes and further figures. International accounting standards do not give the profit and loss account primacy but the balance sheet. In fact, the profit and loss account looks set to disappear altogether.¹⁷ Tax, on the other hand, is historical: that is it must be based on an artificial period already completed and is concerned with the profit or loss in that limited period. 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 is an artificial structure and needs to operate in this way to be manageable. The tax system must arrive at one figure on which to base an assessment.

In addition, to operate fairly and efficiently, it is often argued that a tax system must recognise ability to pay and subject the taxpayer to tax when it is most convenient to

Columbia University Press; H.C. Simons (1938) *Personal Income Taxation*, Chicago University of Chicago Press).

¹⁶ W.T. Baxter, Correspondence, [1978] *British Tax Review* 67.

¹⁷ See Wilson, n. 7 above.

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 market this problem of liquidity might be met by borrowing by the taxpayer against unrealised 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 realisation principle seems more important for tax purposes than it is for accounting purposes, particularly as we move towards fair value accounting.¹⁹ The volatility inherent in fair value accounting reflects volatility in the market and so, arguably,²⁰ 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.

Generally, the different objectives of tax and financial accounts make it desirable that the rules for each one are not unduly influenced by the rules for the other. At present international accounting standard setters pay little regard to tax implications and would be unlikely to take kindly to the suggestions that they needed to add tax to the list of considerations and pressure they must take on board already.²¹ Commercial accounting considerations could be distorted by tax pressures. This is not to say that tax and financial accounting should operate in isolation from each other and some mutual awareness and cross referencing will no doubt be valuable, but there should be clear differences, although these do need to be made explicit and based on some established principles.

Alignment of taxable and accounting profits to prevent abuse has been the subject of considerable debate in the USA recently following the Enron and WorldCom scandals.²² Currently in the USA, tax and commercial accounts can differ significantly. This has led to a Wall Street columnist calling for conformity between book (accounting) and tax income to combat tax shelters; a call that attracted some support, but now appears to have been rejected largely for the reasons discussed above.²³ The suggestion that has emerged most strongly from the ensuing debate is that public disclosure of tax accounts should be required, or that there should be more and better information provided on the book/tax reconciliation forms that exist already.²⁴ Both the Securities and Exchange Commission and the US Treasury, to

¹⁸ For example, Adam Smith's Canons of Taxation, Adam Smith, *The Nature & Causes of the Wealth of Nations*, Book V, Chap. 11, Part II "Of Taxes", paras. 1-7.

¹⁹ In an interesting unpublished paper presented to the NYU School of Law Colloquium on Tax Policy and Public Finance (Spring 2004, Number 12), 'An Economic Analysis of the Realization Rule', 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.

²⁰ This is not uncontroversial in relation to commercial accounting either. There is strong resistance to IAS 39 in Europe for this reason, spearheaded by French banks: Roger Murray and Larissa Clark (2003) 'IAS 39, cash flow hedges and tax' 8 *Financial Instruments Tax and Accounting Review* 1; Andrew Parker (2003) 'Compliance costs soar for new IAS rules' *Financial Times* November 24th.

²¹ Wilson, n. 7 above; Nobes (2003) n. 1 above, p.38.

²² It is not necessarily tax regulation that is at fault here: it may be commercial accounts that require the modification, see George Plesko and Lillian Mills (2003) 'Bridging the Reporting Gap: A Proposal for more Informative Reconciling of Book and Tax Income' 56 *National Tax Journal* 4. Plesko and Mills cite the *Wall Street Journal* (January 29th 2003) as stating that 'Profits reported to the IRS, where firms have less discretion in making calculations, are considered to be closer to the truth...'

²³ Knott and Rosenfeld n. 6 above.

²⁴ Knott and Rosenfeld n. 6 above (Part II) document the history of the Wall Street Journal article and follow up and they also discuss the issues of publication of tax returns and the Schedule M-1

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 EXAMINATION OF THE UK LEGISLATIVE/CASE LAW BALANCE

On the basis of the above arguments it would seem that complete alignment is neither possible, nor desirable. Nevertheless, in any tax system based on profit, the commercial accounts and tax accounts will almost certainly have the same starting place, so the interesting question becomes one of the degree to which there should be divergence rather than whether there should be divergence at all. In addition, to the extent that there is divergence, who should be the final arbiter of taxable profits in any given case? The matter could be one for the legislature, the courts or the accounting profession or, most probably, some combination of the three, but the relationship between these sources of definition will need management and regulation.

These are the central issues arising in every tax system struggling with this issue. In Australia, the position has been well summarised by D'Ascenzo and England:

...the real reform issue ...is probably not whether accounting profit and loss should form the starting point for tax purposes. It already does in practice to some extent. The real issue might be how to best structure and draft income tax law so as to use accounting concepts where it is sensible to do so, and to clearly identify where there are differences from accounting outcomes. The way forward seems to be a careful and pragmatic review of the situations of divergence between accounting concepts and tax rules. As far as I know, such a review is not on the drawing board.²⁷

reconciliation of book and tax accounts. See also Gil B. Manzon and George Plesko (2002), 'The Relation Between Financial and Tax Reporting Measures of Income' 55 *Tax Law Review* 175; Plesko and Mills n 15 above; David Lenter, Joel Slemrod and Douglas Shackelford (2003) 'Public Disclosure of Corporate Tax Return Information: Accounting, Economics and Legal Perspectives' 56 *National Tax Journal* 803.

²⁵ Knott and Rosenfeld n. 6 above, note the calls of Senator Grassley (Chair of the Senate Finance Committee) for such improvements and how these have been supported by the academic community. See Gary McGill and Edmund Outslay (2002) 'Did Enron pay taxes?: Using Accounting Information to Decipher Tax Status' *Tax Notes* August 19, 1125.

