How to Build a Bridge: Eliminating the Book-Tax Accounting Gap

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Article

HOW TO BUILD A BRIDGE: ELIMINATING THE BOOK-TAX ACCOUNTING GAP

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I. INTRODUCTION

Accounting is no longer a way to provide an accurate and unified view of a company's finances. Instead, it has become a means to an end. For the public books, the goal is to achieve smooth and steady earnings growth that will lift the value of the company's stock .... For the IRS, the goal is the exact opposite—keeping income, and thus taxes, to a minimum. ¹

In 1999, Treasury released data indicating a rise in book-tax differences in the late 1990s, which it interpreted as evidence of increased tax shelter activity. ² Although the latter contention remains unproven, ³ the implications of the data are clear. Whether corporations are engaging in abusive tax shelters or simply taking advantage of deliberate disparities between the tax and financial accounting systems, there has been increased “demand for tax-favored investing and financing activities, specific factors that generate timing and permanent differences between financial and taxable income, and factors that may create noise in the estimation of financial and taxable income.” ⁴
Since that 1999 report, a deluge of financial scandals has drawn increased public and governmental attention to the accounting methods used by U.S. corporations and their professional advisers. Corporations in the United States produce two sets of accounts each year. The financial statements given to investors and the public are prepared according to Generally Accepted Accounting Principles (GAAP), which include guidelines established by the private sector Financial Accounting Standards Board (FASB) and governed by the Securities and Exchange Commission (SEC). Tax law appears to base income reporting on financial reporting: “Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” In fact, however, the starting point for taxable income is vague. There is no requirement that the books used to calculate taxable income be the same as those used to produce the financial statements. A corporation may use different accounting methods for items within the same business, may combine cash and accrual methods, and may use different methods for different trades or businesses.

This Article argues that the asserted benefits of the book-tax divide no longer justify its substantial costs in terms of tax compliance, revenue collection, economic policy, and the perceived unfairness of the U.S. income tax laws. As Treasury, Congress, and numerous scholars and practitioners have recognized, when the tax consequences of a transaction are severed from the economic consequences, the results can be pernicious. The book-tax divide in particular opens an enormous gap within which corporations seeking to reduce tax liabilities can shelter reported financial income. To the extent that they do, the government and citizens are the victims. The resulting accounting gimmicks can often create a tax shelter for sophisticated taxpayers to reduce their tax liability—increasing the burden that the rest of the citizens must bear. Capital market investors also fall prey to the book-tax divide, since it creates opportunities for businesses to mislead shareholders and investors about a firm's actual economic health. Moreover, as discussed further below, the complexity of maintaining two separate sets of books (three for those firms potentially subject to the corporate alternative minimum tax) generates tremendous compliance costs and incentives for cutting corners.

So where did the book-tax gap come from, and why do Congress, regulators, and accountants continue to perpetuate it? The most common justification, put forth by businesses and all three branches of government, including the Supreme Court, is that financial accounting and tax accounting require separate methodologies to serve their differing goals. Federal income taxation is primarily supposed to raise money for the government. It is also used to provide economic incentives for socially beneficial items such as home ownership, retirement savings, and health care. Financial accounts, by contrast, must provide investors (current and potential) with an accurate picture of a corporation's economic position: its assets, liabilities, ongoing activities, revenue trends, and profitability prospects. Thus, some have argued that a unified system cannot accommodate these differing objectives.

This Article, in contrast, considers that neither the tax system's primary goal of raising revenue nor the financial accounting system's primary goal of providing investor information would be compromised under a system of near-total accounting conformity. To be sure, under a radically revised accounting system such as the one proposed herein, legislators will have to give up the myriad tax preferences that currently litter the Code. The starting point for taxable income will be financial income as reported to investors, which should ideally be a close approximation of economic income. Then, a few of the most important tax provisions—for example, the credits for research expenses and for foreign income taxes paid—should be retained as selected departures from reported financial income. But the scale and scope of those departures will have to remain limited to prevent erosion of the system. This Article will argue that the current Schedule M-3, the form upon which corporations reconcile financial statement income to taxable income, can be used as a template for such a system.

A secondary, more recently voiced objection to book-tax conformity concerns the potential loss of valuable information contained in having two sets of data. Yet the pathologies of the current system—tax shelters, financial misrepresentations, loss of taxpayer confidence, and high compliance costs—far outweigh any benefits achieved from the comparison. Moreover, those
benefits are largely academic ones for the consumption of economists and tax professors; how many investors are going to sit down and compare a corporate tax return against a financial statement, with each document numbering perhaps into the hundreds of pages?

Finally, even those who might favor book-tax conformity as an abstract concept one day might ask, why now? The answer, if not found in the increasingly alarming data regarding tax and accounting fraud, lies in the corridors of power in Washington. Tax reform will be a hotly contested issue in the mid-term congressional elections of 2006, as well as the presidential election of 2008. The need for tax reform is there. If anything is going to be accomplished, now is the time to do it.

Whatever shape the reform proposals will take in the closing months of 2006, the Bush administration has made clear its intent to lower corporate tax rates. Already in the American Jobs Creation Act of 2004 (AJCA), Congress lowered the top rate on domestic manufacturing and small corporations and extended the liberal section 179 rules that allow small businesses to expense many otherwise depreciable investments. In the conference report, legislators noted that “[t]he conferees ... expect that the tax-writing committees will explore a unified top corporate tax rate in the context of fundamental tax reform.” In other words, a unified and lower corporate tax rate designed to help U.S. multinationals compete on a global scale is on the agenda.

In an age of soaring federal deficits, and given the political imperative of revenue neutrality, any such rate reduction must be offset by base broadening measures. Modified book-tax conformity would achieve the base broadening objective by disallowing the vast majority of tax preferences (relative to financial accounting treatment) for corporate business transactions. Moreover, the present book-tax difference provides a harbor for abusive tax shelters that would be swept away in a system of near uniformity of accounting standards. Such a change would help ensure that revenue neutrality would not require more politically difficult increases in personal income taxes (another area in which the second Bush administration wants to make permanent rate cuts) and would help remedy the perceived inequities of the corporate tax.

II. DIVIDE AND CONQUER

A. Economic Income, Taxable Income, and Everything In—Between

From today's perspective, it is easy to talk about the book-tax gap as a fact of life. Yet, the existence of two different income reporting systems was not preordained. As discussed above, the computation of taxable income starts from “the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” Yet, in the post—World War II period, the Code has not adopted GAAP as the mandatory—or even presumptive—starting point for corporate taxable income. Rather, the modern Treasury has “recognized that no uniform method of accounting can be prescribed for all taxpayers.” The standard for permissible methods lies, instead, with the Service's requirement that the method used “clearly reflect[] income.” In making this determination, the Service favors consistency over specific methodology: “no method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year.” Although the regulations declare that income calculated using GAAP will “generally” be considered a clear reflection of income, the Service has consistently denied taxpayers' attempts to interpret this provision as creating a presumption in favor of income calculated under GAAP standards. When GAAP treatment does not reflect the current year economic reality of the transaction, the taxpayer “finds no shelter beneath an accountancy presumption.”

