THE TAXATION OF BUSINESS INCOME

ALIGNING TAXABLE INCOME WITH ACCOUNTING INCOME

Graeme Macdonald

Tax Law Review Committee

THE INSTITUTE FOR FISCAL STUDIES

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THE TAXATION OF BUSINESS INCOME
ALIGNING TAXABLE INCOME WITH ACCOUNTING INCOME

FOREWORD

Introduction

1. This discussion paper forms part of the Committee's on-going work on the relationship between tax and accounts. David Hole started the work and Graeme Macdonald has continued it following David's returned to KPMG at the end of his period of secondment to the TLRC research staff.

2. Recent judicial and legislative developments affecting this topic have fully justified the Committee's decision to take on this project. The paper records the variety of ways in which, increasingly, the courts, Inland Revenue and Government have come to accept the use of accounting standards in computing taxable business profits. The Finance Act 2002 in particular will continue this process with a number of accounting related measures.

3. It is possible, however, to view these continuing legislative and judicial developments as ad hoc responses to the basic difficulties of measuring income, rather than a co-ordinated approach designed comprehensively to align tax and accounting measures of income. The question is whether, from the perspective of both tax policy makers and accounting standard setters, this is a satisfactory way to proceed, whether it would be possible and desirable more formally to align the tax and accounting measures or whether each should pursue a separate course?

The measurement of income

4. Graeme Macdonald notes that, "Income is an abstraction; it is not something given in nature which is observable. As such it does not have a singular meaning." [1] If we were concerned solely to measure for tax purposes the value that a corporate business produces over its life, we could seek to do so relatively simply by measuring what the company distributed to its proprietors during its lifetime and on liquidation, whether directly through payment of dividends, share repurchases and capital reductions, or indirectly by allowing its proprietors to enjoy and consume that value through the company, for example by allowing them the private use of its assets.

5. A tax on income, including a tax on business profits, cannot wait upon distribution to measure the business' financial success and business lives, like individual lives, are divided into discrete time periods for tax purposes. That by itself need not present insuperable difficulties: within a single time period a business may venture upon many transactions which before the period's end generate a known result that reflects the value added (or lost) in those transactions.

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[1] Paragraph 2.2.

6. Few businesses, however, have such entirely straightforward affairs with transactions that begin and end within a single time period without spanning the year end. Their affairs instead reflect an on-going cycle of transactions, some of which may be complete, others of which may be on-going and the eventual outcome of many of which can only be estimated when the period ends.

7. No system designed to measure and tax income can rely entirely on a 'wait and see' approach to unfinished business at the year end. If, however, the final outcome of transactions is unknown who is to say what value unfinished business has added for the company's proprietors? And if subsequent events prove the current estimate incorrect, what adjustment should thereafter be allowed?

Accounting solutions to tax problems

8. Income measurement presents the tax policy makers with two basic dilemmas. The first, is where should they look for the rules that they need to measure income in a business context? Should they devise their own rules or can they look elsewhere and, if so, to what extent? The second is how far the rules can concentrate on the past—to measure the known outcome of completed transactions—and how far should they look to the future, to measure the anticipated outcome of incomplete transactions?

9. Historically, the UK tax system has looked outside the strict confines of legislation for its basic rules to compute business income. As accountants are engaged in an activity that raises similar problems to which they must provide at least some answers, accounting profits have been seen as a suitable starting point for measuring taxable profit. The historical overlay of the structure of the UK income tax, however, has ensured that accounting figures are only used on a trade-by-trade basis rather than by reference to the financial results of a particular company's overall activities. And a corollary of that approach has been to treat each company as a separate tax unit, without seeking to consolidate the results of other companies that share the same or a substantially common ownership.

10. The use of accounting solutions to the problems of income measurement also involves the adoption of accounting judgements. Judgements as to the future, however, can often produce two (or more) equally valid but entirely different outcomes. So long as accounting principles and practices underlying those different judgement were relatively undeveloped, the courts were driven unavoidably to develop their own criteria to decide which outcome should be preferred when asked to strike a balance between the interests of a particular taxpayer and those of the State.

11. Progressively, however, as the principles and practices that guide the accounting profession have become more sophisticated and better formulated and have allowed individual accountants less freedom to make different judgements, so the courts and Revenue have become more comfortable in accepting those principles and practices for tax purposes.

Questions for consideration and comment

12. The acceptance of accounting principles and practices by the courts is bound to be selective to a degree as it depends upon which cases they are asked to consider. It is

open to government and the Revenue to adopt a more consistent approach. Thus far, however, legislation has selectively adopted particular principles—"true and fair"—and particular standards, without betraying a clear plan as to where the increasing relationship between tax and accounting could, might or ought to lead.

13. The general drift towards greater reliance on accounting principles and practices to measure income for tax purposes, however, raises fundamental questions—

- Is it appropriate from a tax policy perspective to link the tax system to an evolving process, and one that is increasingly developed at an international level where less regard may be had to the tax issues at a national level?

- To what extent are current accounting principles and practices consistent with the requirements of the tax system, and does the direction of current accounting evolution suggest that closer alignment is possible or rather that tax and account may need to diverge?

- Is the greater reliance of taxation on accounting likely to make it more difficult to achieve the consensus that is needed to adopt or amend particular practices or standards, or may it subvert the process of agreement by making it easier to achieve consensus on tax favourable as compared to tax disadvantageous proposals?

It is with questions such as these in mind that Graeme Macdonald has written his paper and considers whether or not it would now be appropriate to seek a more formal and consistent alignment of taxable and accounting income.

14. The views expressed in his paper do not necessarily represent the views of the Tax Law Review Committee. The Committee has, however, authorised its publication to promote debate on the issues raised by the growing relationship between tax and accounting in the measurement of taxable business profits.

15. Chapter 6 sets out a number of questions that the Committee proposes to address in its further work on this topic and on which it welcomes the views of all interested parties.

Malcolm Gammie
TLRC Research Director

CHAPTER 1. INTRODUCTION

1.1 The relationship between accounting and taxable profit has been (and remains) an evolving one. It has been an issue in the first instance because there is no definition in the tax statutes of business income and no positive indications of how to measure it. The response of the courts, when asked to adjudicate on such matters, has traditionally been to seek evidence as to normal accounting practice and then to decide whether this is appropriate in principle for tax purposes, deciding for itself what the correct principles should be.[1] However, recent (in the context of an income tax that has now been operating for over two hundred years) developments make it appropriate to review this position in order to see whether it is desirable and, if so, now possible formally to align taxable income with accounting income more closely than has hitherto been the case.

1.2 The most fundamental development has been the formulation and publication of accounting standards, latterly through an independent body established for the purpose. This has provided the courts with a body of objective evidence as to accepted accounting practice. The courts in turn have increasingly come to accept these standards as determinative of what should be measured as taxable income,[2] without resorting to principles of their own making.

1.3 The Inland Revenue similarly seems increasingly willing to accept income measured according to accounting standards as appropriate for tax purposes: consultative papers have suggested adopting accounting treatment of items in place of existing statute,[3] new statute has been explicitly formulated around existing accounting practices,[4] cases have been argued on the basis of accounting standards even though not applicable to the business in question, cases decided according to standards have not been appealed even when they have run counter to principles previously developed by the courts themselves,[5] and a general statutory requirement has been introduced to the effect that business income should be computed according to an accounting basis which gives a true and fair view,[6] a requirement central to company accounting. Finally, Government itself—in and out of office—has suggested that harmonisation of accounting and taxable profits is desirable, with accounting profits being used as the measures of taxable profits, where possible.[7]

1.4 The purpose of this discussion paper is therefore to consider some basic issues that arise in considering the alignment of accounting and taxable profits; whether it is

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[1] See for example *Odeon Associated Theatres Ltd* v. *Jones* (1971) 48 TC 257.
[2] See for example *Gallagher* v. *Jones* (1993) 66 TC 77, and *Johnston* v. *Britannia Airways Ltd* (1994) 67 TC 99.
[3] See, for example, the Inland Revenue's Technical Note, *A review of small business taxation*, March 2001.
[4] See Statutory Developments paragraphs 4.29ff.
[5] *Herbert Smith (a firm)* v. *Honour* (1999) 72 TC 130.
[6] FA 1998, s. 42
[7] *Labour's Approach to Corporate Taxation*, IFS Conference on Company Taxation, 1995, and Treasury Explanatory Note on Clause 80 of the Finance Bill 1997.

desirable, appropriate or possible to seek greater alignment; and whether any further alignment should simply evolve as at present, on an *ad hoc* basis, or whether it is possible, given the principles underlying accounting standards and the needs of the tax system, to align them more formally. In so doing we hope to explore the implications of any possible alignment in a way that is not always possible when the process is left to evolve case by case.

1.5 The context in which we address this issue is not one in which there is seen to be a conflict between law and accounting; rather it is as a question of tax policy or design. The issues are whether accounting can serve tax policy and whether the law which implements tax policy needs changing; the answers will depend on whether, in principle, accounting measures can be shown to be capable of serving the tax system and whether, in practice, they would serve it better than the present measures given by statute and case law.

CHAPTER 2. THE NATURE OF INCOME

The nature of income measurement

2.1 The question of whether or not to align measures of taxable business income with accounting measures of income arises largely because of the nature of income as a measure. Were the tax base for business to be *cash flows* then, assuming these were reported as part of the financial reporting process, differences between the tax base and the accounting reports would arise from certain categories of cash flow being excluded by tax statute and, possibly, from other non-cash transactions being included. Legal argument would undoubtedly exist around the boundaries of the exclusions and inclusions, but the measurement of cash flows would generally be unproblematic.[1]

2.2 This is because cash flows are observable and easily measured. By contrast, the measurement of *income* is problematic. Income is an abstraction; it is not something given in nature which is observable. As such it does not have a singular meaning. One cannot assert that a particular measure of income is true or false as a matter of fact; the measure can only accord, or not, with either a predetermined definition or an established practice. Further, since income is a conceptual rather than a natural phenomenon, that definition or practice will reflect the purpose for which the measurement is being undertaken.

2.3 This was clearly recognised some time ago by the economist John Hicks, who observed in the context of a discussion on income measurement that—

> "most economic controversies about definition arise from a failure to keep in mind the relation of every definition to the purpose for which it is to be used. We have to be prepared to use different definitions for different purposes; and although we can often save ourselves trouble by adopting compromises, which will do well enough for more than one purpose, we must always remember that compromises have the defects of compromises, and in fine analysis they will need qualification."[2]

2.4 In asking whether we can align taxable income with accounting measures of business income, we have to recognise the different purposes for which measurement is undertaken in each case and then consider whether tax can accept a compromise or whether, as Hicks observed, the nature of tax requires the qualification of fine analysis.

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[1] Recognising that inflation and exchange rates could remain issues.

[2] Hicks, Maintaining capital intact: a reply, *Economica* IX (1942), reprinted in *Readings in the Concept and Measurement of Income,* (R.H. Parker & G.C. Harcourt eds.) (Cambridge University Press, 1969)

The historical relationship between law and accounting

2.5 The formal position of the courts in deciding cases involving the measurement of business income was to refrain from becoming embroiled in arguments as to what is the 'correct' measure of income. In company law, "all that is left, and very judiciously left, to the commercial world".[3] This is perhaps an acceptable approach when all parties have broadly similar interests but, inevitably, the courts did have to make decisions that had implications for income measurement, especially in the context of dividend payments.

2.6 In 1889, the courts decided that a company need not make good a loss in value of capital before it could pay a dividend: in accounting terms that depreciation need not be provided for or, in economic parlance, that capital did not have to be maintained.[4] The Law Quarterly Review thought that the decision, "will meet with the approval of the commercial and legal world" with businessmen no longer, "able to complain of being confined in the straight waistcoat of a legal formula".[5] The Accountant, however, branded the judgement as "startling",[6] "monstrous" and, "the most mischievous which has ever been given in relation to company matters".[7] The question is how could a court come to a conclusion that was in fact, "entirely against the almost universal practice of accountants and businessmen"?[8] It is a significant question because the decision continued to apply through the force of precedent until the Companies Act of 1985 when for the first time statute required depreciation to be deducted in computing profit.[9]

2.7 In the tax field the courts observed at an early stage that the word "profits" was to be, "understood in its natural and proper sense - in a sense which no commercial man would misunderstand",[10] and, that they should be, "ascertained on ordinary principles of commercial trading".[11] The question of what was profit did not reflect a rule of law[12] but was instead a matter of fact, "and of fact to be ascertained by the tests applied in ordinary business".[13]

2.8 Having said that, the courts immediately had to face the reality that in ordinary business there may be more than one way of measuring the income of a period and that their role was to decide, "whether what is proposed in each case is fair both to the Crown and to the subject."[14] Where there was such a choice, "The one which shows

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[3] *Lee* v. *Neuchatel Asphalte Co.* (1889) 41 Ch D 1.
[4] *ibid*.
[5] The Law Quarterly Review, April 1889, p.221.
[6] The Accountant, March 23rd 1889, p.149.
[7] The Accountant, February 23rd 1889, p.89.
[8] See note 6 above.
[9] Companies Act 1985, Sch. 4 para. 18.
[10] *Gresham Life Assurance* v. *Styles* (1892) 3 TC 185 at 188.
[11] *ibid* 189.
[12] "The very nature of the thing forbids it", *Sun Insurance Office* v. *Clark* (1912) 6 TC 59 at 82.
[13] *ibid* at 78.
[14] *ibid* at 75.

most accurately the position between the Revenue on the one hand and the taxpayer on the other hand is the one which ought to be adopted".[15]

2.9 This approach implicitly recognises that the taxpayer and the Crown have diametrically opposed interests. Thus, while it is possible to pay lip service to the principle that the ordinary principles of commercial accounting shall prevail subject to statutory intervention, the reality is that, "the ordinary principles of commercial accounting shall be applied except when the courts decide they shall not be applied."[16]

2.10 The question remains, however: by reference to what do the courts decide one accounting practice rather than another gives a just result? It is all very well to suggest that the decisions in any particular case do not constitute a rule of law, but the combination of the courts' willingness to adjudicate on what is the appropriate accounting treatment and the operation of precedent have imbued these decisions with the force of law without there necessarily being any clear conceptual underpinning to them. We have to remember too, that when the courts first had to resolve the issue there was no accounting profession to pronounce on these matters.

2.11 Historically, there has been a further issue that has been central to how far accounting and taxable income have been aligned. This has involved statute and its interpretation, in particular with regard to the meaning of capital. As has been noted, this was the issue of concern in company law and one that was decided contrary to almost every accounting or economic concept of income. The early income tax legislation prohibited the deduction of capital expenditure, and understandably so:[17] income tax was a temporary tax and the burden of the tax should not be determined by the vagaries of the timing of lumpy expenditure.

2.12 There was then no recognised accountancy practice of charging depreciation. Similarly, it was not until 1878 that tax legislation recognised the need to allow for the loss in value of assets arising from their use in earning business profits, although it seems that bodies of local Commissioners were before then allowing charges for wear and tear of machinery. When first asked to decide the matter, the Courts interpreted the statute as prohibiting any such allowance and over the years decisions as to what is capital (either expenditure or receipt) have in some cases significantly departed from most recognised concepts of income, largely because the statute in question was not designed to tax income over a period of years, rather than for the particular year in which Parliament chose to impose the tax.