²⁶ Erika Nijenhuis, David Chung and Maxim Kulikov, (2002) 'The New Disclosure and Listing Regulations for Tax Shelters' *Tax Notes* November 18, 943.

²⁷ Michael D'Ascenzo and Andrew England (2003), 'The Tax and Accounting Interface', *Proceedings of the 15th Australasian Tax Teachers Association Conference* <http://pandora.nla.gov.au/pan/23524/20030305/Michael%20D%92Ascenzo.doc> (although their article was written in their personal capacity, both authors were senior staff of the Australian Tax Authority (ATO) and so in a position to know if any work was ongoing on this subject in the ATO).

In order to discuss this further, the current UK position will be examined. The positions in Australia and the UK are not identical²⁸ 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.

Section 42 was amended in 2002 so that the words *in accordance with generally accepted accounting practice* were substituted for the words in italics in the original. In the Finance Bill 2004 the definition of generally accepted accounting practice has been expanded to include generally accepted accounting practice with respect to accounts prepared in accordance with IAS where the taxpayer company or entity prepares its accounts using IAS.³²

It may seem, then, that the position is now straightforward but, as we shall see, important questions remain undetermined regarding the extent to which the phrase 'adjustments authorised by the law' refers to case law as well as to overriding legislation. In addition, there may be occasions when the available accounting standards do not answer the questions arising for tax purposes conclusively or when tax law characterises a sum in such a way that accounting standards are held not to come into the picture at all. In such cases, there appears to be a continuing role remaining for the courts, but the extent of this is unclear.

²⁸ Justice D G Hill (2003), 'The Interface Between Tax Law and Accounting Concepts And Practice As Seen By the Courts' *Proceedings of the 15th Australasian Tax Teachers Association Conference* <http://pandora.nla.gov.au/pan/23524/20030305/Justice%20Hill.doc>

²⁹ The main difference between the UK and Australian case law seems to be in relation to losses and outgoings where in Australia the question arises whether they have been 'incurred', whilst in the UK the question remains the more general one of what is the taxpayer's profit. This has led to a more jurisprudential approach in Australia than in the UK, see Hill, *ibid.* citing *CIR v Mitsubishi Motors New Zealand Ltd.* [1995] STC 989 (PC). On the introduction of international accounting standards in Australia see Greg Leyden and Brett Croft (2004), 'International financial reporting standards and Australian income tax', *The Tax Specialist* Vol. 7 198.

³⁰ [1993] STC 537.

³¹ Discussed further below and see also Judith Freedman (1993) 'Ordinary Principles of Commercial Accounting- Clear Guidance or a Mystery Tour?' [1993] *British Tax Review* 468.

³² Section 836A Income and Corporation Taxes Act 1988 and clause 50 of the Finance Bill 2004.

Profit definition - the role of the courts prior to 1998

The meaning of the words 'annual profits or gains arising or accruing from a trade, profession or vocation' in the charging provision contained in the Taxes Acts,³³ was originally defined in case law only, to the extent that it was defined at all. Initially it was said that profit should be understood in its 'natural and proper sense - in a sense which no commercial man could misunderstand'.³⁴ Gradually this sense acquired a gloss from the case law. It was never entirely agreed whether that gloss carried the status of law or whether the question of definition of profit remained purely a question of fact, in the sense that precedent could have no bearing upon it and the higher courts could not review a decision.³⁵ It was clear, though, that profit was to be treated as a technical term upon which expert evidence was admissible.³⁶

To the cynical, the law/ fact distinction is a circular issue.³⁷ The courts will find that there is a question of law if they wish to intervene. As Cross and Harris put it

...the question of whether a case will be treated as a precedent depends on the way in which future courts treat that case.³⁸

This is not merely an academic view. The Rt. Hon. Sir John Laws, Lord Justice of Appeal agrees that the boundary between law and fact is not fixed.

Where there are reasonable choices to be made between one interpretation and another of a defining phrase in legislation....It depends on what the higher courts think ought to be a matter of law: or, more pointedly, what they think should be subject to judicial control.³⁹

In the context of deciding upon taxable profits, one way of reconciling the positions was put forward by Pennycuik VC in *Odeon Associated Theatres Ltd v Jones*⁴⁰ at first instance:

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. I use the word 'correct' deliberately. In order to ascertain what the correct principles are it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the

³³ Section 18 Income and Corporation Taxes Act 1988.

³⁴ *Gresham Life Assurance Soc. v Styles* 3 TC 165.

³⁵ See Judith Freedman (1987) 'Profit and Prophets- Law and Accountancy on the Timing of Receipts' (two parts)[1987] *British Tax Review* 61, 104 where the author argues that the word 'profits' had at that time acquired a legal meaning through the case law, relying on cases such as *Minister of National Revenue v Anaconda American Brass Ltd* [1956] AC 85; *Willingale v International Commercial Bank Ltd* [1978] 1 All. E.R and *Odeon Associated Theatres Ltd v Jones* [1971] 2 All E. R. 407.

³⁶ John Bell and George Engle (1995) *Cross on Statutory Interpretation*, (3rd ed.) Butterworths, London at p 61-'When it is agreed or contended that statutory words have a technical meaning, evidence with regard to that meaning is unquestionably admissible...'. This is normally an indication of a question of fact in itself.

³⁷ For further discussion of this difficult issue see Etienne Mureinik (1982) 'The Application of Rules: Law or Fact?' 98 *Law Quarterly Review* 587; Timothy Endicott (1998) 'Questions of Law' 114 *Law Quarterly Review* 292.

