Accounting and taxation: Conjoined twins or separate siblings?

Prem Sikka
Essex Business School, University of Essex, Colchester, Essex CO4 3SQ, UK

A R T I C L E   I N F O

Article history:
Received 28 November 2016
Accepted 9 December 2016
Available online xxx

Keywords:
Tax avoidance
Accounting
Transfer pricing
Accounting standards
Unitary taxation

A B S T R A C T

This paper explores the relationship between accounting and taxation through the recent proposals for curbing corporate tax avoidance advanced by the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU). The OECD is content to tweak pricing and fails to address the faultlines of accounting. The EU is promoting ‘unitary taxation’ and advocates a major reform of the way taxable profits are to be calculated. As IFRS have reduced the usefulness of accounting numbers for taxation purposes, the EU has sought to recalibrate basic elements of accounting. This has considerable implications for the development of accounting.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

The corporate tax system is in crisis as intensification of economic globalization has enabled corporations to shift their profits to low/no tax jurisdictions and avoid paying taxes in countries where their economic activity is primarily located (US Senate Permanent Subcommittee on Investigations, 2005, 2008a, 2008b, 2013; UK House of Commons Public Accounts Committee, 2013a, 2013b, 2013c). The revenues lost due to tax avoidance, including those relating to corporate practices, are hard to estimate, but the European Union (EU) estimates the “level of tax evasion and avoidance in Europe to be around €1 trillion [£830 billion or US$1.25 trillion]” (European Commission, 2012), equivalent to 7–8% of the gross domestic product (GDP) of all EU member states. The US Treasury has estimated its tax gap (tax avoidance, evasion and arrears) to be $385 billion.1 A large number of transnational corporations pay little/no tax by using complex organizational structures and accounting techniques to shift profits to little/no tax jurisdictions (US Government Accountability Office, 2008, 2013; UK House of Commons Public Accounts Committee, 2013a, 2013c).

Faced with the ability of corporations to shift profits and erode the tax base, nation states have sought to attract capital by offering lower corporate tax rates (Organisation for Economic Co-operation and Development, 1998; KPMG, 2013). For example, the UK corporation tax rate has declined from 52% in 1982–20% in 2016, the lowest ever and is set further decline to 17% by 2017. However, the reduction in the headline corporate tax rate has neither stemmed tax avoidance nor checked the ingenuity of the tax avoidance industry to craft novel schemes (Mitchell and Sikka, 2011). Unsurprisingly, the erosion of tax base and profit shifting has become a major international political issue (International Monetary Fund, 2013a,

E-mail address: prems@essex.ac.uk


http://dx.doi.org/10.1016/j.accfor.2016.12.003
0155-9982/© 2016 Elsevier Ltd. All rights reserved.

Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), http://dx.doi.org/10.1016/j.accfor.2016.12.003
Since corporate taxes are levied on profits, any attempt to address profit shifting needs to pay attention to the role of accounting practices in determining taxable profits. Historically, profit/loss as shown by the annual financial accounts has been the starting point for computation of taxable profits, but for a considerable period taxation and accounting practices have followed divergent trajectories (Green, 1995; Whittington, 1995) resulting in increased complexity, uncertainty and leakages of tax revenues (Sikka and Willmott, 2010; European Commission, 2001). The accounting definitions of assets, liabilities, income, and expenses have been unable to prevent corporations from conjuring-up intangibles assets, management fees and royalty programmes and avoid taxes (United States Bankruptcy Court Southern District of New York, 2004). Commentators have noted that intragroup transactions “can reduce or even eliminate profits in one place at a stroke of an accountant’s pen” (Action-Aid, 2012: 8); businesses “exploit accounting rules to move money around to reduce or entirely evade tax liabilities” (Christian-Aid, 2009: 4) and “transfer pricing is the leading edge of what is wrong with international taxation” (Sheppard, 2012).

The efforts to check erosion of tax base and shifting of profits have resulted in two broad proposals for reform. The first approach advanced by the Organisation for Economic Co-operation and Development (OECD), and supported by many corporations and accountancy firms, advocates ad hoc reforms to patch-up the current system for taxing corporate profits (OECD, 2013a, 2013b, 2013c, 2014, 2015). Its main aim is to strengthen documentation of transfer pricing practices and restrict tax relief on interest payments. The OECD does not scrutinise the role of accounting logics in taxation and does not propose any fundamental changes to the way tax liabilities are calculated. In contrast, a second approach under the heading of ‘unitary taxation’ pays attention to the role of accounting and calls for a fundamental reform of the way corporate tax liabilities are calculated. It has many similarities with the Common Consolidated Corporate Tax Base (CCCTB), a system advocated by the European Union (EU) for taxing transnational corporations operating within the EU (European Commission, 2001, 2003, 2011, 2015a, 2015b, 2016). The key idea of unitary taxation and CCCTB is to eliminate profits on all intragroup transactions and treat consolidated profits as the tax base. These profits can then be apportioned to each jurisdiction according to a formula and taxed by the relevant EU member state, in accordance with its democratic mandate (Picciotto, 1992; Weiner, 2005; Clausing and Avi-Yonah, 2007; Avi-Yonah, Clausing, & Durst, 2009).

This paper examines the role of accounting in both the OECD proposals for checking tax avoidance, and the calls for adoption of unitary taxation. This paper is divided into four further sections. The first of these (Section 2) provides a theoretical framework for understanding politics of profit shifting by corporations and the consequent erosion of the tax base upon which a nation state can levy corporate taxes. It argues that the intensification of neoliberalism in the form of competition and mobility of capital has created opportunities for tax avoidance. It has also undermined the previously agreed international rules for calculation of corporate tax liabilities. Section 3 explains that the OECD seeks to manage tensions between accounting and taxation by minimal adjustments to transfer pricing rules for determination of profits that a state can tax. It argues that this strategy cannot adequately address profit shifting and check tax avoidance. Therefore, an alternative approach is needed and section sketches the main contours of unitary taxation. Section 4 examines some of the problems and possibilities of the role of accounting practices in unitary taxation, particularly the variants of CCCTB, a version of unitary taxation, promoted by the EU. Section 5 concludes the paper with a summary and reflections on the role of accounting in the tax base debate.

2. Profit shifting and erosion of tax base

Taxation revenues are the basis of the modern state as without them it cannot perform its administrative or redistributive functions. The tensions between the state’s willingness to levy taxes and taxpayer’s willingness to pay have encouraged tax avoidance and even resulted in revolts and revolutions (Daunton, 2001; Frecknall-Hughes, 2007). Nevertheless, taxation revenues remain central to the functioning of the modern state and tensions are managed through policy adjustments and concessions to powerful segments of society.

The intensification of contemporary corporate tax avoidance has coincided with the rise of neoliberalism, which has encouraged mobility of capital. Historically, liberalism has been a complex amalgam of contradictory ideas, concepts and philosophies from the left and the right of the political spectrum. Some elements promoted ideologies about the rule of law, democratic governance, egalitarianism and an antipathy towards unrestricted capitalism (Gray, 1995). It also encompassed progressive thinkers, such as John Maynard Keynes and William Beveridge, who envisaged progressive taxation, constraints on the movement of capital and a key role for the state in redistributing wealth to create a more equitable and just society. However, since the 1970s, under the influence of writers such as Milton Freedman and Friedrich August von Hayek, liberalism has been rapidly transformed into neoliberalism (Harvey, 2005). The neo or newer elements are strong faith in free markets, pursuit of economic efficiency through cost reductions, global mobility of capital and a restricted economic role for the state. Competition is a key concept and is to be applied to every sector of society, including corporations, nations, government departments, schools and hospitals because this somehow secures efficient allocation of resources and opens the door to wealth and riches.