2.13 One concludes, therefore, that any attempt to align taxable profits with accounting profits cannot proceed without some agreement as to the fundamentals (as opposed to the fine analysis) of income measurement. It must assume that the taxation of income is a continuing impost rather than an isolated special charge and should include a review of tax legislation and of the general approach to accounting practice.

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[15] *Patrick* v. *Broadstone Mills Ltd* (1954) 35 TC 44 at 68.

[16] Edey, *Income and the valuation of stock in trade*, [1962] British Tax Review 164, reprinted as in note 2 pp.230-238 at p. 231.

[17] See Edwards, *Tax treatment of capital expenditure and the measurement of accounting profit*, [1976] British Tax Review pp.300-319.

The tax base

Income as the tax base

2.14 For better or for worse, the tax base with which we are concerned is income, both personal and business. The purpose of income measurement for taxation is to provide a measure of taxable capacity.[18] Definitions of income abound and are usually expressed, initially at least, in terms of personal income and more especially by reference to personal consumption. Thus—

> "Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in value of the store of property rights between the beginning and end of the period in question."[19]

> "Income...equals the value of the individual's consumption *plus* the increment in the money value of his prospect which has accrued during the week; it equals consumption plus capital accumulation."[20]

Thus income is equivalent to consumption plus saving, and since saving represents consumption foregone, the income measures the potential for consumption arising in a period.

2.15 It is possible to adapt definitions of personal income to produce a measure of business income by regarding the business as an entity separate from the person running or owning it (whatever its legal status). For personal consumption one substitutes the distribution or withdrawal of profit from the entity as a necessary prelude to personal consumption. Further, whilst the words in the definition import a positive meaning (as does the word income itself), accumulation is taken to encompass its negative, depletion, and profit distribution would allow for the reverse flow, capital introduced.

2.16 However, in the context of measuring business profit the notion of capital accumulation or depletion is potentially more problematic than measuring personal income. In the personal context, capital accumulation (saving) represents the potential for consumption; it reflects a personal decision to forego consumption and one can therefore assume that accumulated wealth is held as a store of future consumption. The same may be true for a business: wealth may be held within the business pending future distribution. It may also be held, however, as a factor of production and changes in its measure, positive or negative, may not affect the potential for distribution. This problem arises because business profit is measured in discrete periods, whereas the reality is that the economic activity that gives rise to it is an ongoing continuum; it is an issue to which we return below.

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[18] Income is not the sole measure of taxable capacity, nor necessarily the most appropriate measure of taxable capacity. Other measures include value added, payroll and property.
[19] H.C. Simons, *Personal Income Taxation*, 1938, reprinted as in note 2, p. 68.
[20] J.R. Hicks, *Value and Capital*, 1946, reprinted as in note 2, p.81.

A comprehensive measure of income

2.17 The essence of income as a tax base is that it should comprehensive.[21] As well as fully capturing taxable capacity, comprehensive income also meets the neutrality and equity criteria outlined below. The UK's measure of income for tax purposes has never been fully comprehensive. This was especially so before the introduction in 1965 of Capital Gains Tax. Since then, however, if income and capital gains tax are taken together, we can see that, except in one important regard, they broadly approximate to the economists' definitions of income, especially when gains are taxed at the same rates as income. Where the UK tax system diverges from those definitions, as with most tax systems, is that only capital gains realised through transactions are taxed while gains arising from revaluations of assets held are excluded.

2.18 There are also a range of exemptions and modifications that lead away from a comprehensive definition of income. In considering the specific question of taxable business income, however, it is suggested that we should be willing to consider income and gains together, and not just income (in terms of taxable income). One of the implications of this is that once gains are recognised (leaving aside here the question of when this should be) there should no barrier to aggregating all gains and losses for a period (although the rate structure might require the special treatment of lumpy gains or losses). This is, of course, at variance with rules restricting the set-off of capital losses or losses from particular sources against other income.

2.19 As indicated above, accounting regards a business, whether incorporated or not, as an entity in itself. Through the life of the business all the transactions of the business with third parties (including the owners) will be recorded and accounted for; this accords with the idea of comprehensiveness said to be necessary for income as a tax base. Tax law however does not do this; instead it defines certain sources of income and seeks to tax the income flowing from them. There is no recognition of the business as an entity, and the individually identified sources, such as trade for example, are narrower in their conception than business. The result can be that certain transactions (involving expenses[22] in particular but not exclusively[23]) are never recognised for tax purposes: they are not regarded as being a cost associated with the trade (as opposed to the business) and they do not result in the acquisition of an asset so that there are no disposal proceeds against which to set them. Perhaps the first stage in any alignment of accounting and taxable income should be to accept for tax purposes the entity being accounted for, so that the business effectively becomes the source of income. Gains and losses from all of the business activities, including disposals of assets accounted for within the entity, would as a minimum be recognised for tax purposes even if in some respects they were taxed differentially.

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[21] See for example Memorandum of Dissent, Report of the Royal Commission on the Taxation of Profits and Incomes, Cmnd. 9474, H.M.S.O. 1955, and Report of the Royal Commission on Taxation (Canada) both reprinted in Public Finance (R.W. Houghton ed.).

[22] See for example D.Gunson, *Tax Nothings*, Chartered Institute of Taxation, 1997.

[23] For an example of the taxpayer arguing that what are recognised to be profits do not arise from a trade, see *Tapemaze* v. *Melluish* (2000) 73 TC 167.

2.20 The definitions of income given above are *ex post* and are considered appropriate for tax purposes because it is usually agreed that as objective a measure as possible is required and that *ex post* measures, whatever their shortcomings, meet that requirement more nearly than *ex ante* measures. We thus exclude from consideration here measures of income based exclusively on expectations of future cash flows (present values), although we should note that financial reporting is increasingly using forward looking measures involving discounting,[24] and that the courts have recognised the case for deducting the present value of future payments, "provided such present value can be satisfactorily determined or fairly estimated".[25] Instead income measures the amount that could have been consumed, or in the business context the amount that could have been distributed or withdrawn.

2.21 However, we have also to note that the definitions indicate that income is a measure over time—it is periodic—without in any way determining the period over which it is in fact to be measured. For tax purposes we require a measure annually in order to levy tax regularly, and it is normal for businesses to measure their profits for a year (though they may well measure it more regularly). This means that the profit is not measured for the life of a business; if it were, we might expect all transactions to be evidenced by cash flows, and though the measure would be highly objective it would be of little use.

2.22 Although we might broadly agree as to the general concept of income, it is the periodic measure that is used for practical purposes, including both accounting and taxation. Different ways of dealing with the artificial separation of one period from another will give different periodic measures. In the long term this does not matter—a stream of profits over the lifetime of a business or project will have exactly the same economic value (measured according to the normal economic criterion of present value) whatever the basis of periodic measurement.[26] However, the introduction of taxation changes all that: if a system of periodic income measurement results in earlier rather than later recognition of income, then tax will be paid earlier and the economic value of that charge will thus be higher. Thus the interests of the taxpayer and the tax collector are opposed. This is at the heart of the question we are addressing, but there is no obvious reference point by which to resolve the issue.

Tax criteria

2.23 The criteria we have to resort to are those generally acknowledged as being characteristic of a good tax system. The primary concern is that the tax should achieve its objective, of which we assume the main one to be revenue raising. This is a function both of the tax base and of the rate structure applied to it, so one of our

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[24] See Statement of Principles for Financial Reporting and Financial Reporting Standards 11 and 12, ASB.
[25] *Owen* v. *Southern Railway of Peru Ltd* (1956) 36 TC 602 at 635.
[26] Intuitively this would seem logical since the underlying operating cash flows remain the same regardless of the periodic measurement of income; formally the conclusion rests on the assumption inherent in present value calculation of reinvestment of surplus cash flows at a given rate of return.

concerns would be that that the chosen measurement system should not lead to a significant loss in tax revenues. Subject to this, the criteria usually employed in judging tax systems and proposals for their reform include economic neutrality, equity and administrative feasibility.

2.24 Economic neutrality requires that tax should not unnecessarily distort economic decisions by taxpayers. This suggests that if taxable income is to be aligned with accounting income it should be so for all businesses whatever their legal form. It might be thought possible to align taxable and accounting profits for companies, but if this resulted in different measures of income for incorporated and unincorporated businesses then this would very possibly lead to businesses being conducted through one particular medium purely for tax purposes.

2.25 Horizontal equity suggests that those with equal substantive taxable capacity should be taxed equally. This and economic neutrality both work in the same direction—towards generality as opposed to selectivity. Thus the taxable measure of income should be as comprehensive as possible, capturing all economic income. Failure in this respect will result in some businesses being taxed more heavily than others, and if this is systematic, for example by over or under allowing for depreciation, then certain types of business will be discriminated for or against. This would not only distort economic decision-making but would offend the equity criterion. Given that one of the main aims of the standard setting process was to provide greater comparability, we would not expect accounting measures in themselves to be discriminatory.

2.26 What is possible administratively, and the costs associated with the administrative options, both for the taxpayer and the taxing authority, may have a significant bearing on what is included or excluded from the legislative definition of income. The measure we seek is one which is objective and reliable, with a measurement process which is both certain and understandable. The result, though, might be that the criteria of neutrality and equity are compromised. Thus while gains are taxed by reference to disposal rather than periodic valuation on grounds of administrative convenience, this produces a lock-in effect whereby postponement of tax by not disposing of assets may distort a decision to invest in a more profitable alternative.

2.27 One of the attractions of aligning tax with accounting is that there could be administrative savings both as regards compliance and enforcement. However, accounting reports can differ according to the legal form of the business and its size; so, if it is considered that there should be alignment across all businesses, does this mean that income will be measured according to what is feasible for the smallest

business. To define taxable profits according to the status of the business would raise again questions of neutrality and equity.[27]

[27] The Inland Revenue's Technical Note, *A review of small business taxation*, March 2001, considers the scope for reducing compliance costs for small companies by closer alignment of accounting and tax profit measurement.

CHAPTER 3. ACCOUNTING MEASURES OF INCOME

Accounting practice and principles

3.1 Accounting like most aspects of human endeavour has evolved over time. This has meant that what accountants do in representing and measuring economic transactions (*accounting practice*) has changed, either generally or with regard to specific transactions. Our understanding and explanation of what they do (formulated as *principles*) have also developed.

3.2 There is no reason to suppose that this development has run its full course or that the influences informing that development are limited to the UK. Standards in the UK tend towards consistency with other standards set worldwide, particularly those issued by the International Accounting Standards Board, because many UK companies are multi-nationals. Furthermore, the UK's membership of the European Community will in due course oblige quoted companies to comply with International rather than UK accounting standards.[1]

3.3 We thus have to consider whether, from the point of view of the tax system, it is satisfactory to be tied to an evolving process, the outcome of which cannot be certain and which will probably reflect international negotiation and compromise. To answer that question, given experience to date, we must understand the direction of that evolution: is there fundamentally a trend away from a measure of income which can serve the purposes of both financial reporting and assessment of taxable capacity? Or is the development simply the refinement of an extant process of measurement that has hitherto adequately served the needs of the tax system?

3.4 It is also for consideration whether there is a real risk that alignment will hinder the process of accounting reform because of taxpayer resistance stemming from the tax consequences that might follow any change. This is not immediately a tax problem nor is it a new problem: in 1962 in America it was stated that, "broad principles must transcend the historical limitations of profits 'available for dividends' or 'subject to tax'...measurements should be independent of the dividend and the tax questions but, at the same time, should facilitate the solution of those questions... ".[2]

3.5 More recently David Solomons, noting the danger of taxation swamping all other considerations in accounting policy making, commented that, "Truth and fairness in accounting are no match for a high tax rate",[3] a sentiment echoed by the OECD in the report by the Working Group on Accounting Standards, which identified

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[1] *Proposal for a Regulation of the European Parliament and of the Council on the application of international accounting standards*, (2001/C, 154 E/29), COM(2001) 80 final—2001/0044(COD), submitted by the Commission on February 13th, 2001 and voted on by the European Parliament on March 12th, 2002.

[2] R.T. Sprouse and M. Moonitz, *A tentative set of broad accounting principles for business enterprises*, AICPA, 1962.

[3] D. Solomons, *Making Accounting Policy*, OUP, 1986.

the effect of tax considerations on financial reporting, "as a major institutional obstacle to achieving greater comparability and harmonisation".[4]

3.6 This is potentially an issue for tax policy makers as well. It will always be open to them to adopt piecemeal any accounting changes once generally agreed. Those changes might, however, never become practice if they are seen from the outset to involve a tax cost. On the other hand, if there were a blanket acceptance of accounting practice, then some changes might be agreed more easily because they generate tax relief where previously there was none (writing off goodwill for example).

3.7 Any conclusion as to these issues must depend on establishing—

(a) whether the purpose of accounting is at least not inconsistent with the requirements of the tax system, and

(b) whether it is consistent enough, as evidenced by trends in development of practice and principles, to allow wholesale alignment.

Whatever the conclusion, accounting standards are in the public domain, and will inevitably inform the accepted understanding of business income for tax purposes unless tax legislation specifies how profits are to be measured.

The development of Accounting Standards

3.8 Prior to 1970 accounting practice could be established by reference to what accountants did, to what relevant texts described and to statements by individual professional bodies. This body of evidence did not necessarily point to there being one agreed consistent practice; indeed there would often be conflicting evidence of practice. It was hardly surprising, therefore, that the courts should find themselves having to rationalise principles in order to decide which practice should prevail. It was precisely because there was no standardised practice that the original Accounting Standards Committee (ASC) came into being in 1970.

3.9 The Explanatory Foreword, now withdrawn by the Accounting Standards Board (ASB), stated the primary aim of the standards as being, "to narrow the areas of difference and variety in the accounting treatment of the matters with which they deal."[5] Accounting Standards were not, however, "intended to be a comprehensive code or rigid rules"; rather, regard had to be given to the spirit of and reasoning behind them, and their application was not to supersede the exercise of an informed judgement in determining what constitutes a true and fair view in each circumstance.[6]

3.10 Thus, the standards that were issued did not always limit the possible accounting treatments to one (depreciation is a straightforward but significant example). This does not provide an encouraging prospect for aligning taxable income with accounting income. Equity requires that similar transactions be measured in the

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[4] *The Relationship between Taxation and Financial Reporting*, OECD, 1987, p.9.
[5] Explanatory Foreword, para. 1.
[6] *Ibid* para. 5.

same way save in the most unusual circumstance. It does tell us, however, that it is not now considered impossible for the process of income measurement to be prescribed by regulation.

3.11 In many ways the most important – and durable – standard was SSAP 2, issued in 1971 and only superseded by FRS18 Accounting Policies in June 2001. Whilst not amounting to a statement of principles, (in particular it did not justify accounting practice in terms of any stated purposes), SSAP 2 did set out the broad basic assumptions, referred to as fundamental accounting concepts,[7] which were considered to underlie the preparation of accounts for business and which were regarded as having general acceptability.