³⁸ Rupert Cross and J. W. Harris (1991) *Precedent in English Law*, (4th ed.) Clarendon, Oxford.

³⁹ The Rt. Hon. Sir John Laws (1999) 'Law and Fact' *British Tax Review* 159.

⁴⁰ *Odeon Associated Theatres Ltd v Jones* [1971] 2 All E. R. 407.

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 Pennycuik 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 completely different from that which prevailed in those earlier times. The issue of fact will normally determine the question of what is the correct principle of commercial accountancy. But it will be argued below that there will still be cases where the courts must decide, having taken this evidence, what is the correct principle to be applied in tax cases.

Given the changing nature of accounting practice this is of real significance. On the one hand it could be argued that to insist on following precedent, often based on outdated accounting practices, would stultify the development of tax law. On the other, it could be said that the courts have evolved some tax principles in the course of defining profit and should, at least in the absence of any general legislative tax principles on profit definition, continue to evolve and apply these. In this way the courts can reflect the objectives of the tax system in the way that developing accounting standards do not set out to do. In other words, this is an area where the issues should be subject to judicial control. The role of the courts is therefore at the heart of the debate.

It should be noted here that *Gallagher v Jones* and section 42 of the Finance Act 1998 did not mark a radical departure in the relationship between taxable profits and accounting profits. At no time was there complete independence of tax accounting and financial accounting in the UK, despite the statements suggesting otherwise in some of the books and commentaries comparing the UK with other jurisdictions.⁴¹ The commercial accounts were always the starting point as a matter of case law,⁴² but on relatively rare occasions, although a generally accepted accounting practice had been applied for commercial purposes, a different result was preferred for tax purposes. This was true in some cases on timing⁴³ and most noticeable where the issue was one

⁴¹ See Hoogendoorn n.3 above; Margaret Lamb (1996) 'Accounting and Taxation in the UK' *The European Accounting Review* Vol. 5 Supplement 933.

⁴² See Inland Revenue Guidance Note, Inland Revenue (2004) *International Accounting Standards- The UK Tax Implications* (hereafter 2004 Inland Revenue Guidance note) http://www.inlandrevenue.gov.uk/practitioners/int_accounting.htm

citing the 1926 case *Lothian Chemical Co Ltd v Rogers* 11 TC 508 and for the classic statement of the need to start with accounting practice see *Odeon Associated Theatres Ltd v Jones* [1971] 2 All E. R. 407.

⁴³ For example in *Minister of National Revenue v Anaconda American Brass Ltd* [1956] AC 85 and *Willingale v International Commercial Bank Ltd* [1978] 1 All. E.R. The dictum of Lord Reid in *Duple Motor Bodies v Ostone* [1961] 39TC 537 is often cited: 'it is a cardinal principle that profit shall not be taxed until realised'. Lord Reid himself recognised that this was not a rigid rule of law but did consider it to be a principle: *BSC Footwear v Ridgeway* [1972] 47 TC 495

'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'. But note that Lord Reid dissented in this case. Lord Nolan

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.

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 incentives, both Government and business taxpayers have come to the conclusion that they would prefer to retain the special capital allowances provisions rather than taking accounting depreciation as the basis for calculating profits in this respect.⁵⁰ The flexibility to provide incentives and the benefit from these incentives was too great to be foregone in the interests of possible simplification. The need to take account of practical issues seems to cover the suggestion that, even if there was a move towards commercial accounting treatment for investment properties, for example, fair value changes would not be brought into account for tax. To follow the relevant IAS (IAS 40) on this front, would mean taxing unrealised profits and ignoring problems of liquidity and cash flow, and the Government has drawn back from this.⁵¹

The imminent introduction of IAS 39, or a new UK accounting standard based largely on IAS 39, for UK companies in respect of financial instrument measurement has already resulted in the UK government introducing legislation and regulations in the Finance Bill 2004 permitting further deviations from accounting treatment.⁵² Again, the UK government's intention to follow accounting standards is qualified by practical considerations: here the consequences in terms of volatility of following the provision for hedging in IAS 39, which are more restrictive than those currently in use in the UK, are now agreed by the industry and government to be unacceptable for tax purposes on the current state of the standard.⁵³

Thus legislation will continue to permit deviations from accounting standards on pragmatic grounds, whatever the general rule on alignment. It is this willingness to deviate that may mark the UK out still as a jurisdiction which does not follow the dependency route, although it seems clear that jurisdictions which previously maintained a rule of closer dependency are now considering breaking these links in the light of changing accounting standards.⁵⁴ The Inland Revenue has described the categories in which departures from accounting may be permitted as covering public policy, transfer pricing, structural issues, avoidance, tax neutrality, capital/revenue divide, fiscal incentives, symmetry, realisability and tax capacity, and whether the commercial accounts are a 'true reflection'.⁵⁵ This mixed list based on pre-existing law, pragmatism and principle leaves considerable scope for divergence in the future.

The UK case law position following section 42 Finance Act 1998

Section 42 was not intended to alter the definition of taxable profits of a trade but to codify existing law. It was a by-product of a move to prevent the professions from using the cash basis and the opportunity was taken to include trading profits within a general statutory definition. This intention was expressed in the Explanatory Note to the clause when it was introduced: 'the Government's view is that it does not effect any change in the law on the computation of profits of traders'.⁵⁶ It is nevertheless possible for an inadvertent change to have occurred and the Explanatory Notes would

⁵⁰ Ibid; 2004 Budget Press Release PN 04 (<http://www.ir.gov.uk/budget2004/pn04.htm>).