2 See Harris (1997) for further details.
Neoliberalism has been eagerly embraced by governments in the UK and USA and vigorously exported to other countries through foreign direct investment and trade agreements, and by financial institutions, such as the International Monetary Fund, the World Bank, and the World Trade Organization. Neoliberalism not only informs the economic and social policies of governments, but also provides everyday understandings of what it means to be successful. It interpellates individuals as competitive beings engaged in the endless accumulation of private wealth and consumption. Individuals are expected to meet performance targets and be rewarded accordingly. One consequence of this has been to institutionalise performance related pay for executives often linked to reported profits (Committee on the Financial aspects of Corporate Governance, 1992; Committee on Corporate Governance, 1998). The linking of pay to corporate earnings has incentivised executives to develop strategies to shift profits and avoid taxes (Gaertner, 2014; Levine, 2014). With the average tenure of the chief executives of listed companies at less than five years, the temptation is to build high personal rewards in the shortest possible time, even if that entails avoidance of taxes and erosion of a nation’s tax base. A necessary condition for the operation of markets and pursuit of self-interest is that all individuals, including business enterprises, need to be constrained by social norms and regulatory structures. Such constraints induce stability, predictability and a sense of fairness which is essential for any social system to work. However, the sense of social cohesiveness is increasingly undermined by uncertainties induced by mobility of capital and its ability to escape local taxes (McSmith, 2010). Tax authorities now openly state that the “corporate tax base is under threat. What’s happening is unacceptable to the community, the government, and to regulators”.4

Despite contradictions, the state remains a key site for the congealment of competing social interests (Habermas, 1976: Ofé, 1984: Harvey, 2005). Its sovereignty and disciplinary power has been mobilized to promote competition and mobility of capital, which in turn have consequences for tax revenues and sustainability of social settlements relating to it. The rapid dismantling of currency exchange controls and barriers to cross-border trade, investment and economic flows has enabled capital to roam the world in search for higher profits. This search is not constrained by any sense of social welfare because corporations have “no intrinsic commitment to product, to place, to country, or to type of economic activity. The commitment is to the accumulation of capital. Therefore, the capitalist will shift locus of economic engagement (product, place, country, type of activity) as shifts occur in the opportunities to maximize revenues from undertaking” (Wallerstein, 1996: 89). Freed from the limitations of territorial jurisdictions, corporations can easily establish subsidiaries, affiliates, joint ventures, special purpose entities and trusts in favourable geographical locations to arbitrage global tax systems and lower their tax liabilities. Whilst the shifting of physical production functions takes time, intangible assets and intellectual property can easily be (re)located to desirable jurisdictions, and transfer pricing practices can be manufactured to shift profits (International Monetary Fund, 2013a).

Microstates, often known as tax havens or offshore financial centres, have become key nodes in global mobility of capital and have been particularly innovative in using their sovereignty to craft low/no tax laws that offer shelter to footloose capital in return for company registration fees (Palan, 2002; Sikka, 2003: Smith, 2013). In fact, corporations can exploit the laws of any country, onshore or offshore, to shift profits and avoid taxes in one or more jurisdictions. This is aided by a lucrative tax avoidance industry, staffed by accountants, lawyers and finance experts (Sikka and Willmott, 2010; Mitchell and Sikka, 2011). In neoliberal economies, markets constantly exert pressure for ever higher returns, but do not provide any guidance on upper limits of accumulation, or moral constraints that encourage reflection on social consequences of tax avoidance. Corporate executives are expected to create “systems designed to ensure that the corporation obeys applicable laws, including tax . . .” (OECD, 2004, p. 58), but in contemporary enterprise culture ‘bending the rules’ for personal gain is considered to be a sign of business acumen. Novel interpretations of tax laws, regardless of the social consequences, are considered to be acceptable as long as they produce private profits, especially where competitive pressures link promotion, prestige, status and reward, markets, niches with meeting business targets. Those able to sail close to the wind are seen as financial wizards, and are much in demand as advisers and consultants (Mitchell and Sikka, 2011).

In 1848, Marx and Engels wrote that with the march of capitalism “All fixed, fast-frozen relations, with their train of ancient and venerable prejudices and opinions, are swept away, all new-formed ones become antiquated before they can ossify. All that is solid melts into air, all that is holy is profaned . . .” (Marx and Engels, 1992: 6). So, it is with taxation too as the neoliberal revolution and the accompanying mobility of capital has destabilized the present system for taxing corporate profits and with it the state’s ability to collect tax revenues and meet obligations mandate through the ballot-box. The current system of taxing corporate profits is the outcome of numerous international treaties, court cases and protocols, some more than a century old (Picciotto, 1992, 2011), crafted at a time when western colonial powers controlled large parts of the globe and were keen to prioritize their local financial interests. Legal cases such as Calculata Jute Mills v. Nicholson (1876) 1 Tax Cas. 83 at 103, enunciated principles which continue to inform international corporate taxation. In this case, the company was registered in England, but had no property, or office other place of business in the UK. The largest amount of capital, as well as the greatest number of shares, was owned by persons residing in India, at that time a British colony. The company

---

3 The Daily Telegraph, ‘CEOs must keep learning to avoid the five-year axe’, 18 May 2013 (http://www.telegraph.co.uk/finance/businessclub/managment-advice/10064862/CEOs-must-keep-learning-to-avoid-the-five-year-axe.html; accessed 30 August 2015). Another global study noted that the median tenure for a global CEO is just 2.75 years. (http://www.personneltoday.com/hr/high-ceo-turnover-could-damage-uk-firms/; accessed 30 August 2015). Financial Times reported that 23% of FTSE100 companies replaced their chief executive during the period May 2013 to April 2014 (http://www.ft.com/cms/s/0/b4c51d78-7639-11e4-a777-00144feabdcd.html#axzz411n3C00; accessed 30 August 2015).

manufactured and sold jute in British India. Its entire property was located in India and all books of accounts, papers, and other documents, as well as its moneys, were kept, received, and dealt with by the management in India. The local control was exercised by a director based in India who also executed orders sent from a director in London. The court held that on this basis, the company was resident in London and liable to pay taxes on its entire profits in the UK rather than India.

In the case of De Beers v. Howe [1906] AC 455, 22 TLR 756, 5 Tax Cas. 198, the company had diamond mines in South Africa and these were managed from its head office in Kimberley. Its general meetings were always held there. Some of the directors and life governors lived in South Africa, and there were directors’ meetings at Kimberley as well as in London, but the majority of directors and life governors lived in England, where its chairman Cecil Rhodes also had an office. The court decided that the control was exercised from London and the company was resident and taxable in England. The judges added that “The test of residence is not where it is registered, but where it really keeps house and does its real business. The real business is carried on where the central management and control actually abides”. Companies soon began to use the same rules to shift profits and avoid taxes. An early example was the case of Egyptian Delta Land and Investment Co. Ltd v. Todd (1929) 14TC119, where the company was registered in London to develop land in Egypt, but shifted its board of directors to Cairo consisting entirely of Egyptian nationals, and thus its profits were not taxable in England. One consequence of the above cases is that corporate profits are taxed where companies are controlled (or resident) rather than the place where economic activity for the creation of those profits takes place. The complexities increased with the expansion of international trade, especially as other nations devised competing rules for taxation of profits. Eventually, in 1928, model tax treaties under the auspices of the League of Nations laid the foundations of the present international tax system (Picciotto, 1992, 2011). To address some of the dangers of double taxation, US had adopted the arm’s length model of transfer pricing (for example, see section 45 of the Revenue Act of 1928) and this was recommended in 1933 as a global standard by the League of Nations. It eventually became part of international treaties on taxation. These treaties were devised at a time when corporations were predominantly national and international economic flows were primarily in the form of trade and portfolio investment.