3.12 These basic assumptions consisted of—

(a) the going concern concept—the assumption that the business will continue in operational existence for the foreseeable future so that the implications of liquidation are ignored;

(b) the accruals (or matching) concept—the requirement that revenues and costs be recognised in the period in which they are earned or incurred, not as money is received or paid, with costs being matched to revenues recognised in the period;

(c) the consistency concept—the assumption that there is consistency of accounting treatment as between one period and another;

(d) the concept of prudence—the requirement that revenue and profit are only recognised when realised in cash or reasonably certain of being so realised, and that losses and liabilities are provided for as soon as foreseen.

3.13 All of these ‘concepts’, it might be noted, represent means of dealing with the inherent problems of preparing accounts for a single period in the context of a business that is in fact an on-going concern. As we note below, this is critical from a tax perspective because the application of these concepts will determine when (that is, in which period) transactions are recognised.

3.14 These assumptions were given legal recognition by the inclusion in the 1981 Companies Act of the requirement that all items shown in the company’s accounts should be determined in accordance with specified accounting principles,[8] these being generally in accord with the fundamental concepts of SSAP 2. In particular—

(a) the going concern concept is adopted without the explanatory reference to liquidation;

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[7] SSAP 2, para. 14.

[8] Now Companies Act 1985, Sch. 4 paras. 9-14.

(b) the accrual concept is included in far briefer form than the standard, with no explicit reference to matching but with all depending upon being able to relate income and charges to the accounting period;

(c) the consistency assumption is reproduced almost identically; and

(d) the prudence concept is less detailed as regards realised profits (though with the proviso that realised is to be interpreted in accordance with generally accepted accounting principles),[9] whilst the provision for unrealised losses is more clearly restricted to the current or previous accounting periods.

3.15 Realisation, however is crucial in determining how much a company may distribute as dividend. In short, the assumptions can be seen to have been adopted in as general a form as possible so that subsequent fine-tuning of the concepts would not render the legislation obsolete. Now that we have the requirement that taxable business income be computed subject to the true and fair view, one option might be to similarly incorporate these basic principles into tax statute.

3.16 Following the Report of the Review Committee on the Making of Accounting Standards in 1988, the Secretary of State was given powers under the Companies Act 1989 to delegate the power of setting accounting standards.[10] The same Act defined standards and required companies, other than small or medium-sized companies, to disclose whether accounts had been prepared in accordance with relevant standards and to give details of any material departure from the standards.[11]. Accounting standards in general thus have recognition under company law without the law actually pronouncing them as correct or accepted, whereas the fundamental principles of SSAP 2 effectively have the force of law.

3.17 What legal force standards do have is limited only to larger companies, and certainly does not extend beyond the company sector. To align taxable profits with these standards would thus be going further in the realm of taxation (with the economic consequences which follow) than company law has done, where the emphasis is only on disclosure. Both the Courts and the Inland Revenue, however, seem willing to extend the application of standards in this way. This trend, whilst consistent with the neutrality criterion, may nevertheless create administrative issues for smaller businesses.

3.18 Exercise of the powers in the 1989 Act resulted in the ASB replacing the ASC in 1990. The ASB adopted the then extant SSAPs, including SSAP 2, but issued its own Statement of Aims. These were stated to be, "to establish and improve standards

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[9] Compare for example *The determination of realised profits and disclosure of distributable profits in the context of the Companies Act 1985* issued in 1999 by the Company Law Committee of the Institute of Chartered Accountants in England and Wales, with its predecessor issued in 1982 (Technical Releases 481 and 482). For a commentary on this, see CW Noke, *Accounting Principles: The Consultation Draft on Realised and Distributable Profits*, [2000] British Tax Review pp 84-90.

[10] S.19, now s.256 Companies Act 1985.

[11] Sch. 1 (7), now Sch.36A Companies, Act 1985.

of financial accounting and reporting".[12] It intends to achieve those aims by developing principles to inform its issue of new standards and to guide others in resolving accounting issues, as well as issuing standards themselves.[13]

3.19 It is to these principles that we must look if we are to establish whether the accounting purpose of income measurement is not inconsistent with that of measuring business income for tax purposes. In doing so, we should be mindful that these principles, though promulgated by a body independent of both taxpayers and the taxing authorities, are nevertheless arrived at on the basis of a consensus. The concern of the standard setters is that the tax consequences that would follow if tax were to directly follow accounting standards should not determine whether it is possible or not to arrive at a consensus.

Accounting principles

The ASB Statement of Principles ("SoP")

3.20 The ASB, after a period of consultation, has duly issued a Statement of Principles (SoP).[14] The purpose of the SoP, "is to provide a coherent frame of reference"[15] to inform the development of future, and the review of existing standards. It sets out the principles that the ASB believes should underlie the preparation of general-purpose financial statements,[16] particularly those required to give a true and fair view.[17] It is not, though, a standard itself.[18]

3.21 There is no equivalent in taxation, whether in statute, regulation or statement of practice, which is precisely why we have now to consider this matter: either tax accepts the underlying principles and resultant practices, or it formulates its own so as explicitly to differentiate itself from accounting, or it continues to select the principles and practice on a piecemeal basis.

The true and fair view requirement

3.22 Now that tax has adopted the true and fair view requirement, it is necessary to understand the import of this term. Does adoption require adherence to accounting standards and principles or is there any basis for distinguishing between a true and fair view for financial reporting and one for taxation? The SoP does not define what is meant by true and fair view, but it does suggest that, although it is a dynamic concept,

> "It is inherent in the nature of the true and fair view concept that financial statements will not give a true and fair view unless the information they

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[12] ASB 1991.
[13] *ibid* paras. 2 and 3.
[14] Statement of Principles for Financial Reporting, ASB, 1999.
[15] *ibid* para. 2.
[16] *ibid* para. 1.
[17] *ibid* para. 7.
[18] *ibid* para. 5.

contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed".[19]

3.23 This would seem consistent with the judgement of Sir Thomas Bingham in *Gallagher* v *Jones* that the accounting treatment should not be, "inconsistent with the true facts [*true*] or otherwise inapt [*fair*]" if it is to be used to determine the taxable profits or losses of the business.[20] The implication of this would seem to be that what is a true and fair view has to be determined according to the purpose of the report, so that the issue is whether measuring profit for general financial reports has a purpose which is the same as, or sufficiently similar to, that appropriate for taxation.

General- and special-purpose reports

3.24 The SoP is concerned with general-purpose financial statements directed toward the common information needs of a wide range of users. Computations for tax purposes are considered to constitute a special purpose report.[21] This does not, however, preclude the application of the principles enunciated in the SoP to what is regarded as a special purpose. It simply tells us that the principles are not constrained by the requirements of taxation. It is thus a matter for tax policymakers, rather than for accounting standard setters, whether to adopt these principles for tax purposes. In this regard, we should note again that both the courts and the Inland Revenue have shown a willingness to apply standards as evidence of generally accepted accounting practice, notwithstanding that they are not enforceable upon the taxpayers to whom they have been so applied.

Financial performance and financial position

3.25 The objective of financial statements is said to be to provide information that is useful to a wide range of users in assessing stewardship and making economic decisions with the focus being on financial performance and financial position.[22] Financial performance comprises the return on resources, whilst financial position represents those resources[23] Taking income as being synonymous with return, we see immediately that tax is concerned only with financial performance whilst accounting statements report on that and financial position. Thus not all accounting standards are necessarily directly concerned with reporting profit, whilst others, though effecting the profit measurement, might be driven primarily by concerns over reporting financial position.

3.26 Financial statements are recognised as being concerned with past [24] events. They are nevertheless subject to uncertainty because they function to allocate the effects of transactions to discrete reporting periods. Other information required by users, and included in general-purpose financial reports, is information as to the ways

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[19] *ibid* para. 12.
[20] (1993) 66 TC 77 at 123E, words in brackets added.
[21] SoP, para. 6a.
[22] *ibid* p.16.
[23] *ibid* paras. 1.13 and 1.15.
[24] *ibid* para. 1.8 (c).

in which an entity generates and uses cash.[25] This is seen to provide an additional perspective—and one largely free from allocation and valuation issues—on financial performance and on financial adaptability—that is, its ability to alter the amount and timing of its cash flows.

The qualities of accounting information

3.27 To be useful, information has to have certain qualities. These qualities represent the criteria by which one can judge accounting income. A question, therefore, is how consistent these qualities are with the criteria identified for taxation.

Relevance and reliability

3.28 Primarily, it is required that the information is relevant to the decision making of the user; that is, it could influence their decisions.[26] Information on past performance is considered relevant in assessing past and future performance,[27] with performance subsisting in the return obtained on resources as shown in a financial performance statement.[28] Thus accounting is offering us an *ex post* measure of income and this at least is consistent with the requirements of taxation. Accounting is using income, however, to measure *performance* and this is not necessarily the same as using income as a measure of *taxable capacity*. It is here that the paths of accounting and taxation might diverge.

3.29 Information will not be used if it is unreliable. It is only considered reliable [29] if it can be presented as free from material error or from bias. Neither of these considerations in themselves prevents information that is reliable from being suitable for taxation. What is more problematic is what level of possible error, given an uncertain environment, is considered acceptable. Put another way, should we, as a primary consideration (and regardless of its other weaknesses), be seeking a periodic measure of taxable income that is free from error. Similarly, prudence [30] in the exercise of judgements is considered to be a proper reaction to uncertainty but not to the extent of creating bias, for example by deliberately understating revenues or overstating expenses.

3.30 There is clearly a conflict here between a system that allows for judgement (which may prove *ex post* to be erroneous) and one (such as a tax system) that relies on rigid rules on the grounds of certainty of consistent application. However, even the tax system has recognised the role of judgement (for example with regard to provisions) but with the proviso that the judgement is backed by adequate evidence so as, “to supply a figure reliable enough for the purpose”.[31]

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[25] *ibid* pp. 23 and 24.
[26] *ibid* p. 32.
[27] *ibid* para. 1.14(a).
[28] *ibid* paras.7.3(a) and 7.9-7.11.
[29] *ibid* paras. 3.7 and 3.8.
[30] *ibid* paras. 3.18-3.20.
[31] *Owen* v *Southern Railway of Peru, Ltd* (1956) 36 TC 602 at 643.

3.31 Further, the asymmetry evident in the concept for accounting—that, "it requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets and gains than is required for liabilities and losses"[32]—is also evident in taxation—"that the taxpayer should not be put at any risk of being charged with a higher amount of profit than can be determined with reasonable certainty".[33]

3.32 Relevance and reliability will be significant in the choice of the measurement basis.[34] A decision as to whether to report transactions by reference to their historic cost or some other monetary equivalent is, therefore, a question for decision by reference to usefulness, rather than a predetermined output given by the accounting process. This clearly has implications for aligning tax with accounting income because to move from historic cost would involve change to the measurement of taxable income. The question would then be whether the valuation basis chosen as being relevant for reporting on performance is satisfactory for measuring taxable capacity; we return to this below.[35]

<u>The substance of transactions</u>

3.33 The most problematic of the qualities that the SoP requires of information might seem to be that in order to be reliable, it should represent faithfully the substance or commercial effect of transactions and not merely their legal form. It is important to understand, however, why this is problematic. It is not *per se a* problem for tax policy: if there is general agreement as to what constitutes economic gain, or income, (which *might* be expressed in an accounting standard), deciding the substance according to that agreement would not seem to be an obstacle to the realisation of policy objectives—to tax economic gain.

3.34 Indeed, "an exact analysis of the legal form"[36] was recognised by Lord Radcliffe as not being determinative of profit measurement for tax purposes, and the decision in *Gallagher* v. *Jones* represented the acceptance of an accounting practice based on substance rather than, "the juristic classification of the legal rights".[37] Further, it would now seem to be generally recognised that accounting concepts such as profit and loss are concepts, "which might not be capable of being held within the confines of purely juristic analysis".[38]

3.35 Where it seems to be a problem is in enforcing that tax policy through, or as part of, the general legal system. The adoption of a substance principle in accounting appears to be granting to the accounting process that which is more properly the preserve of the legal process. However, if tax law is but the manifestation of tax

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[32] SoP, para. 3.19.
[33] *Duple Motor Bodies v. Ostime* (1961) 39 TC 537 at 567.
[34] SoP, para. 6.23(a).
[35] See para. 3.63.
[36] see note 61 below.
[37] *Hallstroms Pty Ltd v. Federal Comr of Taxation* (1946) 72 CLR 634 at 648, quoted with approval in *BP Australia Ltd v. Comr of Taxation of the Commonwealth of Australia* [1966] AC 224 at 264.
[38] *MacNiven v. Westmoreland Investments Ltd.* (2001) 73 TC 1 at 65E.

policy coupled with the power of enforcement of that policy, and if the policy were to adopt accounting measures of business income, (accepting the principles on which it is measured), then is the issue of substance in income measurement (particularly given that it applies in the context of positively trying to provide more useful information than would be given by resort according to legal form) really problematic in the legal context?

3.36 Whatever the answer to that question there remains, as with materiality, the protection of requiring disclosure of what would usually be the exceptional cases—transactions which have been reported in accordance not with their legal form but with their economic substance.

Comparability and consistency

3.37 Comparability [39] is a further quality required of useful information so as to compare both different entities and different periods. Consistency [40] of accounting practice facilitates this, although the SoP is concerned that consistency should not become an impediment to improved accounting practice.

3.38 Again one can argue that comparability is consistent with the need for general applicability and equity in a tax system. The proviso that consistency should not impede change simply requires that for tax purposes there should be adequate mechanisms to ensure that changes do not result in omission from, or double counting in, the tax base.[41]

3.39 Consistency does not have the same importance as it did under SSAP 2 [42] and this is reflected in the new Financial Reporting Standard on Accounting Policies (FRS 18) which replaces it and which suggests that accounting policies should be reviewed regularly.[43] FRS 18 proposes that accounting policies should be chosen which meet the information qualities set out in the SoP (and which include consistency and prudence) and recognises that two notions play a pervasive role in financial reporting and the selection of accounting policies: the going concern assumption and the accruals concept.[44] The accruals concept here is limited to the straightforward requirement that transactions should be recognised according to the period in which they occur, rather than according to when the associated cash payments or receipts take place. References to matching with a view to measuring profit are removed, having been dealt with in the SoP, and realisation is included only with reference complying with company legislation.[45]

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[39] SoP, para. 3.21 and 3.22.
[40] *ibid* para. 3.23.
[41] See *Pearce v. Woodall-Duckham Ltd* (1977) 51 TC 271. See also Inland Revenue Press Release, 1st August 2001 and draft Finance Bill 2002 Clauses concerning "Tax and Accounting Changes in Law and Practice".
[42] FRS 18, App. IV para. 12.
[43] *ibid* para. 1.b.
[44] *ibid* para. 20.
[45] *ibid* para. 28.

Materiality

3.40 The information reported needs to be understandable, so that users can perceive its significance, and finally, even if it meets all the qualitative characteristics outlined, it needs to be material;[46] that is, its omission or misstatement could influence the economic decisions of users.

3.41 This is considered a threshold quality so that information has to be considered against this criterion before being included in a report. If it is not material it cannot, given the stated objective of accounting statements, be useful. Its inclusion may even detract from the usefulness of the report by inhibiting understanding. Materiality, however, is a relative concept: it depends on the size of the omission or misstatement relative to its context. As such materiality is not an unknown concept in tax administration, but it is a facet of administrative discretion rather than a principle of law governing rights as between the taxpayer and the state.