Analysts have already shown that GAAP rules for reconciling financial statement income to reported taxable income can lead to significant inaccuracies in estimates of actual corporate taxes paid and effective tax rates. Under FASB guidelines,
firms report a current year “tax expense” based on current book income. Firms must also delineate the portions of that expense currently owed and those which are deferred either temporarily (due to “temporary differences” in the timing of income and expense recognition between tax and financial accounting methods) or indefinitely (due to “permanent differences,” whereby items of income accrued on the books will never be recognized for tax purposes). Yet, this tax expense is only weakly related to actual taxes paid in any given year, due to: the differing tax and financial reporting rules regarding corporate consolidation, disparate treatment of foreign income and taxes paid, discrepant accounting periods, and net operating loss (NOL) carrybacks and carryforwards. Subsequent tax reassessments may also bias the book-tax comparison. Thus, the information reported to the Service on Schedule M-3 (the schedule that reconciles book income to taxable income) may not, in fact, represent the actual dollar value difference between economic income and income subject to tax. Hence the famous (infamous) and unanswered question: “Did Enron pay taxes?”

Nevertheless, the distinction between book and tax accounting has traditionally been justified on the basis of the two systems' differing goals. As the Code mushroomed over the twentieth century, Congress enacted a litany of conscious deviations from economic income on the assumption that such tax preferences or tax expenditures would stimulate economic activity or other socially useful behaviors. Thus, the corporate tax return is supposed to measure only the items of economic income deemed taxable under U.S. law. As Justice Holmes once put it, “the income tax laws do not profess to embody perfect economic theory.”

Financial statements, by contrast, are supposed to give investors and the public access to accurate, reliable information about a corporation's economic income, its ongoing activities, and its financial prospects. The financials are supposed to communicate adequate information to the public markets so that the markets' invisible hand can then deal the cards of capital appropriately. Thus, the target audience needs full information about the corporation's assets, all existing claims on those assets, and ongoing activities that will generate future cash flow.

Financial accounting's objective of providing information to the capital markets has also informed the way in which accounting standards are regulated. The Securities and Exchange Act of 1934 created the SEC and granted it with the authority to set and oversee reporting standards. But the SEC, in turn, has delegated responsibility for setting the rules of financial accounting to the private sector—namely the American Institute of Certified Public Accountants, the FASB since 1973, and the Public Company Accounting Oversight Board (PCAOB) since 2002—under the assumption that business and accounting experts are better equipped than the federal government to assess U.S. business transactions. As the SEC itself reasons, “in recognition of the expertise, energy and resources of the accounting profession,” it looks to “the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles.” The contrast to tax accounting, once again, could not be more stark.

*987 B. Thor Power: A Blessing from on High

It is ironic that although the courts generally play a marginal role in tax law, it is the Supreme Court that has erected a legal bulwark that, for nearly three decades, has stood strong against any efforts to move toward book-tax conformity. In a strongly worded opinion by Justice Blackmun in the seminal Thor Power case, the Court unanimously held that "in light of the vastly different objectives that financial and tax accounting have ... any presumptive equivalency between tax and financial accounting would be unacceptable." According to the Court, the financial accountant's duty to "provide useful information to management, shareholders, creditors, and others properly interested ... to protect these parties from being misled" dictates an approach dominated by conservatism and “hospitable to estimates, probabilities, and reasonable certainties” of the business's
The Service, on the other hand, must seek “the equitable collection of revenue” and must “protect the public fisc,” “the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty,” and the accountant’s conservatism “cannot bind the Commissioner in his efforts to collect taxes.” Finally, noting that GAAP “are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions,” the Court envisioned a doomsday scenario of book-tax conformity: “a firm ... could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.”

The breadth of this holding is apparent from cases citing Thor Power. Although several courts have distinguished Thor Power along fact specific lines, none has attempted to question the Court’s larger rejection of book-tax conformity. Thor Power receives additional support from the Code’s generous deference to the Service’s discretion in determining proper accounting treatment for tax purposes. Section 446(b) provides that if the taxpayer’s accounting method “does not clearly reflect income, taxable income shall be computed under such method as, in the opinion of the Secretary, does clearly reflect income.” The circularity of this “clear reflection of income” standard becomes clear when one looks at the regulations and interpretations from the Service. The regulations under section 446 authorize the Commissioner to mandate the accounting treatment of any transaction not explicitly covered by the Code as long as, “in the opinion of the Commissioner, income is clearly reflected by the method.” This authorization applies even when the taxpayer has followed GAAP in reporting income, or has been following the same method consistently for years. Moreover, the Service has made clear that among the various measures that may be used to determine a “clear reflection” of income, GAAP conformity is not to be a “controlling standard.”

III. WHAT LIES BENEATH THE GAP

A. Shelters in Elysium

Ironically, Thor Power has become somewhat of a Pyrrhic victory for the government in cases in which it seeks to force book-tax conformity. This assertion is best exemplified by First Federal Savings & Loan Ass’n of Temple v. United States, one of a series of high profile court defeats for the Service that attracted much attention among scholars and practitioners—and much anxiety at Treasury. In First Federal, a Texas district court was asked to consider whether the taxpayer savings and loan (S&L) should be allowed to recognize a loss incurred on a mortgage pool swap with another thrift institution. Over several years, this question arose in five cases in federal courts and the Tax Court, leading ultimately to five defeats for the Service: one in the Tax Court, two in federal appeals courts, and twice before the Supreme Court—most famously (or infamously) in Cottage Savings.

These cases came before the courts as a result of the S&L crisis of the 1970s and 1980s. Soaring interest rates had depleted much of the value of the S&Ls’ existing low-rate mortgages. Sitting on these unrealized book losses, the banks’ federal insurer, the Federal Home Loan Bank Board (FHLBB), did what any savvy business would do: tax planning. The result was FHLBB Memorandum R-49, issued in the summer of 1980. This memorandum laid out the conditions under which FHLBB member institutions could engage in “reciprocal sales” of “substantially identical mortgage loans.” If the exchanged properties met the R-49 criteria, the sales would not need to be reported under the applicable regulatory accounting principles. At the same time, however, because the transactions were labeled “reciprocal sales,” they ought to trigger a tax loss under section 1001. The end result was intended to (1) erase accumulating book losses without leaving a trace on the books; (2) leave the participating S&Ls with virtually the same assets at a new, reduced cost basis; and (3) create a tax loss to generate revenue and ease their liquidity crunch.
In *First Federal*, the government relied on Thor Power's broad grant of authority to the Service to argue that under section 446, taxable income can depart from book income only when the Commissioner explicitly mandates such a departure. In the absence of such a mandate, book-tax conformity must be the rule. The court summarily rejected that argument, holding that such a reading of section 446 would be inconsistent with the Code as a whole, which includes numerous examples of transactions that are treated differently for tax purposes and financial purposes. It therefore ruled that the broad discretion vested in the Commissioner by Thor Power applies only in cases in which the Code does not mandate the accounting treatment of particular items. According to this logic, the court distinguished Thor Power because "the particular accounting method at issue in that case was not governed or controlled by any specific Code section, which is precisely what kept that case ... within the purview of the Commissioner." 53

Yet, having ducked Thor Power along these lines, the court then had to engage in some Code-reading gymnastics to find a statutory provision that would require different book and tax treatment for the mortgage swap. It reached this result through section 1001, which requires that income or loss must result through a “sale or exchange” before it can be realized. 54 The government had argued that the exchanged mortgages were not materially different, and therefore no section 1001 sale or exchange had taken place. It relied on a regulation declaring that “the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.” 55 The court agreed that the exchanged pools were not materially different, but it upheld the recognized loss nevertheless. It interpreted the regulation's mention of material difference as merely an example of, not a prerequisite for, gain or loss recognition. Thus, in the absence of an explicit directive otherwise, section 1001 required loss recognition, even where the exchanged mortgage pools were not materially different.