With the dismantling of currency controls and trade barriers, the patterns of international trade and investment have changed. Corporations are more likely to take direct control of operations through foreign direct investment. Consequently, the established ways of taxing corporate profits have become strained. Pressure for change has also been exerted by emerging economies, no longer under the control of colonial masters, as they seek to collect taxes from profits generated in their territorial jurisdiction. Additional complications have been created by information technologies which have enabled companies to create numerous subsidiaries and online operations, often obscuring where exactly the control resides, or a transaction takes place. Two issues are of particular relevance to this paper. Firstly, various treaties and protocols accepted the principle that “legal persons could reside concomitantly in a number of jurisdictions” (Palan, 2002: 172). This has severe implications. For example, global technology corporations such as Google, eBay, Microsoft, Starbucks, Apple and others have a common board of directors, shareholders and strategy and are thus integrated businesses rather than a loose collection of independent subsidiaries. In recognition of this, corporate laws in most countries require companies to produce consolidated financial statements to signify that they are integrated entities. Consequently, profits on all intergroup transactions are eliminated. However, for tax purposes each subsidiary, joint venture and affiliate is considered to be a separate independent entity. Various treaties enable each state to collect taxes on the profits of subsidiaries resident within its jurisdiction, but this raises problems of allocation, control and co-ordination amongst tax authorities. In a globalised economy, corporations generate profit through integration of their operations, but each state has to disaggregate it and decide how much of the profit is generated within its jurisdiction so that it can tax it. This opens the doors for shifting of profits and tax arbitrage.

Secondly, corporate taxes are generally levied on profits and historically common accounting methods, with some modifications, have generally been acceptable. However, the calculation of profits depends on theories of costs and revenues (Buchanan and Thirlby, 1973; Berry et al., 1985). The inherent malleability of costs and revenues creates considerable difficulties for tax authorities in estimating profits made in any geographical jurisdiction (US Treasury, 2007). In the face of considerable uncertainty, various working methods for allocation of costs began to be used, eventually culminating in the modern day transfer pricing guidelines developed by the OECD (Organisation for Economic Co-operation and Development, 2001, 2004, 2009, 2010). Transfer pricing methods can only work as long as arm’s length prices are available, which assumes that the markets are active, consist of a large number of independent buyers/sellers and can provide objective accounting numbers. Such assumptions are central to the OECD brokered system of corporate taxation, but have become highly problematical.

The next section provides a brief description of the OECD’s preferred approach to checking the shifting of profits.

3. Accounting and taxation: the OECD approach

The Organisation for Economic Co-operation and development5 (OECD) is a key node in the construction of the international system of corporate taxation. One of its major contributions has been to develop rules for transfer pricing for issues

---

5 Banks operate in hundreds of countries, but are supervised on a consolidated basis because their business is integrated (Arnold and Sikka, 2001; Goodhart, 2011)

6 The OECD is a successor to the Organisation for European Economic Co-operation, which was formed in 1948 to promote economic recovery in Western Europe after the Second World War. It originally had 18 western participants and one of its key roles was to implement the Marshall Plan for reconstruction

Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), http://dx.doi.org/10.1016/j.accfor.2016.12.003
arising from the intragroup transfer of good/services across national borders (Organisation for Economic Co-operation and Development, 1979, 2001, 2009). The rules have become part of a variety of multilateral agreements and form the basis for allocating corporate profits to each country. The rules require companies and tax authorities to use “arm’s length” prices for calculation of costs and profits. The arm’s length principle requires that “transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest” (Organisation for Economic Co-operation and Development, 2006: 176). The OECD framework treats “members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business” (OECD, 2010: 5). The absence of arm’s length price is a serious problem and the OECD states that when “transfer pricing does not reflect market forces and the arm’s length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted” (OECD, 2010: 4). The creation of intellectual property and intangible assets is a major feature of the contemporary economy. These assets are often very specific to a company (logos, trademarks) and do not have readily ascertainable market prices. Under such circumstances, tax authorities may resolve disputes by using proxies and making adjustments by using various methods (such as the Comparable Uncontrolled Price method, Resale Price Method, Cost Plus Method) and/or split of profits (such as the Transactional Net Margin Method and Comparable Profits Method).

The OECD principle of treating each subsidiary/affiliate as a separate independent entity fails to recognize that corporations have integrated operations so that they can achieve economies of scale and mop-up profits which would otherwise go to intermediaries. Such economic logics have resulted in corporate domination of the world trade. The top 500 transnational corporations control 70% of the worldwide trade, 80% of the foreign investments, 30% of the global GDP, one-third of all manufacturing exports, 75% of all commodities trade and 80% of the trade in management and technical services; just twenty controlled the coffee trade, four companies control 73% of the global grain trade and just one controlled 98% of the production of packed tea, and five companies control around 80% of the global trade in bananas (Fairtrade Foundation, 2009; Sikka and Willmott, 2010; Murphy, Burch, & Clapp, 2012). Thus, independent arm’s length prices are not easy to ascertain, and their absence plays a key role in tax disputes, profit shifting and tax avoidance. Developing countries claim that they are “losing public revenues as a result of tax malpractice, including transfer mispricing, hedging, tax incentive abuse and other tax-planning schemes, committed mainly by multinational enterprises through foreign direct investment” (United Nations Committee of Experts on International Cooperation in Tax Matters, 2014: 20). Developing countries, in particular, lack the resources to contest transfer prices used by multinationals and lose considerable revenues. One study estimated that in 2006, the mispricing of trade resulted in annual illicit financial flows from a number of developing countries of between $859 billion and $1.06 trillion, and the countries lost average tax revenues of between US$98 billion and US$106 billion annually over the years 2002–2006 (Hollingshead, 2010). The Chinese tax authorities claim that “Almost 90 per cent of the foreign enterprises are making money under the table. … they use transfer pricing to dodge tax payments.” In the face of corporate strategies for avoiding taxes, the international consensus around the arm’s length model is weakening and countries such as Brazil, India, China and South Africa are applying their own adjustments to transfer prices (United Nations, 2013). One consequence of this is that the same corporate profits may be subjected to taxation in more than one place.

The problems of securing arm’s length prices in a world dominated by global monopolies are well documented. For example, Michael Durst, who from 1994 to 1997 served as Director of the US Internal Revenue Service’s Advanced Pricing Agreement (APA) Program, has stated that

‘The basic tenet of arm’s-length transfer pricing—the availability of “uncontrolled comparables” for transactions between commonly controlled parties—is based on a fundamental misunderstanding of practical economics. Multinational groups form because in some industries and markets, it is economically infeasible to operate nonintegrated businesses. For example, in large markets, it is not feasible for manufacturers and distributors to be separately owned. That means that for transactions between members of multinational groups—precisely the transactions for which transfer pricing rules are important—the uncontrolled comparables on which the current rules try to depend seldom if ever exist’ (Durst, 2011: 443).