3.42 Clearly this threshold is not intended to permit the deliberate omission or misstatement of a transaction. This would contradict the other required characteristics of information, particularly that of faithful representation. What is at issue in the context of accounting standards is whether particular transactions are significant enough in the context of the entity being reported on to require application of an accounting standard or an accounting policy. In the context of taxation the issue is different; it is a matter of calculating a tax liability according to the statutes and it cannot be appropriate that the taxpayer be the sole judge of whether the treatment of a transaction in the accounts is material to the final tax liability.

3.43 This does not mean, however, that the SoP is irrelevant to the computation of taxable profits. What it suggests is that, if accounting practice is adopted as the basis for taxing business profit, the taxpayer should be required to disclose any items which have not been reported according to whatever standards might otherwise be appropriate on the grounds of materiality; given that immateriality will be the exception rather than the rule, this would not amount in principle to non-alignment of taxable and accounting profits.

Conclusion

3.44 The importance attached in the SoP to these qualitative characteristics does remind us that, however easily any particular one might sit with the needs of the tax system, the direction of accounting evolution is away from a mere calculus, resulting in a bottom line measure of profit. The evolution is towards a more general and rounded package of information that is intended to be understood as a whole.

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[46] SoP, paras. 3.28-3.32.

Accounting measures of income

The profit and loss account

3.45 Accounting measures of income have traditionally been based on past transactions recorded at their historic transaction consideration. The fundamental concepts of accounting as set out in SSAP 2 were largely concerned with measuring periodic profit and this reflects the primacy of the profit and loss account traditional in financial reporting. The balance sheet essentially resulted from what was and what was not taken into account in the profit and loss account, and would normally reflect assets and liabilities at their transaction values.

3.46 As an aspect of this approach, fixed assets would appear at 'cost', that is to say the proportion of their cost that had not previously been charged against revenues. The going concern assumption was relevant in that it assumed that the business would continue. The cost not written off could, therefore, be charged in the future according to the future use. The monetary value assigned to an asset in the balance sheet was determined by how much of its cost had already been attributed to earning profit. It is this model of income measurement that taxation has taken as its starting point.

The balance sheet approach

3.47 The thrust of income measurement as evidenced by the SoP, however, is changing (although it is still based on past transactions and events). Financial performance is currently reported in two statements: the profit and loss account and the statement of total recognised gains and losses. The statement includes the profit or loss in gains but provides a more comprehensive measure of income than the traditional profit and loss account.[47] Gains and losses are changes in ownership interest not arising from contributions from or distributions to owners,[48] where the ownership interest is measured as the difference between the business' assets and liabilities.[49] Gains and losses are the consequence of recognised changes in assets and liabilities (although not every change in an asset or liability gives rise to a gain or loss; it might be matched by a change in another asset or liability).

3.48 The critical issue now is the effect that a transaction or event has on the assets or liabilities: there can be no gain or loss unless a change in these is recognised. Assets and liabilities are defined respectively as, "rights or other access to future economic benefits controlled by an entity"[50] and, "obligations of an entity to transfer economic benefits",[51] both arising as a result of past transactions or events. Thus expenditure that does not result in control of rights or which has such an uncertain

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[47] FRED 22 proposes combining the two statements into a single statement of financial performance.
[48] SoP, paras. 4.39 and 4.40.
[49] *ibid* para. 4.37.
[50] *ibid* para. 4.6.
[51] *ibid* para. 4.23.

prospect of future benefits that it cannot be recognised[52] as an asset, will be recognised as a loss in the period in which it is incurred.

3.49 Lip-service is paid to matching:[53] the SoP notes that matching might operate in two forms—

(a) on a time basis, where costs or benefits are purely a function of time and are matched to a period accordingly, or

(b) on a revenue basis, where particular costs are associated with particular revenues and are matched against those revenues in the period in which they are recognised.[54]

All depends, however, on the recognition and measurement of assets and liabilities.

3.50 The rationale for using the recognition of assets and liabilities as the starting point is that an effective framework needs robust definitions that are precise and comprehensive. The SoP takes the view that it is possible to meet this requirement through definitions of assets and liabilities but not through elements such as matching, which have traditionally been employed to measure profit.[55] It argues that using robust definitions will impose discipline on the recognition of gains and losses in a way that matching does not:

> "Almost all [business] expenditure is undertaken with a view to acquiring some form of benefit in exchange. Consequently, if matching were used in an unrestricted way, it would be possible to delay the recognition in the performance statement of most items of expenditure insofar as the hoped-for benefits still lay in the future. The Statement imposes a degree of discipline on this process because only items that meet the definitions of, and relevant recognition criteria for, assets, liabilities or ownership interest are recognised in the balance sheet."[56]

3.51 In this instance, the SoP is addressing the pressure to delay the recognition of expenditure so as to portray a better performance for the period. For tax purposes the incentive is usually the reverse—to claim expenditure as a deduction as early as possible. Thus, where expenditure is recognised for tax purposes according to normal accounting practice it is common to require that the practice has in fact been adopted in the published accounting statements. If the claims of the SoP are correct, however, this protection is theoretically redundant because the argument is that the definitions of assets and liabilities are robust enough to withstand these sort of pressures. Should

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[52] Recognition is the subject of chapter 5 of SoP.
[53] *ibid* paras. 5.28-5.32.
[54] For a review of this in tax law see Macdonald, *Matching Accounting and Taxable Profits: Reflections on Gallagher v. Jones*, [1995] British Tax Review pp. 484-498, where it is suggested that matching on a time basis is the more objective approach and has been used more in tax cases.
[55] *ibid* App. III paras. 28 and 29.
[56] *ibid* para. 5.29.

that prove correct, then it may support the view that accounting principles provide a satisfactory starting point for taxation notwithstanding that the definitions are probably wider than those necessary for tax purposes.

3.52 Assets or liabilities will be measured initially by reference to the consideration given in the past transaction, providing that the event or transaction was before the balance sheet date and that an asset or liability (as defined) comes into existence.[57] Thereafter, there may be a remeasurement of the asset or liability to a current value (which will give rise to a gain or loss) if there is reliable evidence as to its value,[58] or a "derecognition" of it where it has ceased to fall within the definition of an asset or liability.[59] The SoP envisages that a mixed measurement system might apply, using different bases for different categories of asset.[60]

3.53 Recognition of gains and losses therefore depends upon whether there is sufficient evidence to report them reliably. Realisation may be part of the evidence but it is no longer a required criterion. Prudence is taken now to mean that the standard of evidence for recognising losses is lower than that for gains. The SoP explicitly recognises that the realisation test originated to protect creditors in the face of accrual as opposed to cash accounting and to provide a criterion for determining distributable profits. It applied to ensure that only gains that were reasonably certain and unlikely to reverse were included as profit.[61]

3.54 The view is now taken that it is, "unrealistic to suppose that distributability *per se* can serve as a primary focus of the presentation of financial performance",[62] because, "Basing the reporting of items of performance on the realisation of assets (particularly assets that have a liquid market) permits the management of reported profits".[63] The SoP argues that while it is possible to extend the traditional meaning of realisation to include, for example, changes in the value of securities for which there is an active market, attempts which are now recognised in our tax statutes, it is better to rely on the basic criteria of reasonable certainty and reliability of measurement rather than to stretch the natural meaning of the term.[64]

3.55 As an alternative, therefore, the SoP suggests that gains might be recognised by reference to the critical event [65] in the operating cycle, this being the point at which there is sufficient evidence to measure the gain reliably. The critical event will often be synonymous with full performance and realisation may be the critical event but,

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[57] *ibid* paras. 6.11-6.13; essentially the old historic cost procedure.
[58] *ibid* paras. 6.17-6.22.
[59] *ibid* paras. 5.22-5.25.
[60] *ibid* para. 6.3.
[61] The contrast here was evident in the stringent test of realisation used by the Court in *Willingale v International Commercial Bank* (1978) 52 TC 242 in comparison to that used by the Bank in its statutory accounts.
[62] SoP, App. III, para. 45.
[63] *Reporting Financial Performance: Proposals for change,* para. 1.14, ASB Discussion paper, 1999.
[64] SoP, App.III paras. 49 and 50, and see discussion in FRED 22 App. IV para 26.
[65] *ibid* paras. 5.33-5.36.

> "In the context of many financial exposures today that are affected directly or indirectly by the presence of deep and active markets, the realisation of an item provides information that is of limited value. A realised gain will reflect the same economic event as an unrealised gain: realisation merely represents confirmation of the gain."[66]

What is mere confirmation for accounting may, however, be critical for taxation. The certainty threshold is probably now one of the clearest differences between accounting and taxation.

3.56 Expenditure that does not result in the recognition of an asset will be recognised automatically as a loss in the period in which it is incurred. Where expenditure gives rise to an asset the future benefits may be consumed over a number of periods, in which case the asset will be derecognised wholly or in part. To the extent that it is derecognised, there will be a loss for the period. Assuming that transactions take place at fair value, the initial measurement of assets and liabilities will be at their transaction cost (historic cost) and this will be adjusted (not remeasured) as the asset is consumed (and derecognised).

3.57 This adjustment is intended to reflect the benefits used up in a period. Where this cannot be measured directly—either by matching on a time basis or by association with specific gains—then the expenditure is written off systematically over the life of the asset,[67] i.e. historic cost depreciation in the case of a fixed asset. There is clearly an element of uncertainty here and the process involves judgement, which might be mistaken. The definition of assets and liabilities might be robust but it is clear that there remains room for discretion; the question is whether the exercise of judgement in this context is acceptable in measuring taxable income and whether it can be assumed to be free from bias.

3.58 Although assets and liabilities will usually be measured initially at historic cost, the SoP envisages that some or all of them may be measured subsequently at current value. This will involve remeasurement and the change in value will be included in the total gains and losses for a period since the ownership interest will have changed by an equal amount. As a result, all gains recognised in a period will be reported regardless of whether they arise from operations or from revaluation, and whether realised or not.

3.59 The Exposure Draft of the SoP suggested distinguishing between the type of assets or liabilities to which the gains or losses are attributable. Those arising from assets or liabilities, "held on a continuing basis primarily in order to enable the entity's operations to be carried out",[68] were to be reported in the statement of total recognised gains (if arising on revaluation as opposed to allocation of benefit through matching); all others would appear in the profit and loss account. The distinction between the two statements is that the profit and loss account reports the results of

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[66] Reporting Financial Performance, para. 4.12.
[67] *ibid* para. 5.31.
[68] Exposure Draft of Statement of principles for financial reporting, paras. 6.25-6.28, ASB 1995.

operating and financing while the statement of total gains and losses provides a summary of all the changes in ownership interest, including those recognised on revaluation of assets and liabilities held for use on a continuing basis.

3.60 The SoP makes no equivalent reference to this classification of assets, but the proposed revision of FRS3, Reporting Financial Performance,[69] suggests a single statement of financial performance divided into three sections showing operating gains, financing and treasury gains and other holding gains. The latter section would include a business' holding gains on, "items, held for the long term, that are connected with but incidental to its main trading activities",[70] and would include gains recognised in the period of disposal under the historical cost convention.[71]

Comparing the balance sheet and profit and loss account approaches

3.61 The explanation of financial reporting offered by the SoP is often referred to as the "balance sheet" approach. This is because its starting point is to establish whether there are assets and liabilities, and then what their value is, with the profit and loss falling out as the change in value of those assets and liabilities. The contrast with the traditional approach is clear: the balance sheet approach reflects measurement by reference to the change in value of a stock between two points in time whereas the traditional approach has been to measure the flows during that period.

3.62 The difference in the resultant measure of income is essentially that changes in the value of assets and liabilities not evidenced by realisation (a transaction with a third party) are now included as income whereas traditionally they would be excluded until realisation. This means that gains and losses are recognised earlier than under the traditional approach [72] and that gains and losses may be recognised where none would have been recognised before.[73] The justification for this approach is that it gives a better measure of performance in that it enables more informed economic decisions to be made. The selection of the measurement basis should reflect the objective of financial statements, the need for relevance and reliability, the nature of the assets or liabilities being measured and the particular circumstances.[74]

3.63 The basis of valuation adopted in the Statement of Principles is what is termed 'deprival' value,[75] the recompense the owner of an asset would receive were he to be deprived of the asset. In the normal case of the asset being economically viable the value would be current replacement cost because replacement of the asset would restore the owner's financial position to that which existed prior to deprival. In the case of an asset for which replacement was not economically viable (because its economic value was less than replacement cost), the recompense would be its

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[69] FRED 22.
[70] *ibid* para. 27.
[71] *ibid* paras. 26 and 122 and App. IV para. 27.
[72] Although the prudence concept meant that losses were recognised whether realised or not.
[73] Being matched by subsequent increases or decreases in charges to the profit and loss account for the using up of the asset.
[74] *ibid* para. 6.23.
[75] *ibid* paras. 6.6-6.9.

recoverable amount—the higher of net realisable value or economic value in use, the sum needed to restore the owner to his previous financial position. As a basis of valuation this seems appropriate to measuring what has been used up in a period, for use will in fact have deprived the owner of some of or all his asset. Incorporating this in the performance statement will reflect the current cost of operations. Income measured on this basis indicates the amount that could be consumed or distributed on the assumption that operations continue.[76]

Adopting the balance sheet approach for tax purposes

3.64 Is this a suitable valuation base for taxation and can we expect the tax system to move to taxing unrealised gains and losses? Traditionally, tax law has permitted only the taxation of realised profits and has not recognised unrealised losses. The latter position has been now been affected by the decision in *Herbert Smith v Honour*[77] and the Inland Revenue's explicit acceptance of that decision as recognising prudence as a generally accepted principle of accounting computation. Here, perhaps, the difficulty becomes apparent of aligning taxation with an evolving criterion. Arguably, prudence no longer is as important as it was when SSAP 2 was first published. Now the question would be whether either the liability had increased (which it had not) or whether the asset has decreased (which in deprival value terms it had).

3.65 Retention of the realisation threshold would accord with company law requirements for distributable profits and is consistent with the idea that realisation provides evidence of there being profit to distribute. Similarly, for tax purposes realisation is evidence that there is in fact the potential for consumption (or distribution). This perhaps justifies the strong nature of the test that the courts have adopted in applying it, remembering that the question is whether there is income available for consumption in respect of a particular period in isolation.

3.66 As noted above,[78] the contrast between this use of realisation and that adopted in accounting is clear in the *Willingale* case: whilst for accounting purposes the gain on holding a bill to maturity could be considered with certainty to be the minimum gain, with an approximation of the periodic income given by a time apportionment, for tax purposes periodic consumption would only be available through sale or maturity of the bill, that is, a transaction with a third party. Of course, it can be argued that it would be possible to borrow for the purposes of distribution or consumption against the maturity value of the bill, and this is probably correct. Once we have set our face against taxing according to expected future cash flows (because of lack of objectivity), the nearest we can get to periodic consumption potential, without the evidence of actual realisation, is resale value.

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[76] The relevance of a balance sheet reporting assets and liabilities on the basis of hypothetical deprival is less clear: it tells us the minimum economic value of the assets and liabilities and perhaps its information value is to give that as a benchmark against which to assess reported income.
[77] (1999) 72 TC 130.
[78] Note 61 above.