In the subsequent Cottage Savings decision, the Supreme Court followed much the same reasoning to uphold the taxpayer's asserted tax loss in the absence of any book loss. 56 This statement from the highest court in the land stands for the proposition that a taxpayer may report a tax loss even where there is no reported book loss. It thus illustrates the dangers of the book-tax divide and of the Court's earlier defense of the two accounting systems in Thor Power.

Indeed, once one moves away from the courts, it is striking that both Treasury 57 and the Joint Committee on Taxation (JCT) 58 include in their definitions of abusive tax shelters those transactions in which the tax treatment is severed from the financial treatment. Treasury's 1999 White Paper listed “lack of economic substance” and “inconsistent financial and accounting treatment” as the first two “common characteristics” of a corporate tax shelter, noting that with “most recent corporate tax shelters involving public companies, the financial accounting treatment of a shelter item has been inconsistent with its Federal income tax treatment.” 59 Treasury went on to draw an explicit link between the lack of economic substance and the book-tax gap associated with a given transaction:

This characteristic [of inconsistent accounting treatment] is consistent with the observation that corporate tax shelters generally do not have any underlying economic substance other than tax savings. If the transaction had economic substance, the result generally would be reported on the financial statements. 60 Thus, a “successful shelter with a book-tax disparity is Elysium for a corporation; it not only reduces the corporation's tax liability, but also reduces its effective tax rate.” 61

Similarly, the JCT includes among its five corporate tax shelter indicators the combination of “significant reasonably expected net tax benefits and a reasonably expected ‘permanent difference’ for U.S. financial reporting purposes under generally accepted accounting principles.” 62 President Bill Clinton's final budget proposal also argued that financial accounting preferences
accounted for a significant portion of the corporate tax shelter phenomenon. And most recently, the 2003 JCT report on the investigation into Enron's accounting revealed that the presence of book-tax differences played a large role in Enron's financial misrepresentations.

*993 It has been well documented that the book-tax gap grew over the past 15 years. In 1999, Treasury calculated aggregate pre-tax book to taxable income ratios of 1.82 and 1.86 in 1995 and 1996, respectively—significantly higher than the 1.25 average from 1990 to 1994. Scholars have corroborated Treasury's assertion that “the difference between book income and taxable income has increased recently” by looking at financial statements and other publicly available information, tax return data, and effective tax rates. George Plesko finds that the excess of pretax book income over tax net income peaked above $300 billion in 1999 before falling to slightly negative figures by 2001 (a drop driven by firms with losses, which Plesko conjectures is due to the economic downturn of those years). Favorable tax depreciation rules appeared to account for a decreasing portion of this differential during the second half of the 1990s, as nondepreciation total differences rose from negative figures in 1995 to nearly a third of the total difference by 1999 (and nearly the entire difference among firms with net income, whose book-tax differences peaked a year later in 2000). The latest comprehensive study finds that the aggregate book-tax difference of nonfinancial services U.S. corporations turned dramatically positive again in 2003 to over $156 billion (the highest level since 1986, nearly three times the 1999 peak, and a more than tenfold increase in the space of one year).

Yet, despite the widespread recognition that shelters lurk in the book-tax gap, the Code continues to perpetuate these arbitrage opportunities. As one practitioner put it, “arguing for the transaction's sanction from the literal words of the statute is legitimate planning, and has won many a day in court.” Seen from this perspective, the Code is giving corporations that engage in tax shelters an interest-free loan financed by the federal government—one that often will never be repaid. Indeed, a study released in December 2004, based on the largest existing survey of tax shelter activity, suggests that corporations are in fact using tax shelters as financing. The study found that firms using tax shelters had an average debt-to-assets ratio nearly 30% lower than that of comparable firms—19%, as compared to 27.4%—in the year of the sheltering activity, despite having comparable ratios in earlier years. If this difference were entirely attributable to tax shelters, it would mean that U.S. taxpayers were bankrolling nine percent of the operating costs of tax sheltering corporations. It also suggests higher capital risk for investors than is evidenced in the financial statements (and the companies' credit ratings), since that loan from the government might disappear if the Service catches on to the game.

The only analysis of what the tax rates would look like under a uniform accounting system confirms that the new system would allow for lower corporate tax rates. Conducted in 1998, this study found that for the tax years 1994 and 1995, a flat rate corporate tax of 26.3% and 28.4%, respectively, would be revenue neutral vis-à-vis the 35% rate that applies to most corporate income. A replication of that analysis for the tax years 1990, 1995, and 1998-2002 shows that the revenue neutral rate rises as high as 36% or 37% in years of economic downturn (2001 and 2002) but falls significantly below 30% in 1995 and 1998-2000, hitting 27.15% and 26.51% in two of those years. The average revenue neutral rate is just over 31%.

*995 B. Rambo Comes to Wall Street

Tax shelters are not the only pernicious byproduct of the book-tax divide. Recent history shows a general rise in corporate willingness to push the boundaries of the accounting rules, abandoning the relative conservatism that historically characterized financial accounting. Indeed, analysts have noted the similarity between the accounting frauds revealed in recent years and tax shelter transactions. With regard to the Enron transactions, for example:
Fallout from Enron’s accounting scams invites comparison to the corporate tax shelter phenomenon and reactions thereto. In both cases, complex structures are created by financial engineers ... to facilitate apparent compliance with vague, inconsistent, and confused rules.... Moreover, the motivations of [tax fraud and accounting fraud] are similar: to meet earnings growth targets set by the marketplace. 77

As the Wall Street Journal has remarked, “lying to shareholders and lying to the IRS are just opposite sides of the same coin.” 78

Some have gone even further, suggesting a possible causal connection between the two phenomena: “When professionals get used to pushing the limits of literal compliance in one area, might it be that the practice extends to other, related areas? ... [If so, the] aggressive planning and Rambo-cowboy mentality that has bred the current crop of corporate tax shelters may have paved the way for pushing the envelope in other areas as well.” 79 Treasury accurately noted that if a corporation reduces its effective tax rate one year through finding a tax shelter with a book-tax disparity, “the corporation may be under pressure to continue to engage in corporate tax shelters in order to meet market expectations of maintaining the low rate.” 80

Yet the legislative and regulatory responses to the acknowledged tax and financial accounting problems have been anything but two sides of the same coin. There was widespread and virulent public outrage over the wave of corporate scandals over the past several years, with much attention focused on the accounting gimmicks that businesses use to shield debt and inflate assets. Congress and the SEC “jump[ed] on the accounting industry with fists at the ready,” 81 most notably with the passage of the Sarbanes-Oxley Act 82 and the creation of *996 the PCAOB. 83

By contrast, the tax side of corporate accounting manipulation has inspired no such boldness. The Wall Street Journal chastised Congress for “having addressed only half of the credibility crisis that afflicts corporate America.” While Sarbanes-Oxley “will make it harder for companies to mislead shareholders about how much they are earning ... nothing has been done to deter them from misleading the Internal Revenue Service about how little they are earning.” 84 Book-tax conformity would achieve that objective.