In his evidence to the US House Ways and Means Committee, Martin Sullivan, an economist at Tax Analysts, said that

“The arm’s length method is seriously flawed in both theory and practice. The theoretical problem is that because of synergies within a large corporations—what economists call ‘economies of scope’—the economic relationship between entities within a corporate group are not the same as those between parties. The practical problem is the lack of truly comparable unrelated transactions that can be used to apply the arm’s-length method to related party transactions. As manufacturing and the importance of national borders shrink, cross-border transfers of valuable intellectual property within a single multinational are becoming increasingly common. Unfortunately, this is the type of transfer pricing issue that poses the greatest challenge to the arm’s-length method. The simple reason is that intangibles by their nature are unique, and so it is always difficult, and frequently impossible, to identify transactions between unrelated parties involving the transfer of comparable intangible assets. Administering the arm’s-length method without com-

of Western Europe. In the 1990s, following the dissolution of the Soviet bloc, its membership expanded and covers 34 countries. Most notably, emerging economic powers such as Brazil, Russia, India, China and South Africa (collectively known as BRICS countries) do not have a direct membership of the OECD.


Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), http://dx.doi.org/10.1016/j.accfor.2016.12.003
parables is like playing hockey without a puck. Modifying the arm’s length standard will not get the job done. The only credible long-term solution is the defenestration of the arm’s length standard and its replacement with formulary apportionment methods.” (US House of Representatives Committee on Ways and Means, 2010).

In the face of challenges, the OECD could have revisited its principles of taxation and transfer pricing, but it has not done so. Its director told a UK parliamentary committee that the “current transfer pricing system ‘works more or less’, with the exception of some flaws.” Its Base Erosion Profit Shifting (BEPS) project (OECD, 2013a, 2013b, 2013c, 2015) remains wedded to the arm’s length and the separate entity approach. It claims that organised tax avoidance can be checked by tweaking transfer pricing practices (OECD, 2015) and “Improved and better-coordinated transfer pricing documentation will increase the quality of information provided to tax administrations” (OECD, 2015: 17). A number of countries have ‘thin capitalisation’ rules and the OECD recommends severe limits on the tax deductibility of interest payments on intragroup loans (Organisation for Economic Co-operation and Development, 2015), though the current international rules are by no means uniform (Blouin, Huizinga, Laeven, & Nicodème, 2014).

The OECD approach is problematical because it fails to address the fault lines identified above. It is challenged by “Unitary Taxation” which offers an alternative way of calculating taxable profits, tax liabilities and checking shifting of profits. It is often identified with formulary apportionment methods and Common Consolidated Corporate Tax Base (CCCTB) advocated by the European Union (Avi-Yonah et al., 2009, 2011; Clauzard and Avi-Yonah, 2007; European Commission, 2001, 2003, 2011, 2016; Picciotto, 1992; Weiner, 2005; US House of Representatives Committee on Ways and Means, 2010). Nevertheless, the OECD is not keen on unitary taxation and has declared “that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioural changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach” (OECD, 2013c: 14). A Deloitte partner has referred to concept of unitary taxation as “completely daft”8 and the UK government has opposed the initiative (UK House of Lords Economic Affairs Committee, 2013). In contrast, the International Monetary Fund (2013b) argued that there is considerable interest among civil society organizations and others in more radical alternatives to the current international tax framework, such as ‘formulary apportionment’… Even if the conclusion is that these are infeasible or undesirable, such schemes … deserve a more thorough and realistic assessment” (p. 14). Therefore, the next section examines the contours of unitary taxation and the role of accounting in determining taxable profits and tax liabilities.

4. Accounting and unitary taxation

Unlike the OECD approach, the concept of unitary taxation “does not allow the TNC to be taxed as if it were collection of separate entities in different jurisdictions, but instead treats a TNC engaged in a unified business as a single entity, requiring it to submit a single set of worldwide consolidated accounts in each country where it has a business presence, the apportioning the overall global profit to the various countries according to a weighted formula reflecting its genuine economic presence in each country. Each country involved sees the combined report and can then tax its portion of profits at its own rate” (Picciotto, 2012: 1). In supporting the system, Avi-Yonah et al. (2009) state that

“Under a formulary profit split, tax liabilities would reflect the economic reality of globally integrated businesses, and they would not vary among businesses based on their relative abilities to shift the ownership of intangible property. Firms would have no incentive to shift income across countries through legal and accounting techniques, as tax liabilities would be based on total world income as well as the share of a firm’s sales that occur in each destination. Moreover, since even the shifting of income involving legal and accounting techniques typically involves moving real activities to low-tax countries, the tax incentive to locate plant and equipment, as well as employment, in low-tax countries would also be reduced” (p. 507).

Unitary taxation can be applied globally, regionally (e.g. European Union countries) or unilaterally by nation states.9 Influential commentators have argued that a “Well conceived apportionment is the best – perhaps only – answer to the problem presented by multiple company tax jurisdictions” (Kay, 2012). A number of leading NGOs have argued that

“A unitary approach for the taxation of MNCs would better reflect how businesses operate in today’s globalised world. It would also make the aggressive strategies adopted by MNCs to avoid paying their fair share of tax pointless, especially artificial profit-shifting to tax havens” (Christian-Aid, 2013: 5).

10 It is used in the domestic context of some states, such as the US, Canada and Switzerland, within an agreed framework of law. It prevents domestic tax havens from depriving other regions of taxes. For example, a company can be registered in Delaware but trades in California. Its profits in California cannot escape taxes because it claims to be resident in Delaware. A formula, mainly related to sales, is used to apportion profits to all US states and then each state can tax it at the appropriate rate.
Central to all arguments for unitary taxation is the assumption that intragroup transactions do not add any economic value to overall wealth creation. Such logic is embedded in the principles for the production of consolidated financial statements. For example, the UK’s Companies 2006 Act requires that audited group financial statements must comprise a consolidated balance sheet and a consolidated profit and loss account for the whole group. The statutory requirements are built on the key idea that a group of companies under common control, ownership and strategies is not a disparate collection of entities, but is rather a single integrated economic unit. In this process, the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. All profits arising from intragroup transactions are eliminated from the consolidated accounts (International Accounting Standards Board, 2012b). The elimination of intragroup profits/losses is well established in accounting, but not generally applied to taxation. The reason for this is that international rules for corporate taxation (Picciotto, 1992) were crafted at a time when accounting rules for the production of consolidated financial statements were in their infancy and were often not required by law (Bircher, 1988; Edwards, 1991).

A crucial aspect of unitary taxation is the establishment of a tax base. This is generally understood to be the profits upon which tax can be levied. But which profits? One possibility is that financial accounting and taxation practices are so closely aligned that accounting numbers can furnish a meaningful tax base. If they diverge then nature of revenue and expenses for tax purposes would need to be (re)defined so that a common tax base can be determined and applied across a geographical trading bloc (such as the European Union), or maybe even across the world. These issues are explored below.