3.67 In the case of readily marketable assets that are both inherently susceptible to and actually held with a view to resale, this presents few problems. These assets, usually financial assets, represent a store of future distribution or consumption potential. The SoP envisages the use of this valuation basis for this kind of asset,[79] and where tax statute has explicitly permitted accounting measures of income for tax purposes, it has involved this kind of asset (or liability) and this measure of value.[80] Whilst an increase in realisable value does accord with the basic *ex post* definition of income as the potential for consumption or distribution in a period, this measure is only objectively available in respect of some assets. Rather than selectively tax the income of such assets, we may conclude on grounds of neutrality, equity and administration that all income be taxed when realised.[81]

3.68 The SoP, however, would include the increase in replacement cost of an asset (where that is its deprival value) as a gain. Not only is this gain not realised but, more pertinently in the context of taxation, it does not of itself represent an increase in the potential for consumption or distribution.[82] At best, this gain can be said to represent future cost savings. It is not costs, however, that give rise to consumption or distribution; it is future transactions that generate cash inflows, either through production or from resale of the asset. It thus seems appropriate that neither statute nor case law recognises any valuation other than one based on resale value or historic cost. Resale value is a measure of a potential inflow, while historic cost simply ensures that there is no gain recognised in respect of the asset until disposal. We might conclude, therefore, that gains recognised under the SoP through valuation at replacement cost should not be recognised for tax purposes.

3.69 The case for taxing only realised gains has rested on administrative feasibility—reducing the costs of complying with and monitoring valuations not evidenced by a market transaction. Thus capital gains are taxed on a realisation basis rather than an accrual basis, notwithstanding the potential for economic distortion caused by the "lock-in" effect. There is, however, a further argument for taxing business only on gains actually realised on resale rather than on changes in value

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[79] SoP, App III, para. 57(b).

[80] For example loan relationships in FA 1996.

[81] This is a second best solution because the realisation basis creates distortion through the lock-in effect and is inequitable in that borrowing against assets with gains does allow consumption or distribution.

[82] Consider a machine costing £100 purchased at the beginning of year 1 with a view to producing an output at the end of year 2; the present value of that output is £140. At the end of year 1, the replacement cost has risen to £110 and the expected output remains as before (its present value having risen by the rate of interest). Whether there is any gain at any time depends on the output, its level and value. Nothing has happened in the first year to change the expected income, and we have already discarded income measures based on future cash flows as being insufficiently objective. To appropriate some of that income, in advance of production, to the period in which the replacement cost of the asset has risen, is in fact appropriating income on the assumption of expected future cash flows - that they are greater than the current replacement cost. This might tell us something about management's decision making, but it says nothing about taxable capacity in that first year. Nothing has happened which changes the capacity to distribute or consume.

arising on remeasurement by reference to a hypothetical sale. This arises in the context of business assets held for use rather than resale.

3.70 Exempting such assets from any requirement to revalue periodically at realisable value recognises that the process of periodic income measurement in the context of a continuing business (the going concern concept) is a highly abstract activity. Such assets do not represent a store of distribution or consumption potential and any changes in value (whether loss or gain) depend on hypothetical transactions that are unlikely to take place. To measure income on the basis of valuing all assets at their realisable value indicates the amount that could be consumed or distributed on the assumption that current operations cease. Such a hypothesis, however, is generally contrary to reality. Accordingly, such a measure lacks the certainty and objectivity usually required in assessing taxable capacity.

3.71 Revaluing such assets may, however, produce relevant economic information. It will indicate how adaptable the business is and will provide a benchmark [83] against which to assess anticipated future returns. It could be perfectly appropriate to report this kind of information as part of the process of measuring financial performance and its relevance might well outweigh its unreliability. If it were not a requirement and if there were tax consequences, however, we might expect to see a reluctance to recognise such changes in value in the accounts, with a consequent loss in information value. Again, we may note that periodic measures of performance do not necessarily equate to periodic measures of taxable capacity, even though both may be approximations to the central concept of income and will over the long term give the same result.

3.72 The trend in accounting practice towards revaluation of assets held on a continuing basis with a view to use in the business may therefore be at variance with the needs of the tax system. It means for tax purposes that gains on revaluation would be excluded, that gains on realisation of such assets would be included, and that depreciation (where applied) would be measured on the historic cost basis. However, we should note that even where assets and liabilities are measured according to their historic cost, the SoP proposes that where the recoverable amount is below historic cost then assets should be remeasured at this amount.[84]

3.73 Broadly, the stock valuation rule, accepted by the courts, of 'lower of cost or market value' is equivalent to this, although recoverable amount requires also accounting for the present value in use. The SoP, however, envisages applying this test to all assets, not just to stock and work in progress, in order to make historical cost more relevant to users by ensuring that assets are not reported at amounts greater than their recoverable amount. Arguably, the effect is to charge an unrealised loss to the profit and loss account, which in tax terms is inconsistent with the cardinal principle of realisation; hence Lord Reid's view that this anticipation of a loss was illogical.[85] At one level, this was only reflecting the asymmetry inherent even now in

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[83] I.e. the opportunity cost of continuing to hold the asset.
[84] SoP, para. 6.18.
[85] *Duple Motor Bodies v. Ostime* (1961) 39 TC 537, 570.

the prudence concept. There is, however, a more fundamental distinction: whereas recognition of an unrealised gain is anticipating a future transaction, writing down historic cost to recoverable amount is recognising as a loss expenditure which has taken place.[86]

Adjustment for inflation

3.74 Interestingly, in view of all the discussion and proposals in the recent past, the issue of dealing with general price level changes hardly warrants a mention in the SoP. The SoP suggests that adjustment would be made for the loss in purchasing power of the entity's financial capital, that being the ownership interest, when price level changes are significant [87]. No attempt is made, however, to define what is significant. What is surprising about the lack of attention to this issue is that for reporting purposes it is a crucial aspect of comparability over time, as well being central to the fundamental definition of income.

3.75 It is this last aspect that is relevant to tax. It is generally agreed that changes in the unit of measurement should be discounted before arriving at a final measure of taxable income, so that tax is only levied on real consumption potential. At present, the tax system only allows for inflation through the indexation allowance [88] available to companies in respect of the disposal of assets not accounted for in the computation of income.

3.76 If for tax purposes the business were identified as the entity for which income is measured, and all business assets were ring fenced, then indexation of the ownership interest would provide a relatively straightforward way of allowing for inflation. This would avoid the need to allow for it in respect of individual assets but it would require an annual allowance even when inflation levels were low, because long held assets would otherwise be discriminated against. This would have revenue implications but it should be noted that, assuming that the ownership interest excludes loan finance, any allowance on assets is reduced by the effective charge on loans. This would be an improvement on the present position where indexation relief is given regardless of how the asset is financed.

Conclusion

3.77 This necessarily brief review of the principles behind accounting income measurement gives us some notion of the direction in which accounting is evolving. Its concern is with the provision of information, and income measurement is but part of the information set some of which is not always quantifiable. Whereas in the past objectivity and accuracy were essential to reporting, some loss of those characteristics in the interest of providing better information is now acceptable.

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[86] See further discussion at para. 4.25.
[87] SoP, paras. 6.39 –6.42.
[88] TCGA 1992, Pt. II. Ch. IV.

Small businesses

3.78 The principles set out in the SoP are intended to be relevant to the financial statements of all profit-oriented entities. It has been developed, however, with large entities in mind [89] and there is the general point that accounting standards only apply to large companies. If a justification for aligning taxable profit with accounting profit is to minimise compliance costs, it would seem contradictory for the tax system to impose on smaller businesses computational requirements that are not required of them for financial reporting purposes.

3.79 Prompted by the concern to reduce the burdens on business the ASB has issued the Financial Reporting Standard for Smaller Entities.[90] This standard (FRSSE) may be applied to small companies or other small unincorporated entities which prepare financial statements intended to show a true and fair view.[91] Its adoption is optional, but it cannot apply to large or medium sized companies, to public companies or to banks, building societies or insurance companies. Its effect is to exempt entities adopting it from other accounting standards [92] but the definitions and accounting treatments are generally to the same effect as existing accounting standards.

3.80 In deciding what to include in the FRSSE, the ASB has regard to a number of criteria, in particular the issue of ease of compliance and whether, "The treatment prescribed by the standard or requirement is compatible with that already used, or expected to be used, by the Inland Revenue in computing taxable profits".[93] This suggests that the FRSSE might provide a basis for some alignment of accounting and taxable profits, either by wholesale adoption or by the issue of an equivalent which covers only those items pertinent to taxation.

3.81 What the FRSSE does is to set out the minimal conditions that should be met if accounting reports are to show a true and fair view. Legislation, if it were to be relevant to all taxpayers, would similarly need to be minimalist and cover similar issues to those in the FRSSE. These essentially concern the timing of recognition of income and expenditure and include accounting for research and development and goodwill, depreciation of tangible fixed assets, provisions, and stocks and long term contracts.

3.82 While the SoP argues that the principles it sets out are applicable to all profit-oriented entities, the FRSSE specifically adopts the accounting principles in the Companies Act 1985.[94] This would imply that the Companies Act principles are not inconsistent with the SoP, except as regards the realisation requirement. The effect of the inconsistency is said not to be clear.[95] What is clear is that however profits may be

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[89] SoP, App III para. 8.
[90] ASB 2000.
[91] *ibid* para. 1.1.
[92] *ibid* p.4
[93] *ibid* p.6 para. (f).
[94] *ibid* p.57.
[95] SoP, App. I para.8.

presented, only realised profits may be distributed.[96] Similarly, it could be the rule that notwithstanding accounting principles that recognise unrealised gains and losses, only realised gains would be subject to tax.

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[96] Companies Act 1985, s. 263 (3).

CHAPTER 4. THE RELATIONSHIP OF TAX AND ACCOUNTING

Taxation by source rather than entity

4.1 Taxable income is measured according to the rules applicable to the source of that income. This is immediately more restrictive than the general concept of income because everything depends on the recognition of the source. In particular, capital gains are not taxed as income. As previously argued, however, capital gains are part of the general concept of income and so cannot be excluded from consideration. Furthermore, it is the income of a trade or profession that is measured, not the income of the trading entity, which is what accounting is measuring and reporting.

4.2 Even for corporation tax, where the profits of the company are taxed,[1] income is still measured according to the source [2] rather than the company and losses are treated differently depending upon whether they are capital or income losses and in the latter case according to their source. There are therefore instances where the entity approach would result in expenditure being deducted that is not allowed to be deducted in computing the profits of the trade, and where losses would be set against income to measure entity profit but not in measuring taxable profit.

4.3 As the tax statutes provide no definition, trading income has been taken to be income as measured for accounting purposes, subject to any statutory interventions and to any other interventions that arise from the operation of precedent. It is therefore statute, its interpretation and the precedents as to what constitutes normal accounting practice, which potentially give rise to the differences between taxable and accounting income. Where the differences arise, they can be examined with a view to establishing whether their retention is necessary for an efficient tax policy.

Allowable deductions and consumption

4.4 One of the requirements of tax policy is to distinguish between expenditure that is properly a cost of earning income and expenditure that represents personal consumption. The central definitions of income previously outlined make it clear that consumption is an application of income and therefore cannot figure in its measurement. The criterion for distinguishing between the two categories of expenditure is contained in s.74(1)(a)-(c) of the Taxes Act 1988, with the requirement that expenditure be ‘wholly and exclusively’ incurred ‘for the purposes of the trade’ being the rule that is most commonly applied for these purposes.

4.5 In some cases there is genuine difficulty in deciding on which side of the divide between consumption and business expense particular expenditure lies. One solution is to disallow all expenditure of a defined category regardless of whether it in fact relates to consumption or not. An example of this is entertaining expenditure,

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[1] Being income from all sources and gains; TA 1988 s. 6(4)(a).
[2] TA 1988 s. 9(3).

which might very properly be included as an expense in the accounts of a business but which is disallowed in any event under s.577. Accounting income will always be subject to this type of scrutiny but while technically it can lead to non-alignment of accounting and taxable measures of income, that result can be seen to be in the clear interests of tax policy.

Capital expenditure

The disallowance of capital expenditure

4.6 Traditionally the other major statutory departure from accounting measurement has arisen from the application of s.74(f), which prohibits the deduction of, "any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade...". Although the wording might not suggest that the provision relates to capital expenditure, it is s.74(f) that is usually invoked to disallow what are capital items.

4.7 One can understand such a rule being formulated in the context of, or to deal with cash accounting.[3] The section has in some way, however, been rendered redundant: normal accounting practice would not deduct what is generally understood as capital expenditure. It is and has long been accounting practice to allocate such expenditure to the periods in which its benefits are used up. In accounting parlance the expenditure would be "capitalised", but this has an entirely different significance from its treatment under tax law. To have expenditure classified as capital for tax purposes is potentially a deathblow. Unless it qualifies for capital allowances, it will never be recognised in measuring taxable income. By contrast, capitalised expenditure in accounting is spread over its useful economic life.

4.8 There seems no good reason from the perspective of tax policy to prevent this normal accounting practice. Indeed, to give no allowance for such expenditure is both distortionary and inequitable, and totally at odds with any generally understood notion of income. Of course, the expenditure might attract capital allowances but to do so it must come within the words of the capital allowances legislation, where again exclusion through statutory interpretation [4] leads to a complete loss of tax recognition.

Adopting accounting depreciation for tax purposes

4.9 The crux of the issue, both for depreciating fixed assets and for other expenditure the benefit of which spans several periods, is whether, if accounting measures were adopted for tax purposes, there is any way to protect business tax revenues from a tendency to accelerate write-offs either through the chosen rate of depreciation or through the estimated life over which the expenditure is written off.[5] The accounting standard on depreciation (FRS 15 Tangible Fixed Assets) does not set

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[3] See paragraph 2.11 above.

[4] For example with regard to the meaning of "plant".

[5] An issue raised in the *Technical note on the Taxation of Intellectual Property,* para.3.27, Inland Revenue, 2000.

out to standardise these variables; instead it requires that, "The depreciation method used should reflect as fairly as possible the pattern in which the asset's economic benefits are consumed".[6]

4.10 Before rejecting this guideline as too soft and as inappropriate to a recalcitrant body of taxpayers, we should consider whether the standard (and the same argument applies in respect of other standards) in fact sets tests that the taxpayer must show he has complied with if challenged by the Inland Revenue. The Revenue for its part could set boundaries for acceptable rates of depreciation for different assets with the result that businesses might elect to report within these bands so that accounting rates of depreciation were aligned with those applicable for tax purposes. There will always be some taxpayers who will test the boundaries of any provision. The question is whether the compliance saving associated with removal of the capital allowances legislation would outweigh the necessity of having to challenge taxpayers according to a less rigid set of rules, particularly if, say, all questions of accounting were dealt with by a specially appointed body of commissioners.