**C. Paying the Piper**

Substantially harmonizing tax and financial accounting would help reduce the damaging incentives built into the two separate systems. Financial statements and tax statements have mirror-image goals: firms want to maximize the income reported to investors while minimizing the taxable income reported to the Service. As long as the consequences of an upward shift in financial income remain isolated from the tax accounts and vice versa, these two objectives are not irreconcilable. As recent years have shown, however, corporations—aided by the law and by accounting professionals who monitor and advise their corporate clients 85 —have succumbed to increasing pressures to maximize profits. 86 Evermore aggressive means of raising financial income while lowering tax liability gradually cross the shadowy line between business judgment and rules abuse. The tax shelter phenomenon and the corporate accounting scandals represent corporations going to the edges of the tax and financial accounting rules—and beyond. By linking the consequences of tax and book reporting, a unified system could make such abusive accounting much more painful and much less attractive.

*997 Such a system would also reduce the enormous compliance costs of the dual accounting system. In a survey of hundreds of U.S. tax executives a decade ago, a significant number endorsed book-tax conformity along book income lines. Respondents cited the lack of conformity as a major source of their firms’ tax compliance costs, directly behind the frequency of changes to the Code, evenly tied with the controlled foreign corporation rules, and ahead of the transfer pricing rules. 87 Significantly,
these executives did not endorse a book income floor along the lines of the 1986-1989 corporate alternative minimum tax (AMT), which they cited as by far the most significant source of compliance costs deriving from the 1986 reforms. When asked how the tax laws might be changed to lower compliance costs, these corporations listed book-tax conformity second only to uniformity of state and federal income taxes.

IV. LEARNING FROM OUR MISTAKES

A. Fixing the Code: Radicalism Meets Recidivism

This Article proposes a system of accounting conformity along book income lines, with certain legislated exceptions for tax policy purposes. This proposal is simpler than the AMT and Treasury's 1999 idea of a book income tax floor (which Treasury acknowledged would create “significant complexity”) in that taxpayers would not calculate separate book and tax incomes and then be taxed on the higher of the two. Such a dual system prevailed from 1986 to 1989, when the corporate AMT was structured to tax corporations on the excess of book income over reported taxable income. This strategy had a crucial weakness that doomed the AMT from the beginning: lawmakers in 1986 simply shifted the pressure point of tax planning from taxable income to book income. Yet, despite the AMT’s failure as a means of taxing book income, the 1986-1989 corporate AMT does provide a valuable precedent for the base-broadening changes that would have to be made in a conformed accounting system.

Book-tax conformity also finds precedent in several specific linkages that the taxing authorities have legislated over the years. These specific conforming transactions include: (1) the last-in, first-out (LIFO) conformity requirement for end-of-year inventory valuation under section 472(c) and (e); (2) the section 166(a)(2) limit on bad debt deductions; (3) the regulatory limit on the deferral of certain prepayments for goods until no later than such payments are accrued in the financial statements; (4) sections 455 and 456, which defer the inclusion of prepaid subscription income and membership dues, respectively, until earned and accrued under financial reporting rules; (5) pre-1986 section 471, which linked the tax treatment of some manufacturing inventory costs to their book treatment; and (6) pre-1986 section 166(c), which used the reserve method for deducting worthless debts. The legislative history of such provisions suggests that the statutory linkages were in part motivated by the legislators' desire to follow the lead of financial accountants, whether it be in the application of the matching concept to prepaid income, the accounting industry's official acceptance of the LIFO method for certain businesses, or the use of the accrual method.

Yet, the current Code is simply inadequate for combating the tax shelter problem more broadly. The AJCA, for example, has been deemed “the most radical revision of business taxes since 1986.” True enough, but “radical” in the context of tax legislation is a far cry from the dictionary's definition. The Act contains no fewer than 39 separate provisions related to tax shelters, which appear in modified form in the administration's 13 fiscal year 2005 proposals to combat abusive transactions. Yet, the reader would be excused for having a strong sense of déjà vu; these proposals simply follow the same, tired approaches of increased reporting, increased penalties, micro-changes and “repeated revision[s]” to the statute and regulations—and exponentially increased complexity. The same strategy again appears in a February 2005 report by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security, which recommends that Congress, the Service, the SEC, and the Department of Justice simply continue their enforcement efforts with the help of further legislative tweaks and increased penalties on wrongdoers. If the administration is really serious about cracking down on corporate tax shelters, it is time to close the book-tax gap.
Amidst all the publicity about corporate accounting high jinks and the evidence of increased book-tax gaps leading up to 2001, the most common arguments offered in support of the continued book-tax divide have added strength to the government’s inclination to seek the easy answer—disclosure—rather than more far reaching change. Yet, disclosure of the book-tax difference will simply increase compliance costs while not solving the underlying problem.

Some economists and tax practitioners see inherent value in having two sets of data.

> “[E]stimated taxable income provides information to stock market participants incremental to the information in pretax book income and vice versa [,and] ... the incremental information in [each] measure would be lost if the same set of rules were used to calculate both measures.”

Although investors can only estimate taxable income from the tax information provided in a corporation’s financial statements, some suggest that investors use this estimate to assess the quality of reported earnings.

Yet, Hanlon and other commentators note that if taxable income “is incrementally informative only because it informs about earnings management ... and if conformity reduces incentives to manage earnings, then there would be no role for a signal about earnings management in book income and little would be lost through conformity.” Other defenders of the book-tax gap have raised a more political concern: if the tax consequences are too closely linked to reported financial statements, the FASB might become the target of tax lobbying by powerful corporate constituencies.

These economic and political defenses of the book-tax divide have led some academics and prominent figures in Washington to propose that investors and the public could benefit from greater disclosure of the book-tax difference rather than any closing of the gap. Senator Charles Grassley raised this possibility in a letter to then-Treasury Secretary Paul O’Neill and SEC Chairman Harvey Pitt in the summer of 2002. A short time prior to the sending of this letter, the Wall Street Journal had suggested public disclosure of corporate tax returns as a first step toward restoring the credibility of public company accounting. Acknowledging that the hundreds of pages of data involved in even a relatively simple corporate tax return “may not be much use to the average investor,” the Journal expressed the hope that “conscientious stock analysts ... could spend their time analyzing the gaps between book and tax income, attempting to find truth in between.”

Complete disclosure of a corporate tax return seems infeasible due to both privacy and administrability concerns, as forced public disclosure would be inefficient and potentially harmful to business competition. Intermediate options, such as “summary version” disclosure of corporate tax returns, enhanced tax reconciliation on corporate financial statements, or some combination thereof have received much attention. But no consensus has been reached on whether such disclosure would sufficiently protect businesses or how the formula should be calculated. Moreover, any movement along those lines would simply add complexity to the already cumbersome book-tax accounting regime.