4.1. Using financial accounting as a tax base

Accounting practices are a sedimentsed residue of political negotiations and bargaining amongst economic and political elites in a dynamic social environment. Thus, sufficiency of social consensus gives accounting numbers, even when they are intellectually impure, the appearance of hardiness (Hines, 1988). The accounting numbers are contestable as they are always dependent on competing theories. Contemporary financial reporting is increasingly crafted to respond to the assumed needs of shareholders trading in capital markets. In contrast, taxation practices are always a matter of law, and are crafted by the state to manage social policy objectives and the interests of the state, shareholders and various segments of society are not necessarily aligned.

As financial accounting and taxation are both concerned with profits, a commonsensical view suggests that there should be a close relationship between the two. Generally, corporate tax computations begin with accounting profits and these are then adjusted for a variety of factors, such as capital allowances, accelerated depreciation, charitable donations, disallowable expenses, grants, credits, capital gains, etc. Depending on local histories and politics, there may be a high, partial or low dependence between accounting and taxation practices. Historically, countries, such as France and Germany were considered to have a closer relationship between company accounts and taxation, whereas UK, Ireland, Czech Republic, Denmark, Norway, Poland and the Netherlands had a higher degree of divergence between the two (Hoogendoorn, 1996; Richard, 2012). In any case, the relationship between accounting and taxation has fluctuated and is not precise (Aisbitt, 2002; European Commission, 1992; Porcano and Tran, 1998). Courts have been willing to consider accounting approaches, but have often found concepts, such as “depreciation,” “profits,” and “capital” to be too elastic and fuzzy for taxation purposes (Lamb, 2002).

The divergence between accounting and taxation practices is shaped by competing economic, market and political pressures. Conventional financial statements based on ‘generally accepted accounting principles’ may not necessarily be entirely acceptable for tax purposes. Some of the tensions are captured by court judgments. For example, in the US case of Thor Power Tool Company v Commissioner 439 U.S. 522 (1979), the presiding judge said that

“The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that “possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets. In view of the Treasury’s markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

This difference in objectives is mirrored in numerous differences of treatment. Where the tax law requires that a deduction be deferred until “all the events” have occurred that will make it fixed and certain . . . accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated. Conversely, where the tax law requires that income be recognized currently under “claim of right,” “ability to pay,” and “control” rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched.


Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), http://dx.doi.org/10.1016/j.accfor.2016.12.003
Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.

Questions about whether a particular item of expenditure is to be classified as capital or revenue has a major bearing on calculation of taxable profits. On this, the UK tax authority, Her Majesty’s Revenue and Customs (HMRC) states that “the question of capital or revenue is a question of law not of accountancy. What matters is the effect of the expenditure in question. Accountancy does not determine that effect but may be informative as to what was the effect”.12

The co-operation and divergence between accounting and taxation is also emphasized in the case of *Heather v P E Consulting Group Ltd* [1972] 48TC293 to support its position. The judge said that “The courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the courts. They are not to be deflected from their true course by the evidence of accountants, however eminent”

In *Herbert Smith v Honour* [1999] STC 173, the judge said that “In some cases accounts said to be correctly prepared according to generally accepted principles of commercial accounting are found to be based on an analysis of the factual position which is wrong in law. In such a case the correct legal analysis will override the accounts as prepared … In some cases the accounts properly prepared on generally accepted principles of commercial accounting have been found to be based on factual assumptions which are either insufficiently reliable … or simply inconsistent with the true facts … In either of these cases an approach more correctly or more reliably based on the facts will be adopted for tax purposes”.

Both taxation and accounting generally recognize that profits can only arise after capital of the enterprise is maintained or restored, but the practices can diverge and result in a variety of calculations from the same data (Hicks, 1965; Sterling and Lemke, 1982; Tweedie and Whittington, 1984). The extant US accounting standards generally advocate the maintenance of financial (or money) capital, whilst the IASB leaves businesses to select either maintenance of financial and physical capital. Historically, not only these but also proprietary, entity and other varieties of capital maintenance concepts have formed part of accounting standards to provide rough and ready relief for the erosion of capital base by price-level changes (Tweedie and Whittington, 1984). It is hard to discern any clear pattern of capital maintenance in current accounting practices as financial statements are a mixture of historical costs, fair values, market values, net realisable and present values. In contrast, taxation practices primarily provide relief for expenditure on the basis of historical costs, sometime adjusted for price level changes, and are closer to maintenance of financial (money) capital. The UK government position is that “There is merit in further alignment of taxable and commercial (i.e. accounting) profits. But if there are good policy reasons for departing from following accounting rules the Government is prepared to do so”.13

At the same time, it notes that “there is also a growing body of statute law that requires the accounting treatment to be adopted for tax. … for legislation which from 1 April 2002 may require the accounting entries in respect of goodwill, intellectual property and other intangible assets to be followed in computations of income for CT …”.14 Therefore, the next subsection considers whether international accounting standards can help to align accounting and taxation profits.

### 4.2. Financial reporting and the Era of markets

The divergence between financial reporting and accounting and taxation practices has accelerated as the state has delegated standard setting to private interest groups (e.g. International Accounting Standards Board, Financial Reporting Council). The ideological triumph of neoliberal philosophies have made the assumed needs of capital markets central to accounting standard setting and further constrained the possibilities of alignment between accounting and taxation prices (Lamb et al. 1998). The conceptual framework for financial reporting, initially developed in the USA and subsequently reformulated by the UK-based Financial Reporting Council and the International Accounting Standards Board, states that the general purpose of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (International Accounting Standards Board, 2013:195).

It further assumes that the primary users need information about the resources of the entity to assess its prospects for future net cash inflows and how effectively and efficiently management has discharged their responsibilities to use the entity’s existing resources. Thus, there is considerable focus on the use of market/fair values (Ryan, 2008; Power, 2010) which in the absence of any observable market prices are dependent on models based on assumptions, and can produce a wide variety of answers.

As a matter of general principle, tax reliefs are rarely, if ever, based on fluctuating market prices, or mathematical models. The income statements based on fair value accounting recognize unrealized gains as the emphasis is on making investors aware of possible future cash flows. This is in stark contrast to taxation principles where generally taxes are only levied after profit/gain from the disposal of an asset or the completion of a transaction has been realized in cash or cash equivalent. The focus on markets has

“added up to a weakening of a transactions-based, realisation focused conception of accounting reliability in favour of one aligned with markets and valuation models” (Power, 2010: 197).

Contemporary financial reporting standards do not give any explicit consideration to the interests of the state or broader society. They are not directly concerned with enabling the state to collect taxes though elements of accounting continue to influence the calculation of taxable profits and liabilities.

4.3. The mirage of convergence of accounting standards

Some have argued that the emergence of international accounting standards would somehow displace local histories, linguistic systems, and cultural mediations and lead to convergence around a single-set of accounting rules and by implication to a single unambiguous set of financial accounting numbers for tax purposes. For example, Picciotto (2012) claims that “Harmonisation of the tax base could be facilitated since many countries accept accounts for tax purposes based on corporate accounting principles, for which international standards now exist” (p. 11). In his evidence to the UK House of Lords Committee on Economic Affairs Sol Picciotto argued that

“there has been a high degree of convergence towards international accounting standards . . . it is possible to move towards greater co-convergence of standards to address the issues posed by multinational companies in a more integrated way. If we can do that for financial standards, I do not see why we cannot start working seriously on that for tax accounting standards and establish a template for combining country-by-country reporting . . . ”

Avi-Yonah et al. (2009) state that

“While there are still differences in accounting among countries, those are diminishing due to the spread of International Accounting Standards, which have been adopted in the EU and Japan” (p. 552).