4.11 Tax policy may, and often does, use the level of depreciation allowances to encourage investment, either generally or for particular assets by accelerating the period of write off. Whether or not this is in any particular case the best means of encouraging investment, we have to recognise that once a tax is in existence it can be used differentially as a deliberate method of influencing business decisions. An immediate conclusion might therefore be that the government should in any event retain control over the system of depreciation and its rates. Tax allowances as part of the income measurement system are not, however, the only way to create incentives. Tax credits can have the same effect and can be applied without any regard to the particular write-off system adopted in measuring taxable income.[7]

Judicial tests of capital

4.12 In the context of this discussion, we also need to consider the way in which the courts have approached what does and what does not constitute capital expenditure. Without embarking upon an exhaustive study of the matter, we can say that what has variously determined the issue has been the nature of the asset acquired, whether the expenditure represents a 'proper debit', and whether to charge the expenditure against the profit of a single period would overly distort that period's profit. None of these tests is problematic in the abstract; indeed, they accord closely with the traditional accounting decision as to whether or not to capitalise the expenditure. However, when the label 'capital' potentially excludes any recognition for tax purposes, these tests lose credibility.

4.13 This is because the legal understanding of capital really does involve categorising expenditure as either capital or income *for all time,* whereas the

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[6] para. 77.
[7] Clearly, however, other considerations enter the choice between tax allowances, tax credits and grants, in terms of the difference between ordinary government expenditure and a tax expenditure. European issues, in terms of State Aid issues, may also arise although tax allowances are not immune from those issues.

accounting approach would not recognise such a dichotomy. Instead, it would allocate the expenditure, however imperfectly, over time according to the loss of future benefit incurred over a period either through the effluxion of time or by direct usage in earning revenues. Traditionally this would have reflected the matching process [8] but following the SoP, it involves first establishing whether there is an asset as defined and then ascertaining the value of the asset.

4.14 The problem almost certainly relates to the insistence of associating capital with assets, of conceptualising capital as a stock of wealth rather than a fund of value. This is inherent in the early company law decisions on dividends and the maintenance of capital (where capital was identified with certain physical assets), and is evident in some tax decisions. Arguably, it stems back to a way of thinking about capital and income that has its origins in trust law where the distinction *is* about separate interests. Evidence that this way of thinking remains to this day appears in the Inland Revenue's statement that, "'capitalised' revenue expenditure is still revenue ... capital expenditure does not become revenue expenditure when, say, depreciation is charged to the profit and loss account."[9]

4.15 The courts and lawyers thus tend to regard the distinction not just technically as one of law but substantively so. Thus, "The question of what is capital and what is revenue is a question of law for the Courts".[10] This is in contrast to the practice of accountants and treats the distinction between capital and revenue as if it *is* something given in nature. In truth, the distinction has no meaning in the context of income measurement. As such, even by the norms of legal interpretation, the meaning should be derived from that context and not from a different context.

True and fair view

4.16 The latest addition to the statutory refinement of accounting measures of income in general is s.42(1) Finance Act 1998. This requires that profits, "must be computed on an accounting basis which gives a true and fair view". This is terminology borrowed from company law, which requires the balance sheet and profit and loss account (separately) to give a true and fair view.[11] Section 42(2)(a) makes it explicit that this does not require compliance with the Companies Act 1985, "except as to the basis of computation", but it is clear that the section envisages that compliance with the accounting principles of the Companies Act will give a true and fair view.

4.17 This term is not, however, restricted in its application to company law. The ASB states that accounting standards are applicable to financial statements that are intended to give a true and fair view [12] and that compliance with accounting standards

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[8] See Chapter 3, note 54.
[9] Tax Bulletin, Inland Revenue, February 1999, p.624.
[10] *Heather v. P-E Consulting Group Ltd* (1972) 48 TC 293 at 322F, commenting on the value to be put on the evidence of accountants following the decision in the *Odeon* case.
[11] Companies Act 1985, s. 228(2).
[12] Foreword to Accounting Standards, para.13.

will normally be necessary in order to give that view.[13] The SoP claims to have, "the true and fair view concept at its foundation"[14] and regards it as, "the ultimate test for financial statements".[15] Mary Arden's Opinion given to the ASB in 1993, following the recognition of accounting standards in the 1989 Companies Act, also suggests that the Court will infer from company legislation that accounts which meet the true and fair requirement will in general follow rather than depart from standards.[16]

4.18 Even if that point is open to argument, it would be hard to say that accounts which meet the accounting principles required by the Companies Act (which generally follow SSAP 2) would not generally meet the true and fair view requirement. This could be put more strongly: that following those principles is a prerequisite of a true and fair view. Of course, it is accepted in the Act itself that compliance with the accounting requirements of the Act may not suffice to give a true and fair view. This is clearly anticipated, however, to be the exception and is no more than a recognition of the fact that not all circumstances can be covered by generalised rules.

4.19 The issue is whether true and fair is an appropriate criteria for tax purposes: does it have a special meaning in the context of company law and potentially a different one for tax purposes? Or is it broadly the same whenever it is used in connection with accounts? Quite clearly the ASB considers that the term has the potential for wider application than companies; this is evident in the primacy given to the true and fair view test in the Financial Reporting Standard for Smaller Entities ("FRSSE"). Equally, it is clear that true and fair is not a matter of exactitude; the same transaction can be represented either in accord with a particular standard or in accord with the FRSSE and either would give a true and fair view. It follows that what underlies the true and fair view must be a matter of principle rather than of detail.

4.20 The principle that the SoP identifies, whilst not defining the meaning of "true and fair", is that, "financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed".[17] This seems to fit almost exactly Sir Thomas Bingham's requirement that for tax purposes generally accepted accounting practice should not be "inapt". The problem, however, remains this: that the appropriateness or otherwise of accounting is defined by the needs of the audience.

4.21 We are accordingly driven back to asking whether the needs of investors are consistent with the needs of the tax system. We have no explicit criteria, however, for determining what is apt for tax purposes. The assumption seems to be that accounting is apt, "subject to any adjustment required or authorised by law"[18] (which would presumably reflect the needs of the tax system).

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[13] *ibid* para16.
[14] SoP, para. 13.
[15] *ibid* para. 10.
[16] Opinion para. 7, reprinted as an Appendix to the Foreword to Accounting Standards.
[17] SoP, para 12.
[18] FA 1998, s.42(1).

The Court's attitude to accounting practice

4.22 The modern judicial approach to accounting practice appears from *Gallagher* v *Jones*, where Sir Thomas Bingham said this—

> "The object is to determine, as accurately as possible, the profits or losses of the taxpayers' business for the accounting periods in question. Subject to any express or implied statutory rule, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which legislation requires to be answered."[19]

4.23 There can be no doubt that there has been a shift in the way in which the courts have dealt with cases involving accounting issues since the issue of accounting standards, particularly since the establishment of the ASB. While it was the case that the courts would take accounting practice as a starting point, it was probably true that ordinary principles of accounting were considered to apply, "except when the courts decide they shall not be applied".[20]

4.24 Over the years—years in which accounting practice was not evidenced by formal statements of practice from a committee appointed under statute—the courts have accepted accrual accounting, initially rejected prudence as a basis for determining taxable profit, required profits and losses to be realised before they can be taxed (subject to the lower of cost and market rule for trading stock) and required consistency of application of accounting practice from one period to another. In doing so, they were exercising judge-made rules as to what constituted, "the correct principles of commercial accountancy"[21] for the purposes of taxation.

4.25 The current position is that, "the reason why the courts rightly attach so much importance to accepted principles of commercial accounting in this context, is of course, that these principles will normally afford the surest means of ascertaining the *true* profits or losses of a trader".[22] The courts now recognise the problem of second-guessing accounting practice: "If we reject the statements of approved accountancy practice … then where are we to look for the criterion?"[23]

4.26 The recent case of *Herbert Smith v Honour* throws into relief the relationship between the current position and earlier precedents. Earlier cases,[24] in which the court

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[19] *Gallagher v. Jones* (1993) 66 TC 77 at 123B.

[20] See Chapter 2, note 16.

[21] *Odeon Associated Theatres Ltd v. Jones (Inspector of Taxes)* (1971) TC 257 at 272.

[22] [1993] STC 537 at 561g.

[23] ibid. 559j.

[24] *Edward Collins & Sons Ltd v. IRC* (1924) 12 TC 773, and *Whimster & Co v. IRC* (1926) 12 TC 813.

had decided that deducting a provision for future liabilities was not permissible for tax purposes, were held to be of insufficient authority given changes in the generally accepted principles of commercial accounting. Thus current accounting practice really does hold sway.

4.27 The decision did not, however, consider the different purposes of taxation and accounting. The provision in *Herbert Smith* would be recognised under FRS12, the standard on accounting for provisions, as an onerous contract.[25] The accounting purpose is to provide information as to the business' financial position, and this includes information as to future obligations. It only follows, however, that it should be recognised as a loss in measuring the income for a period either if the balance sheet approach is taken or if the prudence concept (as applied under SSAP 2) justifies it.

4.28 For tax purposes, the difficulty is not in recognising future expenditure. Instead it is in recognising now future expenditure that will be incurred in generating future incomings, albeit at an insufficient level. Arguably, this is in contrast to, say, the situation where a lease premium has been paid and future rental receipts will produce a shortfall. Here the value of the lease would be reduced to its recoverable amount. The resultant relief for tax purposes would be justified on the basis that the loss (the excess expenditure) had already been incurred.

4.29 This last example is identical to the position taken on valuing stock and work in progress at the lower of cost or recoverable amount (market value). It reflects not an *a priori* definition of income but an attitude to uncertainty. Traditionally, accounting prudence would wish to recognise future losses so as to ensure that distributions were restricted and capital was not depleted for the future by the expected losses. The difference for tax is that losses in the future should attract tax relief, that is tax recovery, whereas reductions in capital consequent upon losses cannot.

4.30 The *Britannia Airways* case,[26] which also involved provision for future expenditure, similarly points to the limited usefulness of the prudence concept as gleaned from SSAP 2 and the Companies Act. The provisions allowed in that case would no longer be acceptable under FRS12. The case also shows the dangers of applying accounting practice on a piecemeal basis rather than as a whole: the provision would not meet the definition of a liability in the SoP and therefore cannot be charged to the profit and loss account notwithstanding that there has been a cost associated with using the aircraft. Accordingly, the provision would not now be acceptable for tax purposes.

4.31 Accounting practice, however, would now increase the rate of depreciation to reflect this cost. This would not be possible for tax purposes unless depreciation for tax also followed accounting. Similarly, the standard would recognise the decommissioning costs of an oil rig as a liability as soon as it was constructed. There would, however, be no immediate charge against profits; this would come through the

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[25] See paras. 71-74 and App. III example 8.
[26] (1994) 67 TC 99.

depreciation charge, having added the prospective decommissioning costs to the cost of the oil rig.

4.32 This is another example of the problem of tying tax to a moving target. It does nevertheless indicate that the courts are able to make decisions on the evidence of broad accounting principles. What has to be resolved is whether the application of the principles is to accord with specific accounting standards, whether the courts should determine their application or whether legislation should be used to adopt specific standards.

Statutory Developments

Foreign exchange and financial instruments

4.33 Increasingly new statute law does refer to accounting practice. What is revealing about these statutes is not just the explicit reference to accounting practice but also the particular accounting practices that are accepted for tax purposes and the traditional tax practices that are being discarded.

4.34 The Finance Act 1993 [27] introduced rules for taxing foreign currency gains (FOREX), and the Finance Act 1994 [28] rules for interest rate and currency contracts, based largely on accounting treatments and applicable only to companies. Under the FOREX rules, exchange gains and losses are recognised on an accruals basis regardless of whether there have been any transactions. Unrealised gains are thus recognised, and without reference to whether they are capital or revenue gains.[29]

4.35 There are provisions that allow certain unrealised gains to be deferred and that permit assets and liabilities to be matched.[30] Specific reference is made to one currency translation method outlined in the Accounting Standard on Foreign Currency Translation (SSAP 20). The 1994 legislation provides for profits or losses to be calculated either on an accruals basis or on a mark to market basis (which recognises unrealised gains), so long as the computation accords with normal accounting practice. Normal accounting practice is not defined. Provision is made for dealing with changes in the basis of accounting as between one period and another.[31]

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[27] Pt. I, Ch. II.
[28] Pt. IV, Ch. II.
[29] The Finance Act 2002 will repeal the 1993 Forex legislation and assimilate it into the Financial Instruments and Loan Relationship rules, see Inland Revenue, *Loan Relationships, Derivative Contracts and Foreign Exchange Gains and Losses, A Technical Note*, 19th December 2001.
[30] Under the new regime the original deferral relief will not be retained and new matching rules extend the previous relief so as to be as effective as possible.
[31] "The new regime will enable taxable profits to follow accounting profits more closely, with few departures from UK GAAP required", Inland Revenue, *op cit*, para 2.4.

Loan relationships

4.36 The taxation of loan interest, and allowance for interest paid, was completely reformed by the loan relationships legislation introduced in the Finance Act 1996.[32] The provisions also apply only to companies. They identify as authorised accounting methods either an accruals basis (according to transactions over time) or a mark to market basis of accounting (according to payments and receipts and changes in value over a period), providing that the method applied conforms to normal accounting practice.[33]

4.37 The tax base may thus depart from the traditional transactions base and admit valuations. This is, however, only in respect of assets for which there is a ready market. It ignores the traditional tax divide between capital and revenue transactions and also allows for the use of different methods as between different relationships, and over time for the same relationship.[34] Consistency is thus not a requirement, but the consequences of changes in the accounting treatment are legislated for in sections 89 and 90 Finance Act 1996.

Leasing

4.38 The 1997 Finance Act resorts to accounting practice as a defence against tax avoidance in connection with finance leases. Section 82 and Schedule 12 apply to any taxpayer but refer to accounting practice as it would apply for companies. There is no explicit reference to the Accounting Standard for finance leases (SSAP21) [35] and this raises the question whether this or the FRSSE would apply in any particular case.

4.39 At the heart of the accounting treatment is accounting for substance rather than form. Thus anti-avoidance legislation is again resorting to an approach that the courts, rightly or wrongly, have been reluctant to embrace to its fullest extent. The legislation also, however, does not adopt the accounting practice in full, with the result that the Schedule is concerned with adjusting for the interface between normal accounting practice and tax, both for income and chargeable gains, and sets out its own definitions covering both fundamental matters such as asset, lease, lessor, etc., as well as those inherent in adapting accounting practice to tax computations.

The accruals basis

4.40 The Finance Act 1998, apart from introducing the true and fair requirement, also included an explicit statutory recognition of the traditional accrual basis required by precedent for many years in tax law (s.46(1)), but only to the extent of not being limited by cash payments and receipts. It does not therefore embrace the matching concept traditionally associated with accruals in accounting and implicit in the Companies Act. Intentionally or not, however, it is in line with accruals as defined in

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[32] Pt. IV, Ch. II.
[33] FA 1996, ss. 85,86.
[34] S.90(1).
[35] A standard which owes its existence to preventing accounting "avoidance" in the form of undisclosed liabilities in the balance sheet.

the Exposure Draft on Accounting Policies. Additionally in s.44 and Schedule 6, there is a scheme for dealing with a change in the basis of accounting from one period to another: the implication of the evolving nature of accounting practice is thus formally recognised.

Research and development

4.41 Relief and tax credits for research and development (R&D) were included in s.68 and Schedules 19 and 20 of the Finance Act 2000. The definition of research and development used for the purpose of company accounts is adopted for all taxpayers but, in this instance, provision is made for the Treasury to prescribe particular activities either as being or as not being within the definition.[36] The ICTA 1988 is amended[37] (inserting s.82A) to allow the deduction of expenditure on R&D in computing profits, provided it is not of a capital nature.