⁵¹ 2004 Inland Revenue Guidance Note, n. 42 above

⁵² Schedule 10 to Finance Bill 2004 and draft regulations to be made thereunder- see 2004 Inland Revenue Guidance Note, n. 42 above.

⁵³ As mentioned above, the accounting standard is generally being criticised for this reason, and not only in connection with taxation (see n 18 above).

⁵⁴ W. Schoen, n. 5 above.

⁵⁵ 2004 Inland Revenue Guidance Note, n. 42 above.

⁵⁶ Explanatory Notes to clause 42 Finance (No 2) Bill 1998.

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 Team⁵⁷ 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 much the same thing and the definition of generally accepted accounting practice refers to true and fair view.⁵⁹ ‘True and fair view’ is of course a key concept in accounting and company law, but its inclusion in a taxing statute might be thought to raise the possibility that the courts will one day be called upon to give an interpretation of it, and of the meaning of GAAP more generally, in a tax case.⁶⁰

In giving the explanation that section 42 was not intended to change the law, the Explanatory Notes stated that

The computation of profit remains subject to adjustments permitted or required by tax law, for example, adjustments to ensure that neither a profit nor a loss is anticipated.

It is significant that the example given of an adjustment that may be required by law is not a legislative rule but one established by case law. Likewise, the latest draft legislation published by the Tax Law Rewrite team follows the section 42 wording and the draft Explanatory Note comments that

The general rule is expressly subject to any special rule of law (either expressed in statute or explained by the courts).⁶¹

A slight element of equivocation has crept into the Inland Revenue’s position in their 2004 guidance note on the UK implications of IAS, however, where they state that the

⁵⁷ The UK rewrite of tax legislation is not intended to change the law, only the way in which it is drafted: Inland Revenue (1996) Tax Law Rewrite: The Way Forward, <http://www.inlandrevenue.gov.uk/rewrite/wayforward/tlrc1.htm>.

⁵⁸ <http://www.inlandrevenue.gov.uk/rewrite/exposure/first/response.htm>.

⁵⁹ Income and Corporation Taxes Act 1988, s. 836A (introduced by FA 2002, s.103(2)).

⁶⁰ David Hole (2002) ‘References to accounting practice and periods of account’ (Finance Act Note) British Tax Review 326.

⁶¹ Inland Revenue, Tax Law Rewrite Draft Income Tax (Trading and Other Income) Bill, 2004. Any special rule of law can either have its origins in legislation or in judicial decisions and so the word ‘explained’ is not thought to be signalling any shift in the Inland Revenue’s position here.

words ‘adjustment required or authorised by law’ in section 42 is not necessarily limited to adjustments required by statute.

It may apply to adjustments authorised by case law *to the extent that such a departure is still possible*’ (author’s italics).⁶²

This equivocation reflects a growing debate and exposes a central question. If we re-examine the two part procedure described in the *Odeon* case, outlined above, where first evidence is taken of GAAP and then the ‘correct’ accounting principles are applied, and then couple this with the dictum of Sir Thomas Bingham MR in *Gallagher*, as captured in legislation by section 42, what role is there left for the courts to decide that there should be an answer different from that based on accounting standards? It is argued here that Sir Thomas and the legislation have left considerable scope for the courts to play a role.

The judicial and legislative roles- development or exclusion?

The uncertainty over whether accounting standards are subject to case law principles as well as legislative ones has resulted in calls for the legislature to give clearer guidance on the extent to which accounting standards should be followed. Even before recent developments, this author argued that since tax law and accounting principles did not, and should not, always conform, the divergence should be explicit and properly planned.⁶³ In his research undertaken for the Tax Law Review Committee of the Institute for Fiscal Studies, Macdonald has called for legislation setting out the accounting principles as they apply to taxation rather than leaving this to review by the courts on unspecified principles.⁶⁴ Subsequently, in a paper commissioned by The Association of Chartered Certified Accountants, Christopher Nobes, a Professor of Accounting, has proposed a conceptual framework for the taxable income of business, although his proposed high level criteria are so abstract as to be of little operational value (for example, collection of an equitable share of tax at minimum cost and efficiency).⁶⁵

It seems that many of the so-called tax principles evolved in the case law, such as non-anticipation of profits,⁶⁶ have themselves evolved from the accounting principles of prudence and realisation. These accounting principles are now developing and changing so that what appear to be legal principles could be said to be merely outdated accounting principles. To this extent we can agree with Macdonald that, if there is to be variation from accounting standards, it would be helpful to have legislative guidance on when this should occur. For example, Macdonald suggests a legislative provision stating that gains or losses arising from the revaluation of assets and liabilities to a value not based on transaction consideration shall not be included as taxable gains or losses. Another of his proposed provisions is that

⁶² See n. 51 above.

⁶³ Freedman n. 35 above at p.133.

⁶⁴ Macdonald (2002), n. 1 above, chapter 5.

⁶⁵ Nobes (2003), n 1 above. Some of his detailed rules give results which deviate from the current position and would be unlikely to be acceptable, for example the suggestions that all provisions should be ignored for tax purposes, even if permitted for accounting purposes under FRS12 or IAS 37.

⁶⁶ See *Duple Motor Bodies*, n 43 above.

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

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.

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 European Accounting Review* Vol. 5 Supplement 795. Claes Norberg has pointed out, in correspondence with the author, that the court has referred only 10 tax cases between 1990 and 2003 and that in all of these cases it has followed the opinion of the accounting standards board.

⁷⁵ The International Financial Reporting Interpretations Committee (IFRIC) develops interpretations of IAS. Interpretations are exposed for public comments and then have to be approved by IFRIC and the Board so this will be a time consuming process, Interpretations then become part of the International Accounting Standards Board's (IASB's) authoritative literature (IAS 1).