The above claims may be persuasive as since January 2005 all EU companies listed on a recognized stock exchange have been required to prepare consolidated financial statements in accordance with the requirements of international financial reporting standards (IFRS). However, this does not necessarily provide evidence of convergence within the EU as national traditions and ways of making sense of cultural practices are not easily displaced by the recent advent of international accounting standards. Instead of convergence, there are varieties of adoptions, adaptations, modifications and recommendations; and even then there are a wide range of issues about translation of word/concepts and what they might mean in a particular cultural setting (Larson and Street, 2004; PricewaterhouseCoopers, 2010, 2012). Items such as goodwill have gone through considerable evolution in a number of leading capitalist economies and seem to have converged around “actuarial principles” (Ding, Richard, & Stolowy, 2008). However, the accounting treatment still differs. For example, IFRSs (IFRS 3, IAS 36, IAS 38) require that goodwill appearing in the balance sheet is not to be amortised. Instead, it is to be subjected to an annual impairment test. The resulting diminution, depending on circumstances, may be offset against revaluation reserve or can hit the income statement. In contrast, the German GAAP requires “goodwill to be amortised over its economic life… German GAAP requires an explanation in the notes to the financial statements if the economic life of goodwill exceeds five years” (PricewaterhouseCoopers, 2010: 22)

The global convergence of accounting poses questions about the role and survival national institutions and legislators, especially as their powers may be transferred to the IASB. Such political tensions are captured by Kirsch (2012) who asks “ What will be the role of the SEC in a world of harmonized financial accounting standards for filing, reporting, and listing on US exchanges? What role will the US Congress perceive to be the proper one for the SEC in a world of converged financial reporting standards?” (p. 49). Such considerations may have scuppered possibilities of the US participation in global convergence of accounting standards. For example, a Commissioner with the US Securities and Exchange Commission (SEC) has said that


Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), http://dx.doi.org/10.1016/j.accfor.2016.12.003
"I am not convinced of a need to abandon U.S. GAAP in favor of IFRS ... In practice and in reality, accounting standards may vary between jurisdictions due to legal and cultural factors, as well as differences in perspective. Remember, IFRS is not consistently implemented around the world".\textsuperscript{16}

In the words of a former chairman of the SEC,

"public companies and investors aren't saying clearly that they want it [IFRS]. That's why today there is not even a plan for expanding the voluntary use of IFRS. . . For those of you who remember Monty Python, I think Michael Palin, in speaking about John Cleese's parrot, said it best: This parrot is no more. It's not simply resting, or momentarily stunned. The prospect of full scale IFRS in our lifetimes has ceased to be. It is bereft of life. It rests in peace".\textsuperscript{17}

The chairman of the UK's Financial Reporting Council acknowledges that "we won't get total harmonization, that is having one set of accounting rules and standards across the world.\textsuperscript{18} A major reason for this is that competing histories have positioned accounting practices in a very distinctive way. For example, valuation of inventories is a crucial component not only for financial reporting but also of taxable profits. An almost universal doctrine is that inventories should be valued at the lower of cost and net realizable value. Such rules form part of domestic and international accounting standards (\textit{Financial Accounting Standards Board, 2005; Financial Reporting Council, 1988; International Accounting Standards Board, 2005}), and are favourably cited by tax tribunals and courts.\textsuperscript{19} All accounting norms are based on the principle that cost is the primary basis for estimating the value of inventory, but this apparent convergence marks differences which are firmly rooted in local politics (\textit{Parker, 1965; Noguchi, 2007}). Companies in the EU and former British colonies generally use a method known as First-In-First-Out (FIFO) for determination of costs, whereas companies in the USA use Last-In-First-Out Method (LIFO), a practice that is mandated by law (\textit{Davis, 1982; Pincus, 1989}). Following the US influence on its post-war reconstruction, Japan also uses LIFO (\textit{PricewaterhouseCoopers, 2012}).

Even the harmonization of global/regional accounting rules will not necessarily produce practices acceptable for tax purposes. For example, financial reporting standards define an asset as a 'resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'; and a liability is defined as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits" (\textit{International Accounting Standards Board, 2012a}). Such a definition does not provide a way of distinguishing sham or artificial assets from the rest. For example, in the UK case of \textit{Hifje News and Media Ltd & Ors v Revenue & Customs [2012] UKFTT 696 (TC)}, a media company decided to treat newspaper mastheads, which it already owned, as a new asset for the nominal amount of £1. The mastheads were then immediately leased to subsidiaries and collected over £51 million in royalties, which reduced the reported profits of some subsidiaries. The subsidiary companies then sought to secure tax relief for the payment of royalties paid to the parent company. The creation of the asset was overseen by Ernst & Young who in their capacity as auditors issued an unqualified audit report, signifying that for accounting purposes an asset had been created. The court considered the wording of relevant accounting standards and testimony of accounting experts, but decided that a valid asset had not been created and rejected the claim for tax relief on intragroup royalty payments.

The above examples illustrate some of the difficulties in producing uniform consolidated accounts. The relationship between accounting and tax practices is complex, and since the 1970s the two have followed divergent paths. Consequently, the gap between the two has increased as accounting standards seek to meet the assumed needs of capital markets, whereas taxation practices are closely aligned to law and social objectives pursued by the state. A survey of corporate tax systems in 153 countries shows that no country calculates tax liability by solely relying on profits recorded for financial reporting purposes (\textit{PricewaterhouseCoopers, 2014}). They all make adjustments (e.g. depreciation, disallowable expenses), to varying degrees, to accounting profits to arrive at taxable profits. Some of the problems for using IFRSs for tax purposes are captured in the following statement from the Indian tax authority.

"It is our conscious decision not to accept IFRS system for tax purposes. And we are not alone here; most countries in the world have followed this approach. Even the US does not have IFRS for tax purposes ... Our system is not ready yet to accept the IFRS system as a recognised system for income-tax purposes ... When you switch over from a historical costing system to a market value system, you can assign valuations which can lead to significant under-reporting of profits. This could lead to under-reporting of corporate income ... frequent reassessment of assets and liabilities based on fluctuating market value would raise problems in taxation, which is based on the cost of purchasing the


\textsuperscript{18} Reuters, UK watchdog expects progress on global accounting rules, 10 June 2014 (\url{http://www.reuters.com/article/2014/06/10/us-britain-accounts-idUKSBN0EL1P20140610}; accessed 26 April 2015).

\textsuperscript{19} For example see \textit{BSC Footwear Ltd v Ridgway [1971] 47TC495 and Symons v Lord Llewelyn Davies [1982] 56TC630}.
asset. The tax authorities have serious concerns over the sentiment-driven volatility integral to fair valuation of assets and liabilities, which could lead to under-reporting of income.\footnote{The Financial Express, IFRS system not conducive for taxation purposes, says Mitra, 7 April 2011 \url{http://www.financialexpress.com/news/ifrs-system-not-conducive-for-taxation-purposes-says-mitra/772775/}, accessed 18 July 2013.}

4.4. Accounting and the European union’s proposals for unitary taxation

The previous sections provided some background for making sense of some of the accounting issues raised by unitary taxation. Whilst financial reporting and taxation practices remain linked they are not harmonised. Financial accounting practices do not necessarily provide a tax base which is generally driven by state policy and law and courts are able to ignore or override interpretations of economic events offered by accounting practices. It is against this background that the European Union has sought to develop its version of unitary taxation, better known as Common Consolidated Corporate Tax Base (CCCTB). This section looks at some of the challenges that it offers to accounting practices.