After public disclosure, the second best option for making firms accountable for their book-tax gaps is enhanced disclosure on the tax return. “Pretax book income” is the sum of a corporation’s (1) financial net income (the post tax income claimed in its financial statements), and (2) federal income tax. “Tax net income” is the corporation’s pre-tax income. Both figures are reported to the Service on Schedule M of the annual corporate tax return. Starting with the 2004 tax year, the Service is phasing in a new Schedule M-3 that significantly expands the requirements for book-tax disclosure. The new schedule imposes a uniform starting point for book income (the net income reported to the SEC on a corporation’s Form 10-K), provides a formula for reconciling the different entity consolidation rules of financial and tax accounting, requires itemized reporting of each transactional component of the book-tax difference (e.g., stock options or depreciation expenses), and requires corporations to differentiate between permanent and temporary differences. The Service asserts that the more detailed Schedule M-3 disclosures, including itemized...
disclosure on a transaction-by-transaction basis of all components of the book-tax difference, “will help us target our examination efforts on high risk areas, thereby improving and speeding the audit process.” Indeed, the Service has even gone so far as to suggest that it might ease the tax shelter reporting requirements if the Schedule M-3 proves successful.

*1003 To be sure, the Schedule M-3 makes substantial improvements over the old Schedule M-1. With a standard book income base, itemized reporting enhances the quality of the information available to tax auditors, and standard categories allow for comparisons across corporations. These changes will provide useful reference in any attempts to narrow the book-tax gap, and the Schedule M-3 may be used as a template for a uniform accounting system. Indeed, the Service declared in a revenue procedure soon after the Schedule M-3 was announced that filing the form will satisfy a corporation's requirement to disclose to the Service reportable transactions that engender a significant book-tax difference.

Yet, greater disclosure does not go far enough. So long as the law permits a substantial gap between financial and tax income, corporations will have opportunities and incentives for tax reduction, tax avoidance, and investor fraud. No matter how much money Congress pours into the SEC, or how strong an accounting oversight board it creates, corporations will always have the resources and ability to outwit regulators ... as long as they have the incentive. Reuniting book and tax income would take away some of that incentive. If a company wants to overstate its income, it would have to pay more taxes as a result. And if it wanted to reduce taxes, it would have to moderate its income claims.

In other words, reporting alone does nothing to address the substance of the divide. As one commentator has put it, the presence of two different sets of accounting rules, each plagued with a degree of imprecision and subject to multiple interpretations, gives corporations seeking to manipulate earnings or losses “two different bites at the apple.” What used to be seen as an economically advantageous distinction between tax and financial accounting may now be considered “the credibility gap—between book income and taxable income.” Thus, the same Wall Street Journal reporter who advocated public disclosure of the book-tax difference actually considered this recommendation as merely a stopgap measure: “over time, Congress and the Securities and Exchange Commission should work to bring the two measures of income into closer alignment ... [because movement toward] a unified definition of income for both book and tax purposes would go a long way toward alleviating the current problems.”

V. TAKING ON THE COMPETITION

In a world of pure accounting conformity (i.e., financial statements and income tax returns conform to one common set of rules) financial net income and tax net income would be the same. Total uniformity is not a feasible goal in the United States, but it is important to be clear exactly why uniformity cannot be achieved. A review of the arguments against conformity reveals their circularity and the internal dissonance in the anticonformity camp.

A. GAAP: Arts and Sciences

First, the supposed market relevance of the financial statements produced under U.S. accounting rules provides ample fodder for one camp of book-tax conformity critics. These naysayers point to the situation in many Organization for Economic Cooperation and Development (OECD) countries, particularly those in the EU, that legislate book-tax conformity. The German accounting rules, one favorite target, are not designed to provide a true economic picture of a corporation’s financial activities, but to “determin[e] and present [...] the assets of a company [...] to protect the claims of the creditors.... The main
objective of [German] financial accounting is thus similar to the function of income computation for tax purposes, as the measure of income taxation is the full economic capacity of a corporation.”

Across the OECD, such rules arose in economies in which the capital markets played a much smaller role in financing corporate activity. Where equity investors were expected to be less important for corporations, it seemed more acceptable to introduce into corporate financial statements the distortions created by income tax calculations that included various policy mandated departures from true economic income.

By contrast to such systems, the financial accounts of U.S. corporations are supposed to provide a full picture of a corporation's financial activities and prospects—its true economic income—to both shareholders and investors. In its purest, value free, judgment free form, financial accounting has been likened to cartography:

Accounting is financial mapmaking. The better the map, the more completely it represents the complex phenomena that are being mapped. We do not judge a *1005 map by the behavioral effects it produces .... We judge [it] by how well it represents the facts. People can then react to it as they will.

Of course, recent events show that this extreme version of empirical accounting remains aspirational. Indeed, the FASB itself makes clear that although an “aura of precision” surrounds the accounting profession, the “information provided by financial reporting often results from approximate, rather than exact, measures. The measures commonly involve numerous estimates, classifications, summarizations, judgments, and allocations.... [W]ith few exceptions the measures are approximations, which may be based on rules and conventions, rather than exact amounts.”

Thus, the idealistic portrait of cartographic, scientific accounting ignores the individual judgment calls that lie within the financial statement. Because GAAP often provides guidelines and standards rather than strict rules, managers and accountants have considerable discretion over how they apply those standards to particular fact patterns.

This observation, evidenced by the recent corporate accounting scandals, effectively rebuts the argument that closer book-tax conformity would sully or corrupt financial accounting.

B. Bringing Back Conservatism

Going to the opposite extreme, another argument against conformity along the lines of book income asserts that the managerial discretion allowed by financial accounting will lead to excessive accounting conservatism and will hamper the government’s efforts to collect revenues. Under this view, conformity will give managers a dangerous incentive to minimize income in order to reduce tax liabilities, and “GAAP income seems elastic enough that taxing it would cause the reported earnings to shrivel.”

Years of high book-tax ratios, however, lead to the opposite conclusion. Moreover, even under conditions of conformity between tax and book accounting, the temptation to reduce tax liabilities by lowering reported income does not seem to dominate managerial discretionary accounting choices. Scholars have shown that when faced with either a specific conforming transaction or the 1986-1989 book income AMT trigger, public firm managers tend not to adopt a tax position that would reduce reported book income.

Using book income rather than taxable income as the starting point would actually have the beneficial effect of reintroducing the conservatism that, according to financial accounting doctrine, should dominate corporate bookkeeping. A unified accounting system encourages conservatism, because premature or excessive revenue recognition (or delayed loss recognition) will have adverse tax consequences for the corporation.

In fact, recent scholarship has found that managers use the book-tax gap to create deferred tax expenses rather than an immediate tax liability. Areas of such earnings management might include...
bad debt writeoffs, depreciation expenses, the timing of revenue recognition, advance payments, and other contingent revenue or expense items that require managerial estimates. In all these cases, managers can increase reported financial income or smooth out earnings without increasing taxable income. In so doing, they will create a deferred tax expense out of the temporary difference. Thus, deferred tax expenses seem to be useful earnings management tools in cases in which a corporation would otherwise fail to meet analysts’ earnings targets, report an earnings decline, or report a loss. Such findings are further supported by evidence that although book accruals generally dominate tax accruals in terms of the power to explain current stock returns, that dominance decreases from 1987 to 2001 (the years when the book-tax gap was growing) and disappears entirely from 1997 to 2001 (the peak years of the book-tax gap). By substantially eliminating deferred tax expenses, uniform accounting would reduce such opportunities for potentially misleading earnings management, while not preventing valid managerial accounting discretion.