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 *Gallagher v Jones*, set out above.⁷⁶ Although that case is often described as establishing the primacy of accounting standards, in fact it leaves plenty of scope for judicial interpretation in appropriate cases.

To accept an accounting standard as relevant to taxation without investigation of its objectives and effects and to accept accounting evidence on the *application* of that standard, without examining whether that has relied on an incorrect understanding of legal concepts comprised in the standard, would be an abdication of responsibility by the court.⁷⁷ The interaction between taxing legislation and principles and accounting standards will inevitably raise questions for the courts that are not questions to be answered purely on the accounting evidence. It can be agreed that there should be a legislative framework for divergence, but even Macdonald's and Nobes' models do not provide sufficient guidance to enable the role of the judges to disappear altogether. They have, and will continue to have, a role as gap fillers; a role which in this author's view will take them beyond mere adjudication on the facts and into the realm of developing legal rules for the application of accounting standards for tax purposes.

IV. THE JUDGES AS GAP FILLERS

Four areas of potential judicial involvement in deciding on the application for tax purposes of accounting standards have been identified above. These will now be examined in turn. This section of this article, supported by detailed examples taken from the UK case law, shows how courts will be inclined to involve themselves at various levels with decisions even where accounting standards exist. In each case the areas discussed are not covered by specific legislation.

Does the accounting standard apply to the transaction at all?

There may be prior questions for the court to decide, such as whether a sum is a trading receipt for tax purposes at all. It may be that the sum is a capital not a revenue receipt⁷⁸, or that it does not have the characteristics of a trading receipt for some other

⁷⁶ Text to n 31 above.

⁷⁷ Freedman (1993) n 31 above.

⁷⁸ *IRC v John Lewis Properties* [2003] STC 117.

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 Melliush*

...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 retained⁸² 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 Tattersall*,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,

⁷⁹ *Morley v Tattersall* [1938] 3 All ER 296, discussed further below.

⁸⁰ *Tapemaze Ltd v Melliush* [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.

but it did not govern for tax purposes. Atkinson J decided that the receipts could not be trading receipts in the year of receipt.⁸⁶ When the special statute applied to terminate the claim against the broker after three years, however, a new asset came into existence, an asset which had arisen out of a trade transaction. In *Anise*, the Commissioners held, even once the Limitation Acts applied to make the overpayments unrecoverable, they would not have the nature of trading receipts, as they were not part of the trading transaction in the same way as the pawnbroker's retention of a surplus, which is the most profitable part of the pawn broking business. The legal reasoning in this case might be challenged on appeal,⁸⁷ but what is interesting for our purposes is that the reasoning was entirely based on case law and focused on the character of the receipts as a question of law. Accounting standards or practice were simply not discussed and the transfer of a payment to the profit and loss account was seen as 'a purely internal transaction'.⁸⁸

In *Tapemaze v Melliush*,⁸⁹ where the issue was the tax treatment of advance payments retained after the sale of a business, more attention was paid to accounting practice and the judge was not convinced that the character of a receipt was stamped on it once and for all on receipt, but he did consider the question of the source of the profit to be the determining one and he treated this as a question for him to decide on the basis of the original receipt and an analysis of the terms of the sale agreement.

Whilst the courts may be reluctant to become engaged in questioning accounting standards and their application in a direct way, they will have no hesitation in considering the *nature* of payments in the light of contractual terms and legal obligations, seeing this as a prior question to those of timing and quantification which may be rather more the province of the accountants. In this way accounting practice and standards may be excluded from consideration altogether.

Does the accounting standard itself introduce questions of law?

Sometimes accounting standards themselves refer to legal concepts or require analysis of a legal document, most often a contract. An accountant giving an opinion on a legal concept, or the proper construction of a contract, could not bind the court on that point. It is true that the principle that accounting standards should be followed might mean that in some circumstances a court would follow an accounting standard which applied commercial substance over legal form, but where a legal concept formed part of the standard, then that would have to be interpreted according to legal principles. Potentially, this could give rise to a complex interaction of accounting principles and legal concepts, which might make it very difficult to avoid judicial intervention. Simply stating that tax will follow accounting is then only a partial description of the process. There is a circularity here if accounting standards incorporate legal concepts.

⁸⁶ He was much concerned by the fact that if the estimate turned out to be incorrect the accounts could not be re-opened, and, although this might work out year on year fairly enough in the end it would be a problem where, as in this case, there was an excess profits tax. *Sun Insurance Office Ltd. v Clark* [1912] 6TC 59, where such an estimate was permitted, was not cited in *Jays*. On advance payments see now application note G, discussed below, but the initial question of whether a receipt is a trading receipt remains.

⁸⁷ See *Tapemaze v Melliush* n. 80 above and below, not cited in *Anise*.

⁸⁸ In this case the Special Commissioners' application of the case law reached the same practical conclusion as the accountants had done on the tax payable but not because of any reliance on accounting principles by the accountants or the Commissioners.

⁸⁹ See n 80 above.

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 could have more general import is a difficult question.

Prior to the establishment of accounting standards, it was nevertheless the practice to take expert advice on accounting practice. In *Peter Merchant v Stedeford*, where the issue was whether a provision should be permitted for tax purposes where a caterer was under a contractual obligation to replace utensils, an independent accountant considered that it was good accounting practice to make a provision annually, but the court found that a *legal* obligation existed only at the expiry of the contract and so permitted no deduction year on year.⁹⁰ Tucker LJ, having cited the cases law, such as *Sun Insurance Office v Clark*,⁹¹ which stated that the question of what is a profit is primarily one of fact, went on to state that,

If, on analysis, it appears that the opinion expressed by the chartered accountant is based upon an erroneous interpretation of the obligations under this contract, of course the whole value of his evidence goes.