In principle, the EU could have accepted the profits/losses produced by IFRS-based accounts, especially as companies tend to report higher profits to capital markets but prefer to report lower profits to tax authorities. However, there are a number of hurdles. Firstly, though there is EU wide corporate law, there are no equivalent corporate tax laws. So that framework needs to be developed, especially if the EU is to function as an effective single market. Secondly, conventional financial accounting definitions are not always suitable for tax purposes.

The first version of CCCTB developed by the EU envisaged aligning tax base with international accounting standards. For example, the Ruding Report said that

“The Committee believes that commercial accounts produced for financial reporting purposes should form the starting point for the computation of taxable income in all Member States. However, it draws attention to the fact that financial statements are not yet fully harmonized within the Community and even then would serve objectives other than tax” (European Commission, 1992: 37).

Since 2005, EU listed companies have been required to comply with IFRSs, but the previous ambition of aligning tax and accounting practices remained intact. Some difficulties in applying accounting rules for taxation purposes were noted (European Commission, 1992, 2003), but a subsequent press release\footnote{EU Commission, Commission company tax strategy – frequently asked questions, 25 November 2003 \url{http://europa.eu/rapid/press-release_MEMO-03-237_en.htm?locale=en}} said that

“The Commission suggests that if companies will be reporting profits according to a common standard then this common measure of profitability could be used as a starting point for a common EU tax base (i.e. a common definition of taxable profits)”.\footnote{European Commission, 2011: 5.}

A 2006 paper by the European Commission reiterated the need to develop CCCTB for their EU wide activities, but omitted mentioning the use of financial reporting accounting standards, or IFRSs, to provide a uniform tax base (European Commission, 2006). The EU seems to have recognized some of the difficulties associated in using financial reporting standards for tax purposes (see above) and abandoned the first version of CCCTB.

The second version of CCCTB said that

“Harmonisation will only involve the computation of the tax base and will not interfere with financial accounts. Therefore, Member States will maintain their national rules on financial accounting and the CCCTB system will introduce autonomous rules for computing the tax base of companies. These rules shall not affect the preparation of annual or consolidated accounts” (European Commission, 2011: 5).

The above suggested that the EU had embarked on a two-track development. The first track would continue to develop accounting standards for financial reporting, and the second would develop a framework for taxation treatment of individual transactions. No immediate convergence between accounting and taxation rules is envisaged though the calculation of taxable profits, as is the case now, will continue, to some extent, to be influenced by accounting practices.

The EU proposal contained 136 articles which could be considered to be the beginnings of a conceptual framework of accounting standards for taxation purposes (European Commission, 2011). In sharp contrast to current financial reporting practices, Article 9 stated that “In computing the tax base, profits and losses shall be recognised only when realised. Transactions and taxable events shall be measured individually…” Article 10 stated that “The tax base shall be calculated as revenues less exempt revenues, deductible expenses and other deductible items”. Article 12 explains the principles associated with deductible expenses and Article 14 deals with non-deductible expenses. For example, profits already taxed in other jurisdictions are likely to be excluded as well as expenses which are not fully deductible for tax purposes (for example, entertainment and hospitality). Article 59 adds that “In calculating the consolidated tax base, profits and losses arising from transactions directly carried out between members of a group shall be ignored”.

However, it should be added that the EU attaches very different meaning to the word “consolidated” in the context of CCCTB. It does not mean that all the members of a corporate group will be consolidated for tax purposes because all,
especially as group members residing outside the EU, may not be subject to EU wide tax laws. Rather, the EU position was that only those companies which fall within the EU jurisdiction, or those who choose to become subject to CCCTB, will be consolidated. For example, if Amazon operates in the EU member states of Luxembourg and Germany, then those operations will be consolidated and profit/loss on intragroup transactions for those two companies/countries will be eliminated. Of course, Amazon could move contentious transactions to subsidiaries outside the EU. If so, then the member states hope to secure information about the cost structure, royalty fees, etc. to adjust the tax computation, and they can also restrict the amount and type of transaction which will count for tax purposes. In short, CCCTB envisages consolidation of selected transactions for tax purposes rather than any equivalent of accounting consolidation of the entire group.

A transaction-based approach is central to the EU framework and a number of articles cover the tax aspects of various transactions. In contrast to the IASB’s rejection of the concept of prudence, Article 27 offers relief for likely bad debts – “reliably estimate the amount of the bad debt receivable on a percentage basis”. In contrast to the IASB’s preference for the incurred-loss model, Article 25 would grant relief for various accounting provisions – “…any amount arising from that obligation which can be reliably estimated shall be deductible, provided that the eventual settlement of the amount is expected to result in a deductible expense”. To check state-aid, disguised as generous tax deduction of depreciation of fixed assets, there are proposals (Article 36) to standardise the rates. The residues of historical logics are also evident. For example, Article 29 adds that tax relief for inventories “shall be measured by using the first-in first-out (FIFO) or weighted-average cost method”.

In 2015, the EU (re)launched its CCCTB project and this time seeking agreement on wider conceptual issues (e.g. what is permanent establishment) before tackling issues about consolidation with the statement that “the Commission will propose that work on consolidation is postponed until after the common base has been agreed and implemented (European Commission, 2015a: 8). In the next set of proposals, published in October 2016, Common Consolidated Corporate Tax base (CCCTB) morphed into a Common Corporate Tax base (CCTB) and the EU explained that the ‘CCCTB proposal was not going to be adopted in a single step. While there was progress and support on some important areas, discussions faltered on more difficult aspects, notably consolidation. In addition, it became clear that the original proposal needed to be adjusted to be truly effective in tackling tax avoidance and to respond to other challenges such as the need to incentivise R&D (European Commission, 2016). The emphasis is now on agreeing the tax base before moving on to consider the more complex issues of consolidation. The intention is, in due course, to make CCCTB compulsory for large companies (turnover of more than 750 million Euros).

5. Summary and discussion

This paper has examined the problematic relationship between accounting for financial reporting and for taxation purposes through the debates about corporate profit shifting and tax avoidance. Arguably, the two are related (simultaneously conjoined and separate) but are also on divergent paths as financial reporting is focused on the assumed interests of investors whereas taxation is concerned about levying taxes on realized corporate profits in accordance with the law.