4.42 This hardly adds certainty since the meaning of capital is far from clear. By contrast, for example, the FRSSE refers to fixed assets being capitalised, expenditure on pure and applied research being written off in the period of expenditure and development expenditure being similarly written off unless certain conditions exist. In that latter event, the expenditure may be deferred and written off during production for so long as the conditions apply.[38] Fixed assets would almost certainly constitute capital expenditure for tax purposes but pure and applied research and development are not so defined for accounting purposes as to render it impossible that what is written off for accounting is regarded as capital for tax and written off under the Capital Allowances Act. The question is why there is a need to retain the distinction between capital expenditure for tax purposes and capitalised expenditure for accounting? Certainly it was unnecessary for the purpose of targeting the company tax relief or tax credits since this is restricted by the familiar technique of limiting the benefits to qualifying expenditure.

Mobile phone licences

4.43 The 2000 Finance Act also contains provisions relating to the rights acquired under the auction of mobile phone licences (s.87 and Schedule 23). Here, the draftsman has abandoned the tax divide between capital and revenue expenditure in favour of normal accounting practice, although the draftsman has found it impossible to discard completely the old language. Normal accounting practice is again defined by reference to company accounting, although the detailed provisions are apt to cover both the principles in the Companies Act (the traditional accounting approach) and the latest accounting principles as set out in the SoP.

4.44 Expenditure or receipts that can be accounted for through the profit and loss account under normal accounting practice are treated as “revenue” items for tax purposes, providing they are in fact so treated in any statutory accounts. Expenditure that does not result in an asset, or gains in respect of the disposal of an asset, is

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[36] Now TA 1988, s. 837A(3).
[37] By Sch.19 para. 5(1).
[38] Paras. 5.1-5.8.

included in the computation of profits. Any gains or losses arising from the revaluation of the rights are also included, but regardless of whether they are in fact so included in the accounts, providing that would be the appropriate treatment under normal accounting practice.

4.45 The period in which they are recognised for accounting purposes determines the timing of recognition for tax purposes. Accordingly, if the right is revalued, whether by depreciating it or by uprating its value, the change in value is treated as a "revenue" item for tax purposes in that accounting period. There is no requirement that assets should be revalued or that if some are they should all be. The requirement is only that if assets are revalued the changes are to be included in the tax computations, however they are dealt with in the accounts. This is presumably in recognition of the fact that gains on revaluation would not under company law be credited to the profit and loss account but to a revaluation reserve.[39]

4.46 The other requirement protecting the tax base is that the tax treatment for an individual company, both as regards expenditure written off and gains and losses on revaluation, must not be more cautious than that adopted in the consolidated accounts for a group of which the company is a member.[40] This requirement for consistency with published accounts is clearly aimed at preventing the taxpayer taking advantage of the leeway in accounting standards by adopting one basis for tax purposes and another for reporting results.[41]

4.47 Subject to that, it is noteworthy that the rate of write-off of expenditure is essentially constrained only by normal accounting practice; there are no special tax capital allowances. On the other hand there is a disincentive to revaluing a right upwards (even if this would be appropriate for the purpose of giving relevant information in the balance sheet) since that would automatically incur a tax liability because the gain has been recognised even if not included in the statutory profit and loss account.

Intellectual property, goodwill and other intangible assets

4.48 Following an extended consultation process, the Finance Act 2002 will introduce a new regime for taxing intangible assets. The draft legislation [42] is said to follow accounting practice as closely as possible in terms of both the scope of the new regime and its computational approach. The legislation applies to expenditure on the full range of intangible assets according to their accounting definitions and tax relief will generally be given on a basis that matches the write-off in companies' accounts. As a result, accounting profits and losses on goodwill and intangible assets will for the future be brought into account as income.

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[39] Companies Act 1985, Sch. 4, para. 34.

[40] Sch. 23, para. 4.

[41] By producing accounts for the company (which is the tax unit) on one basis, and the group accounts (which are published) on another.

[42] See *Taxation of Intellectual Property, Goodwill and other Intangible Assets: Draft Legislation*, A Technical Note by the Inland Revenue, 27th November 2001.

4.49 At the same time, however, the new legislation incorporates a relief to allow profits on realisation of intangible assets to be rolled over on reinvestment. The draft legislation also incorporates rules for intra-group disposals and for a variety of business reorganisations. Thus, while the new rules adopt the accounting rules as the basis of their approach, they reflect a number of features of the current tax system, producing a comprehensive new regime for the taxation of intangible assets that incorporates both accounting elements and provisions drawn from elsewhere within the existing tax system.

Conclusion

4.50 Much of this legislation has been necessary because the rules, although consistent with accounting practice, are contrary to normal tax practice as developed over the years. In particular it crosses the capital – revenue divide created for tax, but not applied in the same way in accounting. Thus, formally aligning taxable profits in general more closely with accounting profits might simplify the legislation by allowing the repeal of some of these specific provisions.

CHAPTER 5. A POSSIBLE FUTURE APPROACH

The questions for consideration and their context

5.1 In the light of the previous discussion, we return to the issue of whether it suffices to let this area of tax law develop case by case without any formal definitions or principles, or whether we should seek to legislate to embrace accounting principles and practice either wholesale or in part; or has the adoption by statute of the true and fair view criterion for tax purposes already effectively done this? Whatever the answer to these questions the direction of development as evidenced by the review of recent legislation is clear: there is a trend towards explicitly adopting normal accounting practice as the basis for measuring taxable profits.

5.2 The present approach is that normal accounting practice as applied to companies is extended to all taxpayers. This is evident from the general requirement that the true and fair view is the basis for measuring profits. To limit alignment to companies would leave outstanding for the unincorporated sector all the current problems that arise from the lack of a coherent framework for the measurement of business income. It would run counter to the present trend of using standards as evidence of accounting practice acceptable beyond the corporate sector. It would also potentially increase the distortions that already exist between one business medium and another, thereby raising issues of economic neutrality and equity.

5.3 Accounting is an evolving process and accounting standards are subject to change and development. In particular, the trend to the globalisation of standards is evident in the European Commission's acceptance of International Accounting Standards for quoted companies. If control of business taxation is to remain within the national domain, however, it might be thought that any legislation should be framed by reference to UK principles and standards rather than standards that may be determined elsewhere.[1]

5.4 In this respect, the true and fair view concept is now a facet of European company accounting. If it is thought desirable to be able to determine taxable income for UK businesses free of any future EU accounting requirements, arguably the true and fair view should cease to be a standard by which to measure business income for UK taxation. Legislation specifying the principles upon which profit measurement is to be based, and possibly secondary or tertiary legislation accepting or rejecting specific standards, may prove to be the only way of maintaining control over what is to be taxed as business income in the UK. In saying this, we make no judgment on this matter but it illustrates that it will be increasingly difficult for discussion of the closer

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[1] Wilson suggests that, "countries with a strong tradition of tax linkage are likely to maintain at least two financial reporting regimes: IAS for consolidated accounts, and existing national GAAP for individual accounts", whilst the UK will apply IAS standards to all companies. Allister Wilson, *Financial Reporting and taxation: Marriage is out of the question*, [2001] British Tax Review, pp. 86-91.

alignment of taxable and accounting profits to be confined to the UK's national boundaries.

The definition of income and the taxable entity

5.5 The conclusions from this review begin from the premise that there is no coherent set of principles to be gleaned from tax law and administration that can be readily identified with any normally accepted concept of income. This might not have seemed out of place in a context where there was nowhere in the practical affairs of business any formal attempt to define, even approximately, the concept. Now, though, (through the independent ASB) there is evidence as to what is understood by the concept of income in business. This has been formalised in general by the issue of the SoP, and in particular through Financial Reporting Standards, and is also evident in the requirements of the Companies Act 1985.

5.6 In the light of those developments, the issue for consideration is whether, in the interests of certainty, tax policymakers should now be explicit as to the concept of income that is being used generally as a measure of the tax base, either following that used by the ASB, or the Companies Act, or differentiating from both. In particular, the suggestion is that taxable income should accord with generally accepted notions of that concept at least over the lifetime of a business, even if there are differences in the periodic measures of income. If it is otherwise that raises the question as to whether income is an appropriate measure of taxable capacity in the first place.

5.7 Tax could follow accounting wholesale or in part, or it could formulate its own rules. Whatever it does it should recognise the business as the entity for which income is being measured. This means that over the life of a business all transactions [2] would be recognised at some time in computing business income, unless they represent capital funding or repayment (which might be limited to transactions with owners or extend to all loans) or distributions (including personal consumption) to funders.

5.8 It also means that distinctions by source, limitations of loss off-set as between sources (including capital gains here as a source), and disallowance of expenses as being remote from a source (though not from the business) would disappear. The idea of taxing transactions entered into in the course or furtherance of a business is already familiar from VAT and it would not seem problematic to introduce it for income or corporation tax purposes.

The general application of accounting principles and practice for tax purposes

5.9 To align taxation completely with accounting principles and practice would be to require compliance with both accounting principles and accounting standards by all businesses. If only the principles or some particular standards are considered acceptable, then arguably legislation is now necessary in order to stop all standards being applied, because recent court decisions have reverted essentially to the position

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[2] Admitting only those undertaken wholly and exclusively for the purposes of the business.

that statutory modification is the only limit to the application of accounting principles and practice.

5.10 Clearly, it is not every standard that deals with issues of income measurement; some deal with matters of presentation, while others are concerned primarily with the balance sheet and only with the profit and loss account consequentially. Moreover, standards are developed in the knowledge that only certain companies of substantial size will have to comply with them. This suggests that the ASB sees these standards as concerned primarily with the presentation of information and that the costs associated with preparing that information may outweigh the benefits in the case of smaller entities.

5.11 It is in recognition of this problem that it has issued the FRSSE. This is specifically aimed at all entities, incorporated or not, which have to prepare accounts on a true and fair basis. Compliance with it would seem to meet the requirements in tax statute to reflect company accounting practice; and in so far as it deals with issues involved in income measurement it would in principle be suitable for adoption as the basis for the taxation of businesses in general. That its adoption is voluntary so far as the ASB is concerned is immaterial since statute can simply require compliance for tax purposes, but, because it refers to much more than matters of profit measurement, it might nevertheless be preferable in the interests of certainty and clarity to legislate specifically in this area.

Legislating accounting principles and practice for tax purposes

The need to specify general principles

5.12 The question that arises if we do legislate is whether either the legislation, or the accounting principles to which it might refer, can be sufficiently robust. The approach originally taken by the ASC was that—

> "In applying accounting standards, it will be important to have regard to the spirit of and the reasoning behind them. They are not intended to be a comprehensive code of rigid rules … It would be impracticable to establish a code sufficiently elaborate to cater for all business situations and innovations and for every exceptional or marginal case."[3]

5.13 Given the UK's tradition of statutory interpretation it would be dangerous to assume that legislation would be interpreted by reference to some unspecified spirit or reasoning; yet legislation would have to be robust enough to cover all business situations without detailing every conceivable case. This is the very purpose of principles, and is the challenge for any legislator.

5.14 General principles could be legislated for (in line with the Companies Act accounting principles) with the proviso that either the Inland Revenue or the taxpayer may opt on a consistent basis to apply any UK accounting standard that is not in

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[3] Explanatory Foreword, para. 5.

contravention of statute. This would give a less consistent application of standards across taxpayers but it might be a more practicable solution for a range of taxpayers. It would also provide a default position for both parties in the absence of agreement as to the application of the principles to the facts of the case.

The boundaries of acceptable accounting practice

5.15 The legislation to adopt more formally normal accounting practice (as opposed to specifying acceptable principles) as the basis for taxing business income need not be detailed and overlong, as FA 2000 Schedule 23 shows. The objective of the legislation would be to define the boundaries of what accounting practice is acceptable for tax purposes. The boundaries would be set according to the needs of the tax system rather than being dictated by the role of accounting as part of an information set.

5.16 By what criteria would we define these boundaries? Reliability and objectivity of the measurement of income are primary for tax purposes,[4] whereas as we have seen relevance to investor decision-making is at least equally important for accounting. It is thus appropriate for tax purposes to measure income by reference to past transactions, and this, too, is the starting point for accounting.

5.17 Transactions take place with parties external to the business and without any special relationship between the parties, they provide objective evidence as to value. The potential for divergence as between tax and accounting is in ***when*** transactions are recognised: here the requirement to provide information relevant to assessing the past performance and predicting the future performance of a business may determine that gains and losses are recognised at a different time from that which would apply if reliability and objectivity were the sole criteria. Since the timing of the tax charge follows the timing of recognition, this divergence is critical.

Recognising income

5.18 As we have seen, accounting now determines the measure of income according to whether assets and liabilities are recognised; the recognition of revenues and expenses is the consequence of this rather than being the starting point. This does not preclude tax legislation taking as its starting point the revenues and expenses recognised in accounting practice and adjusting this for tax purposes. Traditionally income has not been recognised either for tax, or for distribution under company law, unless it has been realised. Accounting now pays much less regard to this as a criterion for recognition, but it would seem appropriate to retain it for tax, notwithstanding that some markets for particular assets have indeed developed to the extent that market valuations can be regarded as reliable and objective.

5.19 To retain realisation as a criterion for recognising income is consistent with a transaction-based measure of income, and would maintain consistency and thus equity through the tax system, particularly with regard to capital gains where disposal (and thus realisation) is the basis for a tax charge. It might be concluded, however, that

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[4] In the context of this discussion; considerations of economic neutrality and equity are of course also relevant.

realisation is not a robust enough distinction for determining when losses arise (see below). Should this be the case then gains and losses on revaluation might be included in the computation of taxable income, but subject to certain constraints.

5.20 First, the only admissible valuation basis would be net realisable market value;[5] replacement cost, as used under the value to business or deprival value basis for accounting, would not be acceptable[6] because, as noted above,[7] revaluation at replacement cost does not represent any income as generally understood. Second, if revaluation is used, then it should be required to be used for all assets of the same class in order to stop taxpayers "cherry-picking" losses; this would then require legislative definition of classes of assets. A qualification to this, which would apply even if realisation were maintained as a threshold for recognition, would be required to cover the case of assets becoming of permanent negligible value.[8]

Recognising expenditure

5.21 Recognition of expenditures is generally more problematic. By definition, expenditure that has taken place refers to a past transaction and there will be evidence of it. When that expenditure should be recognised in measuring income, however, has still to be determined. Accounting would now recognise the expenditure as it ceases to represent an asset. There seems no reason not to accept this for tax purposes, except that the measurement involved in determining how much expenditure still resides in an asset (and thus how much is allocated at any time as a charge against income) is not an exact science.

5.22 It is impossible to say that an accounting measure is right but it is equally impossible to say that the measure given by, say, capital allowances is right.[9] Both are approximations but in principle the accounting measure, if the result of the faithful application of the accounting standard, should be more appropriate to the individual circumstances of any one business than a specified rate of depreciation applied across the generality of taxpayers. The issue is whether compliance with an accounting standard can be monitored and enforced when a large number of taxpayers are not subject to audit.