In modern circumstances the courts would be likely to be applying an accounting standard in such circumstances; in the case of provisions, FRS 12⁹² (a UK standard very similar to IAS 37). This standard applies where an entity has a present obligation, either legal or constructive. This clearly goes beyond legal obligations and so does change the position from that when the *Stedeford* case was decided, but it must still be for the courts to decide if there is a legal obligation, which is defined by the standard as being an obligation that derives from a contract, legislation or other operation of law.

If a constructive obligation is relied upon then, by definition, this is intended to go further than a legal one. FRS 12 defines a constructive obligation as an obligation that derives from an entity's actions where

- a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities and
- b) as a result the entity has created a *valid* expectation on the part of those other parties that it will discharge those responsibilities.

Had this standard been in force at the time of the *Stedeford* case, the accountant's view would have assumed more importance and possibly the court's construction of the contract would not have been determinative, unless the accountant was still relying on the existence of an actual contract rather than a constructive obligation. Nevertheless, incorporated into this definition of when the standard applies is a legal concept on which clearly the court's decision would be authoritative. More problematic is the question of who would be the final arbiter of non-legal concepts, such as whether a valid expectation had been created or a past pattern had been established. The standard itself proceeds by way of examples but this can leave considerable room for

⁹⁰ *Peter Merchant v Stedeford* 30 TC 496 at 509.

⁹¹ 6 TC 59.

⁹² Accounting Standards Board September 1998.

discussion.⁹³ It is hard to believe that the court would not consider the issue and the terms of the standard if a question on this became crucial for tax purposes. Initially this might be seen as a pure question on the facts but it is possible that such determinations would begin to build into guidance on the construction of the standard. At what point this would then become legal guidance, if at all, remains to be seen. If the issue were to arise in a tax case, there would be the additional consideration of whether the court would explicitly or impliedly take tax considerations into account.

Another example of an accounting standard which embodies legal concepts but goes further than those concepts, is FRS 5, which, together with Application Note G to that standard on revenue recognition,⁹⁴ is similar to IAS 18 and deals with some aspects of timing of particular importance in a tax context. FRS 5 is entitled 'Reporting the substance of transactions' so is clearly intended to go beyond legal rights and duties. Given this, it is significant to note the extent to which the application note is framed in terms of contractual obligations, rights and performance. Although it is intended to look at substance, its basis is certainly contract law and it quotes a leading legal textbook by Treitel⁹⁵ in support of the proposition that

The principle that a seller generates revenue by performing its contractual obligations to the customer is consistent with the idea of performance under the law of contract.

Thus, under G4, a seller recognises revenue under an exchange transaction with a customer when, and to the extent that, it obtains the right to consideration in exchange for performance. This is fully consistent with long-standing UK case law and is very legally based in tone.⁹⁶ Under G5, where a seller receives a payment in advance of performance it recognises a liability equal to the amount received, representing its obligation under the contract. It would be hard for a court to consider this without considering legal rights and duties. This is not to say that the outcome would be anything other than following the standard. The point here, though, is that questions of whether there was an obligation under the contract or a right to consideration would be issues on which the courts would not fear to engage and on which they would expect their determination to be final unless the standard made them subject to some overriding question of substance, which is not the case here. Thus, the case of *Elson v Price's Tailors*⁹⁷ (in which an unclaimed deposit was held taxable when received) would not be dealt with as a matter of pure law on the nature of a deposit as it was in 1962, but there would nevertheless need to be a discussion of whether there was a continuing obligation under the contract at the time when deposits were transferred to

⁹³ Allister Wilson et al. n. 7 above at p. 1958 'The critical event that creates a constructive obligation tends to be elusive...That is not to say that we believe that only legal obligations deserve to be in the balance sheet, but we doubt if this particular approach is the best way of determining which additional items deserve to be there'.

⁹⁴ Accounting Standards Board, November 2003.

⁹⁵ Sir Günter Treitel, (1999) *The Law of Contract* (10th ed.) Sweet and Maxwell, London at p 697, cited in the note on development of the Application Note.

⁹⁶ *J.P. Hall & Co. Ltd v The Commissioners of Inland Revenue* [1921] 3KB 15. The case is a reminder of simpler times but the common sense of the judges accords with the latest sophisticated accounting guidance. See the delightfully brief judgment of Lord Atkin, who stated 'It seems to me that no person here trying to ascertain these profits on the principles of ordinary commercial trading would dream of including profits...which would not be made until the goods had actually been delivered in respect of some contract which was to run over a period of at least two years, and possibly more'.

⁹⁷ [1963] 1 All ER 231.

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 contracts as opposed to severable ones - require complete performance before any right to consideration arises.⁹⁹ It is far from clear to what extent application note G intends to rely on contract law such as this and where it intends to override it.

The corresponding international standard, IAS 18 on revenue recognition is similarly intended to move away from purely legal obligations but incorporates them into its definitions nonetheless. This tendency to resort to legal concepts indicates the central role of legal thinking in the commercial world. It has been fashionable to reject legal form as not reflecting reality, but there are normally sound reasons why the concepts have arisen in the way they have done. IAS 18 refers to the transfer of the risks and rewards of ownership of goods and the ability to measure revenue reliably. The standard acknowledges that in most cases the transfer of the risks and rewards coincides with the transfer of legal title or possession although there may be differences. Once again this calls for an examination of legal issues, even if it is possible that the final determination may go beyond strict legal questions.