C. Avoiding the Sausage Factory

Some commentators generally argue against conformity with a Thor Power argument about the conflicting objectives of the two accounting systems. Yet, whereas in Thor Power the Supreme Court’s concern was with the integrity of the tax system, here the worry is that financial accounting will fall prey to Beltway politics. Critics in this camp assume that under uniform reporting, financial income would gradually come to look like present day taxable income due to incessant erosion of the tax base by politically motivated lawmakers on Capitol Hill. To be sure, Congress’s power to legislate changes to the accounting rules would have to be limited to prevent lawmakers from heading down the slippery slope of preferences and exemptions for every favored home-state business interest. But it is not inevitable that Congress will continually legislate book-tax differences to satisfy special interest groups and contingencies.

One solution to congressional politicking would be to import into the Treasury regulations the limits established by the FASB to ensure the neutrality of its standard setting activities. As the body reasoned in its first accounting concepts statement in 1978:

> The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be .... [I]nvestors, creditors, and others make [resource allocation] decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions .... Thus ... information that is directed toward a particular goal, such as encouraging the reallocation of resources in favor of a particular segment of the economy, [is] likely to fail to serve the broader objectives that financial reporting is intended to serve. If such a principle were included in the Regulations, legislators would not be able to chip away at a uniform accounting system the same way they have done with the Code. Thus, as discussed below, certain crucial exceptions for taxable income (i.e., the dividends-received deduction and the foreign tax credit) would be legislated and written into the Code from the start. Moving forward, however, accounting rules would be determined by a joint regulatory body without congressional involvement.

Moreover, the government should continue to mandate that the FASB be fully funded to ensure its independence. Before 2003, the FASB relied on contributions from accounting firms and the industry and financial communities for about 30% of its operating budget. Sarbanes-Oxley changed the funding structure of the FASB. Sarbanes-Oxley completely replaced contributions from the FASB’s sponsoring constituencies, and instead provided that the FASB would be funded by mandatory fees imposed on securities issuers.
The bill seeks to formalize the SEC's reliance on the FASB and ... to strengthen the independence of the FASB by assuring the funding and eliminating any need for it to seek contributions from accounting firms or companies whose financial statements must conform to FASB's rules.\textsuperscript{154}

This change in the FASB's financing, combined with the regulatory limits on congressional authority, will help insulate the FASB from political pressures and prevent an erosion of the tax base similar to what has been witnessed under the Code. It can also reduce the opportunities for FASB capture by businesses and accountants.

Such insulation of the FASB is crucial because the body must continue to be the primary standard setter for a conformed accounting system. The private sector's involvement in the FASB is crucial to preserving the integrity and value relevance of reported income for shareholders and investors. International analysis has shown that the value relevance (defined as the utility in the pricing of stocks) of reported income is lower in countries where tax rules influence financial accounting rules, but book income's value relevance rises when private sector bodies are involved in accounting standard setting.\textsuperscript{155}

At the same time, however, a system of book-tax conformity would require a strong governmental presence as well. As many commentators have noted, Congress is unlikely to cede to the private sector the authority to set the standards for government revenue collection.\textsuperscript{156} Yet, unfettered congressional oversight of the tax laws has brought the Code to its current state, prompting President Bush\textsuperscript{1009} to make tax simplification a priority of his second-term agenda.\textsuperscript{157} As Senate Finance Chairman Grassley candidly explained after the passage of the AJCA, “one of the reasons it grew [beyond its original purpose] is because the Finance Committee found sufficient offsets, most of the loophole closers, to allow members to get their particular interests into the bill.”\textsuperscript{158} Moreover, the public outcry for strong government action leading up to the passage of Sarbanes-Oxley, as well as the continued corporate accounting scandals, brings into question the common wisdom that the government should not interfere in financial accounting.\textsuperscript{159}

In light of these observations, financial accounting standards should henceforth be regulated by a joint body of the FASB, with representatives from Treasury and the SEC. The SEC already has broad authority to regulate financial accounting, which it has delegated to private sector bodies. But as early SEC Chairman Jerome Frank once noted:

\begin{quote}
Accounting is the language in which the corporation talks to existing stockholders and to prospective investors. We want to be sure that the public never has reason to lose faith in the reports of public accountants.... I understand that certain groups in the profession are moving ahead in good stride ... but if we find that they are ... unable ... to do the job thoroughly we won't hesitate to step in to the full extent of our statutory powers.
\end{quote}

It is now time for the government to “step in” as Frank presaged.

### D. Back to Basics

As is evident from the preceding subpart, a necessary victim of the move to accounting conformity would be the many tax preferences currently written into law, which narrow the tax base for some or all taxpayers. Although a few of the most important tax preferences should be retained,\textsuperscript{161} the vast majority are inappropriate to an accounting system that would aim to both raise revenue and provide economic information to shareholders and investors. This Article argues that under accounting conformity,
legislators would have to stop using the Code as a locus of social and economic policymaking and would instead have to refocus
the tax system on the fundamental goal of revenue raising, with a few narrow exceptions discussed below.

Unfortunately, the personal and corporate tax laws are replete with loopholes and preferences to the point of absurdity. As
Stanley Surrey noted as far back as *1010 1972 (when a plurality of Americans still considered the federal income tax to be
the fairest tax in the land): 162
The tax subsidies tumble into the law without supporting studies, being propelled instead by clichés, debating points, and scraps
of data and tables that are passed off as serious evidence. A tax system that is so vulnerable to this injection of extraneous,
costly, and ill-considered expenditure programs is in a precarious state from the standpoint of ... providing adequate revenues
and maintaining tax equity. 163
Indeed, Boris Bittker articulated the massive scale of the tax law’s departure from economic income when he noted that
suggestions to tax a comprehensive base of income “imply that sections 61(a), 162, 165, 166, 167, and 212 are the only
operative provisions needed for an ideal computation of taxable income.” 164 Although Bittker’s point is extreme, it would be
no exaggeration to say that a good portion of the remaining approximately 9,827 sections of Title 26 represent departures from
a true measurement of the net change in one’s economic power. 165

Such massive loopholes in the Code are dangerous for a variety of reasons. First, they introduce enormous complexity to
interpretation, compliance, and tax planning. 166 Such complexity disproportionately advantages wealthy and sophisticated
taxpayers, who have the resources to spend on tax planning. Widespread tax planning to lower liabilities, in turn, breeds
resentment among the population, a dangerous dynamic in a tax system that depends on self-assessment. Indeed, taxpayers’
willfulness to resist the economic temptation of tax sheltering is historically tied to their perception of the overall fairness of
the Code. 167

*1011 The 1986 corporate AMT illustrates the futility of trying to restore equity to the tax system without addressing
the complexity problem. In 1986, the battle against corporate tax evasion took on the book income “preference”— the idea
that corporations ought to be able to report substantially lower taxable income compared to book income—in an attempt
to improve public perceptions of the corporate income tax. The Senate Finance Committee explained that the 1986 corporate
AMT legislation “should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid
significant tax liability by using exclusions, deductions, and credits.” 168 Thus, the book income adjustment was partly targeted
to have maximal symbolic effect, as reflected in the Committee's assertions that the book income adjustment should “increase
both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in which corporations with
substantial book income have paid no tax, and further broaden the minimum tax base to approach economic income more
closely.” 169 In fact, these congressional justifications of the AMT as a potent political symbol echoed the sentiments of Michael
Graetz, who had first suggested the book income adjustment in testimony to the Senate Finance Committee the previous year.
“You cannot solve the perception problem without a direct link to book income,” said Graetz after the passage of the 1986 act;
“Without a direct connection between the corporate minimum tax and book income, Congress' goal of eliminating the spectacle
of high income corporations paying little or no tax seems unlikely to be fulfilled.” 170