5.23 In deciding whether expenditure does still reside in an asset, accounting refers to the recoverable amount of the expenditure. This involves consideration of the amount that the asset could be sold for and its value in use—valuation. However, this is not to say that gains and losses are being recognised on the basis of unrealised valuations. It is a way of determining how much of the expenditure, which objectively is known to have taken place, is to be regarded as having been consumed. As such, it is no different from spreading that expenditure over what is predicted to be its useful

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[5] Potential realisation costs would be recognised in the same way as a provision for future expenditure related to recognised income.
[6] The effect of not recognising replacement cost would mean that there would be no tax consequences if businesses were to revalue assets for reporting purposes.
[7] See Chapter 3, note 820.
[8] See TCGA 1992, s. 24.
[9] Hence the necessity for separate provisions for short and long life assets.

life. This process can be distinguished from revaluing assets according to market price and including the holding gain or loss in income, as accounting reports may now do in the interest of providing information that is more relevant. This latter gain or loss does not arise from a transaction; but while this criteria clearly excludes gains arising from revaluation is it sufficient to exclude losses?

5.24 Expenditure, the benefit of which is extinguished either by being consumed in production or through the effluxion of time, is recognised as expenditure in the period in which the benefit is extinguished. Can this be distinguished from expenditure on an investment that is no longer matched by the current market value because the future returns are expected to be lower than predicted at the time of investment (the expenditure)?

5.25 The only basis for a distinction is that one type of asset is held for the purpose of consuming it in use, the other is not. Thus, if realisation is to remain a criterion, the choice is either to distinguish between different classes of asset, those held for use in the business and those held for investment, or to not recognise for tax purposes expenditure which would be recognised for accounting purposes on account of the market value having fallen below transaction cost (subject to negligible value exemption to permit recognition of expenditure which has become permanently valueless).

5.26 In the case of expenditure that is spread over its useful life, the tax relief lags the expenditure; in the case of provision for future expenditure, the relief will precede it. Nevertheless this is the logical consequence of measuring income according to transactions and is merely the mirror image of recognising expenditure not when it is made but when its benefits are used up in generating gains. Future costs associated with past transactions that have been recognised as realising a gain have to be provided for if the gain from those transactions is to be completely measured.

5.27 The same does not, however, apply to the recognition of future losses where the transactions giving rise to those losses have not yet taken place. For accounting purposes the leases in *Herbert Smith* would represent onerous contracts (and thus liabilities) arising from a past transaction. However that past transaction was not sufficient in itself to generate either a gain or loss; it required the future transactions of paying and receiving rents, and whatever the certainty of the future amounts involved, it would seem consistent with the realisation criterion to recognise both when the incoming is realised.

Legislative recognition of the relationship of tax and accounting

5.28 Clearly there remain differences between accounting and tax measures if the above divergences are accepted, suggesting that the ideal of full alignment in order to minimise both compliance and enforcement costs is unlikely to be realised. Nevertheless tax can still rely substantially on accounting practice, and legislation making the extent of this reliance, and the differences, explicit could be formulated.

5.29 A possible approach is reflected in the form of the draft section set out below:[10]

> "1. Subject to the provisions of this section and any other provisions of the Taxes Acts, the gains and losses of a business shall be computed for an accounting period by accounting for past transactions between the business and other parties under the historic cost convention according to the transaction consideration and without regard to the date of receipt or payment of cash.
>
> 2. Transactions shall be recognised in an accounting period according to normal accounting practice except as set out in subsection 3.
>
> 3.1 Transactions shall be recognised on the assumption that the business is a going concern except when the accounting period is one in which the business ceases.
>
> 3.2. Gains from transactions shall be recognised in the accounting period in which they are regarded as realised in accordance with normal accounting practice.
>
> 3.3 Losses arising from future transactions shall only be recognised for an accounting period in so far as they can be matched in accordance with normal accounting practice either with transactions that have already been recognised or with that accounting period.
>
> 4. Adjustments to the gains or losses of prior periods resulting from changes in accounting policies with regard to the recognition of transactions shall be accounted for in the accounting period in which the changes are first applied.
>
> 5. Gains or losses computed for prior accounting periods shall only be adjusted in respect of corrections of errors, and errors shall not include normal recurring adjustments or corrections of accounting estimates in prior periods.
>
> 6. Subject to the provisions of this subsection gains or losses arising from the revaluation of assets and liabilities to a value not based on transaction consideration shall not be included as gains or losses.
>
> 6.1 The valuation of stock and work in progress shall be regarded as an accounting policy governing the recognition of transactions in an accounting period under subsection 2.
>
> 6.2 Where assets have become of negligible value the loss may be recognised in the period in which claim is made to that effect.

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[10] This is included both to give some substance to the idea of legislating for accounting principles and to provide some sort of standard against which to test any potential transaction or accounting practice with a view to establishing whether it is clearly covered by the legislation. It also provides a reference point for seeing whether existing legislation could be repealed.

7 Transactions between the business and its owners, or persons connected with them, shall be measured according their fair value rather than their transaction consideration.

8. The Treasury may by regulation specify which accounting standards, or parts thereof, shall not be regarded as normal accounting practice for tax purposes, and specify alternative accounting treatments provided they are consistent with the provisions of this section.

9. In this section—

"business" includes any activities undertaken in the furtherance of any trade, adventure in the nature of trade, profession or vocation;

"normal accounting practice" means normal accounting practice in relation to the accounts of companies incorporated in a part of the United Kingdom, as applied in the accounts of the business, and where the business is a company which is a member of a group, as applied in the consolidated group accounts;

"owners" means in the case of an unincorporated business its owner or partners in the business, and in the case of a company its members; and persons connected with them shall be determined in accordance with....

"accounting standards" means accounting standards issued or accepted by the Accounting Standards Board;

"for tax purposes" means for the purposes of calculating the amount of any profits chargeable to income or corporation tax.

"fair value" is the consideration that would apply to an arm's length transaction."

5.30 Effectively the legislation is setting out the accounting policies that apply for tax purposes. In the terms of FRS 18[11] it is defining the process whereby transactions are recognised and measured for the purposes of taxation. Computation would thus be transaction based using the familiar accruals concept and measuring at historic cost, as at present. The transaction base and historic cost measurement provide the objectivity necessary for a tax system. Under this legislation, normal accounting practice would determine when expenditure was recognised and would replace the traditional capital/revenue distinction. The exceptions provide for the period of account being one in which the business ceases, and for retaining the realisation basis both for gains and losses, thus reversing the *Herbert Smith* decision.

5.31 Having limited the tax base to transactions, gains and losses on revaluation are here automatically excluded, but with some familiar examples being permitted. This is done by regarding the valuation of stock and work in progress as an accounting policy that determines how much expenditure is recognised in a period. Depreciation would

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[11] para. 4.

similarly be regarded as the recognition of the initial outlay, rather than a revaluation, reflecting the distinction between adjustment of historic cost and revaluation at current value made in the SoP. Bad debts are covered by allowing recognition of losses related to transactions already recognised. Unrealised losses are excluded by referencing revaluations to transaction consideration.

5.32 The reference point by which normal accounting practice is defined is company accounting, and since the practice is based on principles, these are subsumed within this term. Practice is assumed to be evidenced by standards, so a negative power is given to exclude application of any standard, and a positive power to prescribe alternative accounting treatments. So far as is possible definition and language is consistent with that used in accounting standards and the SoP.

5.33 The alternative to legislating by reference to accounting practice is to draw up an equivalent to the FRSSE exclusively for tax purposes. This could mirror those parts of the FRSSE considered appropriate, starting with the statement of accounting principles and either replicating or explicitly varying the accounting treatments adopted. It could also permit companies to adopt the accounting treatment offered by particular standards so long as reflected in the statutory accounts and unless specifically barred by regulation simply as a means of reducing compliance costs.

5.34 This does seem to be the only feasible alternative to relying on accounting standards as evidence of accounting practice. Whatever the concerns of the standard setters, it cannot be denied that accounting standards do reflect accounting practice. The present position is that tax follows accounting practice; therefore, we can only cease relying on accounting standards for tax purposes by introducing a separate accounting code for tax purposes.

Conclusion

5.35 This discussion started by noting that income measurement is a purposive activity. An outline of the accounting purpose has been offered by reference to the accounting standard setting process. Its purpose is clearly different from the taxing purpose but it is questionable whether the difference necessarily disqualifies accounting income from being used as the basis for taxing income. One of the attractions of the standard setting process is that it is undertaken by an independent body which is not concerned with the tax implications of its deliberations; both the taxpayer and the Revenue can take some comfort from this. Although formalised accounting principles and standards do not eliminate uncertainty from income measurement, it is difficult to believe that taxation of income in their absence was an any more certain process.

5.36 The question today is whether we can we bring increased, but not absolute, certainty to our tax system by legislating for accounting principles which are appropriate for tax purposes and not inconsistent with those on which accounting practice is based. The application of those principles would still be open to review, and the criterion for review would still be generally accepted accounting practice except to the extent that it is barred by statute.

5.37 This might seem to reflect the *status quo,* and as such add nothing, but what it would do is to delineate which accounting principles and practices are and are not acceptable for tax purposes. Rather than assuming that accounting practice will determine taxable profits subject to review by the courts on the basis of unspecified principles, we would have a reference point against which to judge the appropriateness or otherwise of accounting practice as it develops.

CHAPTER 6. Issues for Consideration

6.1 Even if it is thought desirable to align accounting and taxable profits in a more formal and structured manner, we should consider the possible consequences of such a development. Much would depend on the nature of the legislation: whether it dealt with principle only, or whether it incorporated all accounting standards, and the degree of flexibility built into the legislation.

6.2 One issue is the potential loss of control over the tax base resulting from following income measurement formulated by a body other than the Treasury. A further question, from the perspective of the Accounting Standard setters, is whether the consensus presently necessary for the evolution of standards and improvement in financial reporting would be more difficult to achieve if tax consequences necessarily expected to follow (although arguably they potentially do at present). Thus rather than usefully building upon a continually evolving process, the more formal alignment of tax and accounting may limit the progress of the evolutionary process.

6.3 A further consideration, as for any legislation, is whether the very act of legislating to achieve a more formal and structured alignment of tax and accounting may itself make the system less flexible. Whilst the judicial response to accounting principles and practice may be to an extent ad hoc (depending upon the nature of the cases that come before the courts), it may be more malleable and fit better with evolving standards than formal legislation. On the other hand the judicial function is ideally suited to the application of legislated general principle to the particular facts of given situations.

6.4 Against that background and given that—

a. there exists in accounting standards a body of evidence as to accepted accounting principles and practice promulgated by an independent body;

b. the courts and the Inland Revenue have increasingly accepted this practice as appropriate for measuring taxable income whether or not the entity is subject to the accounting standards regime;

c. new statute has been explicitly formulated around accounting standards

d. statute requires that business income be measured on a true and fair basis,

is it now appropriate for taxable income to be aligned more formally and consistently with accounting income, or is it adequate that alignment and differentiation should continue to evolve on an ad hoc basis?

6.5 Income is currently the tax base and we assume that this will continue. The essence of income as a tax base is that it should be comprehensive. Different measures of income, although according with a common general concept, give rise to different measures in different time periods. Nevertheless, over the lifetime of the business different periodic measures will aggregate to the same lifetime measure of business

income. However a particular periodic measure will determine the timing of tax liabilities and this different periodic measures will result in different lifetime tax burdens.

6.6 Subject to disallowance of items reflecting personal consumption through the medium of the business, should we expect as a minimum that over the lifetime of a business aggregate periodic accounting and taxable incomes should equate; and does this imply that all gains and losses recognised in a period for tax purposes should be netted off regardless of source and regardless of whether traditionally considered as capital or income? Should we be taxing the income of the business rather than a trade?

6.7 Tax systems are commonly judged by the criteria of economic neutrality, equity and administrative feasibility. Economic neutrality and equity are usually consistent with each other in that both require that the same activities should be taxed identically. Administrative considerations in applying the tax, however, may result in the first two criteria not being met.

6.8 Do the criteria of economic neutrality and equity require that there should be a common approach to income measurement for all businesses? Does administrative feasibility suggest that taxable income should be aligned with accounting income in order to minimise compliance and enforcement costs?

6.9 Accounting principles and practice as evidenced by the development of accounting standards have evolved since 1970. A review of that development suggests that the direction of evolution is away from a mere calculus, resulting in a bottom line measure of profit, towards a more general and rounded package of information that is intended to be understood as a whole. What is included in that package is now determined by whether or not certain qualitative characteristics are met.

6.10 The primary requirement is that the information be relevant to a wide range of users in assessing stewardship and making economic decisions. In that context, accounting income provides a measure of performance but the concern is equally to report on financial position in a relevant way. Whilst information will not be relevant if it is not reliable, what has characterised the development of accounting measures is a willingness to accept a lower threshold of certainty than has been previously been the case in the interests of greater relevance. Nevertheless, accounting reports are still based on past transactions and events.

6.11 Is there necessarily a higher threshold of certainty for tax than for accounting? If so, is it nevertheless sufficient for the purposes of aligning tax with accounting that accounting starts from past transactions and events?

6.12 Two other qualitative characteristics which might seem problematic are—

a. that information should represent faithfully the substance or commercial effect of transactions and not merely their legal form,

b. that transactions need only be reported consistently with accounting standards if they are material, materiality being a relative concept.

If these qualities are problematic, is it possible to resolve the problem for tax purposes by requiring disclosure of any transactions in relation to which these characteristics have been invoked?

6.13 Relevance and reliability are significant in the choice of the measurement basis. Assets and liabilities are measured initially according to the consideration given in the past transactions, essentially the historic cost procedure. However, there may be remeasurement to current value if there is reliable evidence as to its value, and a mixed measurement system may be applied using a different valuation basis for different categories of asset. Consequently, gains or losses may be recognised whether or not they have been realised, and either on the basis of realisable value or replacement cost.

6.14 Should realisation be retained as a basis for recognising gains and losses on holding assets for tax purposes? If this principle is departed from for some categories of asset or liability, should the valuation basis be limited to realisable value?

6.15 Alignment with accounting would mean recognising expenditure (subject to personal consumption rules) in accordance with accounting treatment. In particular, this would mean that we should recognise accounting depreciation and abandon the traditional revenue law distinction between capital and income. The capital allowance legislation would be redundant and other measures would be needed if it were thought desirable to offer incentives to encourage investment.

6.16 Should the revenue law distinction between capital and revenue expenditure be abandoned? Would measures be required to protect the revenue from over-depreciation of assets and how should any investment incentives be provided under a regime that relies as a basic rule on accounting depreciation?

6.17 The true and fair requirement is a term borrowed from company law and is thought to imply acceptance of accounting standards. It is also now part of EU company law and the EU is currently considering which accounting standards should be required for EU company law purposes. Accounting standards are thus increasingly becoming subject to international pressures and negotiation.

6.18 Should the true and fair view requirement be removed in order both to ensure that inappropriate accounting standards are not forced onto the UK tax system, and to retain control over the UK tax basis?

6.19 It seems likely that whatever the advantages of aligning tax with accounting, there are going to remain differences. Currently, there is no certainty as to how far alignment does or will apply, or where divergence will arise.

6.20 Should we now legislate in order to make explicit how far measurement of taxable income should follow accounting principles and practice and, if so, at what level of detail?