In similar vein, in relation to long-term contracts, Application Note G, paragraph 18 (elaborating on Statement of Standard Accounting Practice, (SSAP) 9, 'Stocks and long-term contracts' which continues to apply) requires that

A seller should recognise turnover in respect of its performance under a long-term contract when, and to the extent that, it obtains the right to consideration. This should be derived from an assessment of the fair value of the goods or services provided to its reporting date as a proportion of the total fair value of the contract.... The guiding principle is to consider the stage of completion of the contractual obligations, which reflects the extent to which the seller has obtained the right to consideration.

The definition of right to consideration at G3 makes it clear that the right to consideration is not linked to the contractual right to demand stage payments. To allow this would mean that revenue recognition would be distorted by the timing of payments. Instead there must be a relationship between actual performance of the obligations and the right to consideration. Performance is defined as fulfilment of the seller's contractual obligations to a customer through the supply of goods and services. This makes the tests to be applied a curious mix of contractual and non-contractual ones. There is an attempt to apply substance but at each point a return to contractual rights.

⁹⁸ Contrast *Jays the Jewellers* n. 85 above, where there was no receipt.

⁹⁹ *Sumpter v Hedges* [1898] 1 QB 673. The courts are reluctant to construe contracts to perform services so as to require complete performance before any payment becomes due since this can lead to unjust enrichment: *Button v Thompson* (1869) L R 4 CP 330 at 342, cited in Treitel, n. 95 above. The question of whether a particular obligation is entire or severable is one of construction. This is separate from the issue of separation and linking of contractual arrangements also discussed in Application Note G.

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 choose 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?

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 12- capitalised interest is a very weak indication of value so shareholders are entitled to a note showing how much in the balance sheet is so attributable. Generally Lord Millet's comments on accounting in *Secan* have come in for heavy criticism, revealing the danger to judges of commenting on these issues-see Tim Ambrose on the website of the Chartered Institute of Taxation (technical article 18/-9/02) <http://www.tax.org.uk/showarticle.pl?n&id=1328&p=1>; Maurice Parry-Wingfield, (2002) 'Depreciation in a Tangle' *The Tax Journal* 14 October 11; G. Macdonald (2003), 'Further Reflections on Secan Ltd' *The Tax Journal* 3 March 9. Despite this criticism (which did not affect the decision, only the reasoning) the Inland Revenue sought to rely on the reasoning in *Secan* in the *Mars* case, showing how judicial comment will be utilised by both sides of tax disputes and the attempt will be made to turn it into matter of value as a precedent.

Is the accounting standard proposed by the accounting evidence applicable in a tax context?

This is the fundamental open issue - will the courts still permit themselves to ask this question? Following the decision in *Gallagher v Jones*, it is argued by some that 'statutory modification is the only limit to the application of accounting principles and practice'.¹⁰⁶ This is not what the case law states. Returning to the statement of Sir Thomas Bingham MR in *Gallagher*,¹⁰⁷ it is clear that the courts have left themselves a good deal of scope to intervene and to judge the applicability of the accounting standard to the 'true facts'. It is submitted that, whilst they are unlikely to refuse to follow an established accounting standard, they maintain a residual capacity to do so. Section 42 of the Finance Act 1998 quite expressly does nothing to change this.¹⁰⁸

This view is supported by the Inland Revenue who, in their note on the introduction of IAS,¹⁰⁹ envisage the possibility of adjustments to accounting standards being made by case law and refer, for example, to the rule in *Sharkey v Wernher*¹¹⁰ (self-supply to be shown in the books at market value for tax purposes). This 'rule' appears to have been decided contrary to accounting practice of the time¹¹¹ but it now seems to be accepted as established. Unfortunately, accounting evidence was not actually given in the case, but it was argued that a figure of cost should be brought into the books as a matter of good accounting practice.¹¹² There seems to have been some misunderstanding of accounting by the majority who could not understand why it had been admitted that any amount should be brought into the account as a receipt. Lord Oaksey, dissenting, understood that this was accounting practice, saying

It follows, in my opinion, that such expenses as have been incurred to produce an asset which is withdrawn from a trade cannot properly be deducted and must, therefore, be withdrawn from the account which can only be done in accordance with accounting practice by crediting the amount of the expenses

This insertion of a balancing figure was not, though, convincing to the rest of their Lordships. On the one hand, it must be possible that *Sharkey v Wernher* would now be decided differently on the basis of properly presented accounting evidence.¹¹³ On the other, it is hard to see how such a long established and well known rule of case law could be easily overturned: it is more likely that it would be distinguished. Given that the Inland Revenue has more sophisticated legislative tools available to it now to

¹⁰⁶ Macdonald, n 1 above, at p.46.

¹⁰⁷ See text to n 31 above.

¹⁰⁸ See text to n 56 above.

¹⁰⁹ See n. 42 above.

¹¹⁰ [1955] 3 All ER 493.

¹¹¹ J. Tiley (2000) *Revenue Law* Hart Publishing, Oxford p439; H. Edey 'Valuation of Stock in Trade for Income Tax Purposes' [1956] BTR 23.

¹¹² See Lord Radcliffe.

¹¹³ As, for example, in *Symons v Weeks*, n. 100 above, where *Elson v Prices Tailors*, n 97 above, was distinguished as containing no evidence on accountancy practice and having been argued and decided totally on the grounds of the legal character of receipts at a particular date. Warner J stated that no general principle could be derived from the case in these circumstances. But *Elson* did not lay down such a well established principle as does *Sharkey v Wernher*.

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 generally will depend in part on the way cases are presented to the courts, as with any litigation. As solicitors and barristers and ultimately judges become more familiar with the impact of increasingly sophisticated accounting standards on taxation issues, and as significant questions arise involving large sums of money, it is hard to believe that this question will not be tried and tested.