The problem, however, was that the AMT did not discourage tax planning. Corporations could easily lower their tax liability
by distributing the book income adjustment strategically across years, for example by leasing rather than selling goods. 171
Thus, as early as 1987, Bittker commented that “the book income remedy is concerned solely with perceptions, since the
adjustment depends on what the corporation reports, not on the underlying naked facts.” 172 Indeed, the ultimate legislation
paid remarkably little attention to how corporations accounted for the economic reality that the AMT tax base was supposed to approximate. The book income starting point was left vague, like the old Schedule M-1. The statute simply listed a hierarchy of “applicable financial statement[s],” descending from SEC filings to audited statements, other government-mandated filings, or financial statements prepared for creditors, shareholders, or other nontax purposes. In fact, the statement representing book income was not even required to conform to GAAP. As the Senate explained, lawmakers did not intend “to establish the Secretary of the Treasury as an arbiter of acceptable accounting principles.”

By leaving in place the two separate accounting systems and simply establishing a book income trigger for alternative tax liability (or, since 1989, a reported earnings trigger), the AMT has not only tolerated, but also accentuated the existing Code’s complexity. The AMT in effect subjects corporations to three separate tax regimes every year. In the mid-1990s, economists estimated that the corporate AMT raised the tax compliance costs of corporations, relative to those corporations not subject to the AMT, by 18-27%. The JCT found that the AMT accounted for 16.9% of corporations’ total tax compliance costs. And the available data suggest the overall compliance cost associated with the AMT may be several times the revenue collected by the provision. Indeed, because corporations can generally deduct their compliance costs from taxable income, the complexity of the AMT actually reduces net revenues raised by the provision to diminishingly small, perhaps even negative, levels.

The JCT has also implicated the book-tax divide in Enron’s accounting fraud. It has found that the corporation took advantage of the differing accounting rules to create future tax benefits that could increase current reported financial income. Enron “excelled at making complexity an ally,” engaging in tax-motivated transactions that “used exceedingly complicated structures and were designed to produce tax benefits significantly into the future.” Because financial reporting of deferred tax assets and liabilities does not account for the time value of money, Enron was able to report distant future tax benefits in highly inflated present value dollars. Amidst a litany of other recommendations and observations about the faulty tax laws that allowed such gamesmanship by Enron, the JCT also recommended changes to the GAAP rules on accounting for income taxes: “The Joint Committee staff is concerned that businesses are engaging in tax-motivated transactions primarily to obtain financial accounting benefits. The accounting benefits result solely from the manipulation of the Federal income tax laws to create permanent book-tax differences.”

The point is that the complexity of the Code has become unmanageable. The surest way to restore fairness to the system and to improve taxpayer compliance and perceptions is to reduce the loopholes. A book-tax link along book lines would necessarily do so. Without taking such a step, attempts to bring tax liability closer into line with book income are destined to futility. As then Assistant Treasury Secretary for Tax Policy Pamela Olson put it in 2002, “[w]e have complicated compliance by legislating detailed rules on the calculation of taxable income that differ from the rules used to calculate book income, creating inevitable disparities that undermine confidence in our tax and financial accounting systems.”

**E. Equal Opportunity Rulemaking**

The new system would cover companies of all sizes from the beginning. Unlike the recently phased in Schedule M-3, there is no reason to exempt smaller firms at the outset. Such firms are initially exempt from filing Schedule M-3 because it requires companies to report substantial amounts of information that are not readily available under current corporate accounting systems. Thus, it seems only equitable to give smaller taxpayers with fewer resources some extra time to prepare themselves for the new reporting burden. Because book-tax uniformity has the benefit of simplicity, however, no such logic applies.

Some might argue that it is unnecessary to force privately held firms into the conformed accounting system, since they do not face the same incentives to maximize book income. When a manager’s job partly depends on satisfying the consumers...
of the New York Stock Exchange, a cynic might say that manager will be more inclined to play with the numbers to reach revenue targets, both by maximizing book income and by reducing federal tax liabilities. Indeed, empirical analysis shows that public firms report, on average, larger book-tax differences than their privately held counterparts; this observation is readily understandable because public company managers are more likely to have heavily incentive based compensation and are more likely to believe that reported book income affects the market value of the firm's stock.

At the same time, however, the book-tax gap still exists in private company reporting, and it creates potential tax shelter opportunities and substantial complexity. Moreover, requiring both public and private firms to adhere to the same conformed accounting system would provide equity to the tax system, avoiding the oft raised criticism that the comprehensive approach, if applied only to public or large corporations, “selectively denies intended tax preferences to a limited group of taxpayers.” Thus, ideally, the conformed accounting system should apply to both public and private firms equally. If lawmakers want to phase in the system in order to assess its effectiveness at the beginning, then perhaps the start date for private firms can be delayed one or two tax years—the idea being to go after the priority targets first.

F. How to Get There from Here

Opponents of conformity will argue that it is simply too difficult to get there from here. That is, given the conflicting objectives of the two accounting systems and the myriad differences between the financial and tax accounting rules, it is impossible to come up with a reasoned basis for conformity. First, on what measure—tax income or financial income—would conformity be based? Second, if any differences are to be allowed between the two systems, what differences are they, who decides, and how can the system be protected against erosion?

This Article does not accept the defeatist notion that such questions are unanswerable. First; it argues that the income base should be book income, with select qualifications. The Schedule M-3 already requires corporations to have a separate statement of U.S. book income, which is essential for international tax purposes. U.S. book income under a foreign tax credit system is used for calculating the credit limitation, which protects the U.S. tax base on U.S. source income. It would also be necessary under a territorial system as the starting point for the tax base. Moreover, a study of corporate returns from 1987 to 2001 finds that “book income is a relatively better measure of [corporate economic] performance than taxable income,” but that taxable income still measures specific transactions better than financial income. Tax income seems particularly valuable in two situations: (1) loss recognition—suggesting that GAAP becomes increasingly distortionary the more liabilities exceed assets; and (2) the 1997-2001 period, as book income inflation apparently rose. Both instances, however, merely support the use of book income for the conformed accounting system. Corporations with losses currently face tremendous pressures to disguise losses from investors pressures that would be alleviated if publicly disclosed losses would at least have the benefit of lowering tax liabilities. And as for the 1997-2001 years, accounting conformity would impose severe consequences in the form of higher tax liabilities on corporations that sought to inflate their reported book income.

To assert that the corporate tax base should be far simpler and closer to economic reality does not mean that the Code cannot retain certain important tax preferences. Interest received from state and municipal bonds, for example, should be exempt from tax, but would need to be recognized for financial accounting purposes. The system can be conceived of as taxing the net change in cash flows plus the financial valuation of assets and liabilities, with specific deductions for social policy purposes (i.e., state & local bond interest, or the R&D credit).