For nearly a century transfer pricing has been the basis of the international system of corporate taxation enabling each state to levy taxes on corporate profits made in its defined geographical jurisdiction. This system is favoured by the OECD and is under strain because globalization has enabled relatively few corporations to control markets for goods and services and as a result arm’s length prices, central to any operation of transfer pricing, cannot easily be ascertained. In addition, capital has been freed from the prison of defined geographical jurisdictions and is able to engage in a variety of strategies to shift profit to low/no tax jurisdictions and avoid taxes in countries where economic activity takes place. Companies are able to form numerous subsidiaries and affiliates in low/no tax jurisdictions to avoid taxes. Under the OECD rules, each subsidiary of a transnational corporation is treated as an independent taxable entity and this enables transnational corporations to arbitrage the international tax system. For example, the top hundred companies listed on the London Stock Exchange (FTSE100) have 34,216 subsidiary companies, joint ventures and associates (Action-Aid, 2011). Under the current tax system, there are up to 34,216 diverse taxable entities even though they are controlled by only 100 corporations. This enables transnational corporations to shift profits through transfer pricing schemes and generally play-off one state against another. The administration of transfer pricing also entails huge costs, both for tax authorities and taxpayers, especially as the arm’s length model has become difficult to administer. Taxpayers and tax authorities try to make arbitrary adjustments to the prices put forward by the parties, resulting in considerable paperwork, cost and prolonged disputes as even tiny adjustments in prices can lead to large changes in corporate tax liabilities and revenues of nation states (Altman, 2006; Picciotto, 2011). For example, transfer pricing was central to dispute between GlaxoSmithKline (GSK) and the US Internal Revenue Service (IRS). The dispute relating to tax years 1989 through 2005 was eventually resolved in 2006 with the company making a


23 An incurred loss model assumes that all loans will be repaid until evidence to the contrary (known as a loss or trigger event) is identified. Only at that point is the impaired loan (or portfolio of loans) written down to a lower value.

Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), http://dx.doi.org/10.1016/j.accfor.2016.12.003
payment of $3.4 billion.\textsuperscript{24} For over 20 years, GS\K has also been involved in a transfer pricing dispute with the Canadian tax authority and after a 2012 Supreme Court hearing (Canada v. GlaxoSmithK\K ine, Inc., 2012 SCC 52),\textsuperscript{25} the matters were settled with an out-of-court agreement\textsuperscript{26} in 2015. Many developing countries are ill-equipped to negotiate transfer pricing rules with transnational corporations operating within their jurisdictions.

The OECD principles of ‘independent entity’ and transfer pricing are unlikely to impose a significant check on profit shifting, a major reason for leakage of tax revenues. In contrast, despite considerable challenges, unitary taxation has the capacity to check profit shifting (\textit{European Commission, 2015a, 2015b, 2016; Picciotto, 2012}). In this system the tax base consists of consolidated profits (on a transactional basis) of the group of companies. Thus, profits on all (or selected) intragroup transactions are eliminated and all (or selected) transactions through tax havens are negated on consolidation. In fact, it removes economic incentives for transfer pricing which are a central feature of contemporary tax avoidance strategies. Ironically, despite rejecting unitary taxation, the OECD seems to be moving towards some of its elements. For example, its recommendation that nation states restrict the deductibility of deductibility of interest payments on intragroup loans recognizes the principle that economic value is not added or lost until there is a transaction with third parties (Organisation for Economic Co-operation and Development, 2015).

However, unitary taxation also raises major questions, especially about the base on which tax is to be levied. How is to be calculated? Some hoped that the convergence of global accounting standards would generate the appropriate tax base or taxable profits. However, convergence of accounting practices is a long way away and in any case the resulting accounting numbers are not suitable for tax purposes. Financial reporting is driven primarily by the assumed needs of investors, traders and speculators in capital markets. It focuses on fair-market values and recognizes unrealized gains. In contrast, taxation is a matter of law; tax reliefs are primarily based for historical costs and only realized profits are taxable. This paper provided examples to show that on occasions courts have argued that conventional accounting definitions of asset, liability, income and expense do not provide the foundations for a tax base. Such tensions have informed the EU’s CCCTB project.

The initial CCCTB proposals from the EU assumed that IFRS based consolidated financial statements could form the tax base for its version of unitary taxation, but it soon retreated from that position. In the second version of CCCTB advanced by the EU, there is an explicit acceptance that financial reporting and accounting for taxation will develop along divergent paths for the foreseeable future. For the CCCTB project the EU has sought to define the meaning of transactions (revenues, profits, inventory valuation, depreciation, etc.) from a tax perspective. The most recent discussions (\textit{European Commission, 2016}) are focused on the construction of a tax base as that is considered to be a necessary requirement for the development of a single EU market with uniform rules.

For unitary taxation (or CCCTB) to be effective it may be desirable to have international agreement on the composition of tax base and apportionment formulas used for allocation of profits to each jurisdiction, but that is not essential. In fact, some nation states (see above for references to Brazil, India, China) are already tweaking transfer pricing methods and applying their own formulas for allocation of costs and profits (\textit{United Nations, 2013}), though this does create the possibility of double taxation. Unitary taxation may be attractive because it can be applied on global, regional (e.g. EU) and even unilaterally by any state nation, especially an economically powerful state. Unitary taxation does not impinge on the sovereignty of any nation as each country can tax its share of corporate profits at any rate consistent with its local social settlements. It constrains the ability of corporations to concoct intragroup transactions to avoid taxes, but will not inhibit the ability of capital to seek economies of scale by shifting physical production to more desirable locations. There is some working experience of applying unitary taxation, albeit in a domestic context, in federal states such as the US, Canada and Switzerland (see \textit{Avi-Yonah and Benshalom, 2010; Avi-Yonah et al., 2009}), and this may help the EU to refine its unitary taxation framework. However, major challenges remain in devising suitable formulas for apportionment of consolidated profits across EU member states and the entities which are to be consolidated, especially when they reside outside the EU in a defined national or regional context, or a jurisdiction (e.g. an offshore financial centre) which wishes to protect its interests by not being party to the new world of unitary taxation.

The debates about accounting and taxation present opportunities for scholarly research. For example, the EU decision to define the nature of some accounting transactions from taxation perspective (\textit{European Commission, 2011, 2015a, 2015b, 2016}) seems to herald the emergence of a possible conceptual framework for accounting for taxation purposes. In due course, it will probably need to cover tax treatment of diverse topics such as revenue recognition, construction contracts, tangible assets, intangible assets, borrowing costs, leases, provisions, etc (\textit{Sikka and Murphy, 2015}). Accounting standards for taxation may make nation states more sensitive to the impact of accounting on public revenues and may well challenge the authority of the International Accounting Standards Board, and its sponsors, to make accounting rules (\textit{Botzem and Quack, 2009}). Scholarly research can help us to understand the politics, processes and consequences of developing accounting standards for taxation purposes.


\textsuperscript{25} Text is available here http://www.lesialexis.ca/documents/2012S502.pdf.


Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? \textit{Accounting Forum} (2016), http://dx.doi.org/10.1016/j.acf.2016.12.003
Some may not be persuaded by the two-track development of accounting standards, one of financial and another for taxation, and in pursuit of economic efficiency may wish to align financial accounting and taxation practices so that the costs of producing tax accounts and annual financial reports are reduced. This would require major adjustments to the currently dominant conceptual frameworks for financial reporting (International Accounting Standards Board, 2013) and shift the focus away from the assumed needs of investors to other stakeholders. As tax is a matter of law, the revised conceptual framework would need to be part of law and subject to parliamentary debates. The scholarly community can offer reflections on possible future trajectories, their implications for the power of the state, corporations, financial reporting and the checking tax avoidance.

References


Please cite this article in press as: Sikka, P. Accounting and taxation: Conjoined twins or separate siblings? Accounting Forum (2016), xxx–xxx, http://dx.doi.org/10.1016/j.acfcor.2016.12.003