Indeed we can see a tendency to litigate around accounting standards in the recent case of *Mars UK Limited v Trevor William Small*,¹¹⁵ said to be a case waited upon with great interest by many businesses.¹¹⁶ The issue in that case was whether for the purposes of corporation tax, the gross amount of depreciation in stock was required to be added back in arriving at taxable profits, as the Inland Revenue argued, or whether only the net amount had to be so added back (after adjusting for depreciation included in opening and closing stock). The interesting point for our purposes was the approach of the Commissioners. They could simply have followed accounting practice, based on standards, to find for the taxpayers. Instead, although they did come to the same conclusion as the taxpayers' accountants, they engaged in their own more legal analysis to reach this end. This involved examining the capital/ income divide, applying section 74(1)(f) of the Income and Corporation Taxes Act 1988 and looking at the need to avoid a capital amount becoming chargeable to corporation tax on income. Whether their approach, which has been criticised by accountants,¹¹⁷ will be upheld on appeal remains to be seen. It seems very likely that there will be an appeal and this will be fertile ground for further discussion of the role of the courts and the law in relation to the application of accounting standards.

It is in relation to the capital/income divide, unless it is removed by legislation, that the courts seem most likely to continue to consider they have a role to play and that the issue, unlike that of timing, is one of law.¹¹⁸ An example of this can be seen in the area of leases, where notwithstanding that the accounting standard (SSAP 21) requires a proportion of rentals payments to be treated as capital, the rentals are agreed to remain in law revenue payments. This is confirmed by an Inland Revenue statement of practice (SP3/91) and was accepted in *Gallagher v Jones* itself without argument.¹¹⁹ Thus it seems that SSAP 21 applies in so far as it refers to timing but not in so far as it

¹¹⁴ See clause 30 of the Finance Bill 2004 (provision not at arm's length: transactions between UK taxpayers).

¹¹⁵ [2004] SpC 408.

¹¹⁶ Maurice Parry-Wingfield, 'Depreciation in Stock Again', *The Tax Journal*, 12 April 2004 and 17 May 2004.

¹¹⁷ Ibid.

¹¹⁸ See Lord Hoffmann in *CIR v New Zealand Forest Research Institute* [2000] STC 522 (PC); also the classic statement in *Heather v PE Consulting Group* [1973] 1 ALL ER 843

'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'. (Lord Denning MR). The Inland Revenue seem to agree: Inland Revenue Tax Bulletin (1999) 'Relationship Between Accountancy and Taxable Profits: Current Points of Interest' Issue 39 at p624.

¹¹⁹ See n. 30 above at p544; SP3/91 states (para. 9) 'Notwithstanding that SSAP 21 requires a proportion of the rentals payable to be treated as capital repayment, the rentals remain in law revenue payments for the use of the asset, and for tax purposes the whole of the rentals should be allocated to the periods of account for which the asset is leased in accordance with the accruals concept'. (In practice commercial depreciation is normally accepted, but not always; paras. 10-12).

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 interact with other sources of expert knowledge such as science, where a complex evidence set needs to be made susceptible to use for a binary legal decision- guilty or not guilty.¹²³ As systems theory puts it,

Systems are unable to communicate directly with one another, for each system uses different criteria of validity, different forms of authority and different codes for deriving meaning from and assessing the value of information. Put in its simplest terms, they see things differently and there is no possibility of one system being able to internalise the world-view of another. All that it is able to achieve is an internalisation according to its own 'way of seeing' of what it understands from the communications of the other system.¹²⁴

The outcome of litigation on whether an amount is taxable or not is ultimately one reached by the legal system, having absorbed the accounting information into itself. We can anticipate a continuing and creative interaction at a domestic level, and yet further complexities should issues of interpretation of IAS reach the ECJ as well they might once these have been adopted at European level.

CONCLUSION

There is no denying the central relationship between taxable and commercial profits. Equally, there are clear differences in objective between the tax and financial reporting systems. Although the UK government is currently keen to move the taxable profits closer to accounting profits, the difficulties of doing this in a changing accounting environment are becoming apparent and we have seen some retrenchment from the original plans. Even where there is a starting point of following the accounts, the number of exceptions demanded by practicality and public policy is such that the simplicity of alignment is lost. The need to incorporate accounting standards into the legal system, which provides ultimate adjudication on tax matters, further complicates the extent and way in which accounting standards will actually be followed for tax purposes. The result is likely to be a dynamic interaction rather than a static relationship.

At the same time, jurisdictions which have traditionally pursued the path of total, or almost total, dependence are considering movement away from alignment. In countries such as Germany, alignment was achieved by the objectives of the commercial accounts being subordinated to those of the tax system. Once control over the accounting system is lost due to the advent of new international accounting standards, alignment is a less attractive option. The new accounting standards may be contained by restricting them to consolidated accounts not used for taxation, but the impact on German accounting standards is likely to be more pervasive than this. Ultimately it is hard to believe that IAS will not have an impact on domestic standards

¹²² For example, *Symons v Weeks* n 100 above; *Johnston v Britannia Airways Ltd* n 104 above.

¹²³ This analysis borrows from systems theory but does not purport to be an application with which systems theorists would necessarily agree. I am indebted to Richard Nobles of the LSE for discussions of this issue.

¹²⁴ M. King and C. Thornhill (2003), *Niklas Luhmann's Theory of Politics and Law*, Palgrave Macmillan, London at p.27.

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.

to be seen but ultimately, after all the accounting evidence has been given, the judges will adjudicate and the final decision will be a legal one.¹²⁷

¹²⁷ Or, as Justice Hill (n. 28 above) puts it, ‘ultimately Judges will still be there’.