This argument relates to the second question that conformity skeptics will raise: who is to decide on the exceptions, and how? As discussed previously, the decision makers should be the FASB, Treasury, and the SEC, with a confined role for Congress at the beginning of the transition process to legislate tax departures from book income. Such departures, representing current law
deductions or credits, must be carefully selected from among the dizzying array of choices currently available. Consideration must go to the total dollar amount of deductions or credits to determine the significance of each tax measure to corporate income. But dollar amounts alone cannot dictate the decision. Ultimately, lawmakers must bear in mind the ultimate goal of conformity: to reassert the primary goals of tax and corporate accounting—revenue collection and information reporting—through the accurate measurement of economic income in a way that provides the fewest opportunities and incentives for fraud or gimmicks.

VI. TOWARD CONFORMITY

A. Consolidation

A uniform system will have to reconcile the massive gap between the consolidation rules of GAAP and tax accounting. GAAP requires firms to consolidate entities in which the parent has at least a 50% voting stake, whereas consolidation for tax purposes is permitted only for 80% controlling interests. In addition, firms may consolidate only domestic subsidiaries on their tax returns, whereas both domestic and foreign majority owned subsidiaries may be incorporated into the financial statement. And while the tax law permits a deduction for dividends received from corporate holdings, the financial statements must include the income from dividends received from any unconsolidated entity holdings.

If the purpose of consolidated tax reporting is to achieve the “equitable apportionment between [consolidated corporations] of the tax thus computed,” then it would make the most sense for a uniform system to adopt financial reporting's 50% standard. To follow tax law's stricter 80% threshold would be to exclude significant assets and liabilities from a parent corporation's financial statements, substantially degrading the quality of the information reported to investors. In computing tax liability, however, the income and losses of foreign subsidiaries would have to be excluded from the tax return. Foreign entities ordinarily are not U.S. taxpayers, and U.S. parent corporations should not be permitted to net foreign subsidiary losses against U.S. taxable income.

Also included in a uniform system should be the recent FASB guidance on the consolidation of “variable interest entities,” the special purpose entities (SPEs) that have become infamous in the wake of Enron. Previously, firms could form an SPE to keep debt off the balance sheet (in the case of Enron, hiding massive amounts of debt from investors), but could still deduct the losses for tax purposes if the SPE was treated as a partnership. Under revised rules issued at the end of 2003, the FASB requires firms to consolidate any SPE in which it has a “variable interest.” The latter term is defined as any “contractual, ownership, or pecuniary” interest, including equity and regardless of the voting power associated with it, that fluctuates with the net assets and obligations of the entity. Thus, the loophole through which taxpayers could keep an entity off the books by simply not obtaining a majority voting interest has been closed. The guidance provides a ten percent safe harbor, but above ten percent it eschews bright line numerical rules in favor of a “qualitative” and “quantitative” analysis of the interest at stake. The purpose is to “improve comparability between enterprises engaged in similar activities” and “provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprise” to the “financial statements users.”

B. Exceptions to the Rules
Although conformity along the lines of book income should be the rule, a few selected essential tax preferences should be retained either to preserve the principle of double taxation of corporate income or to preserve important social and economic policy objectives. On the first point, the section 243 dividends received deduction ensures that corporations and stockholders are not taxed on the same income twice and preserves the double taxation principle of corporate income taxation. Net operating losses, by allowing the “taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year,” ensure the equal treatment of taxpayers with regular income and those with fluctuating incomes from year to year. If not for this provision, the income tax would become like a tax on capital for those taxpayers whose income in any given year was less than the allowable deductions. Finally, the credit for foreign income taxes paid ensures that U.S. taxpayers do not pay taxes on foreign source income in more than one jurisdiction.

On the second point, the deduction for interest received on state and local bonds and the research tax credit promote favorable investments and should be retained. The state and local bond interest exemption, by allowing local governments to borrow at lower interest rates than other issuers, raises important questions of federalism and revenue sharing among government levels, questions that are not appropriately addressed in a proposal for a conformed accounting system. As for the research credit, it arguably corrects the market imperfections that otherwise prevent companies from realizing the full economic gains of research expenditures. As Congress noted when renewing the credit in 1996:

> Businesses may not find it profitable to invest in some research activities because of the difficulty in capturing the full benefits from the research. Costly technological advances made by one firm are often cheaply copied by its competitors. A research tax credit can help promote investment in research, so that research activities undertaken approach the optimal level for the overall economy.

Thus, the research credit falls under the category of tax preferences that actually fix market distortions rather than creating new ones. As such, it is an important tool that should be preserved in a unified accounting system.

In fact, book-tax conformity with a research credit may have the beneficial effect of minimizing the incentives for firms to become highly leveraged, reducing the risk of future meltdowns such as those seen with Enron and Worldcom. The research credit can be conceived of as a “non-debt tax shield” that should substitute for the use of leverage in corporate finance, but only to the extent that it changes a firm’s marginal tax rate. In addition, debt is more attractive as the tax rate rises; if a uniform accounting system sufficiently broadens the tax base to permit corporate rate reductions, the net effect could be reduced debt-equity ratios.

As for depreciation, it would be quite easy to use accelerated tax depreciation, known as MACRS, rather than the straight-line depreciation used under GAAP. This system, which divides assets into various classes, each with a statutorily defined useful life, provides uniform treatment for all companies, allowing for predictability and comparability across firms. Moreover, there would be little loss of value relevant information to capital markets because financial depreciation is not currently based on economic depreciation, because the expected asset life could still be disclosed separately. Businesses have complained that tax depreciation exacts high compliance costs, but the cost savings from the vastly simplified conformed accounting system would more than offset the continued compliance cost of MACRS.

Finally, the AJCA’s approach to cracking down on corporate inversion transactions—where a corporation reincorporates in a lower-tax foreign jurisdiction by forming a foreign subsidiary—indicates the base broadening changes that the new system would have to make. The AJCA disallows any corporate level loss from inversion transactions and prevents the application of NOLs or deductions against any recognized gain. Whereas the tax law generally considers only 80% ownership to be an
indication of corporate parentage, the AJCA’s loss and *1019 deduction limits cover inversions where the U.S. shareholders of the former U.S. corporation hold 60-80% of the foreign subsidiary’s stock, and apply for 10 years after the inversion transaction(s). 209 This approach should be followed more broadly and even extended. The GAAP consolidation rules, which consider any ownership above 50% to indicate a parent-subsidiary relationship, should be applied throughout the uniform accounting system.

VII. CONCLUSION

It is an article of faith in the United States that the economic performance of firms in a common industry should be measured by the same accounting standards. While uniformity facilitates business regulation, it is also a simple matter of equity:

How do you explain to an intelligent public that it is possible for two companies in the same industry to follow entirely different accounting principles and both get a true and fair view audit report? The public might want to know how many true and fair views [exist] ... and whether there is any common standard against which to measure them all. 210

It is time to make this case with regard to tax and financial accounting. To be sure, corporations will raise a fuss. There will be territorial battles among Congress, Treasury, the SEC, the FASB, the PCAOB, and the myriad other entities involved in regulating accounting standards. These special interests will create complications, but the key is to sell this change to the public at large. Americans are tired of corporate profiteering and they are tired of tax laws riddled with loopholes for those who least need a break. It is not unrealistic to believe that Americans will support this change in the Code just as they have rallied behind Sarbanes-Oxley—and, indeed, behind the rule of law in general since the writing of the Constitution.

One who takes a cynical approach to this view of American solidarity might be willing to accept the flip side of the coin. Even if Americans are not able to agree on a positive preference for a modified common book-tax accounting standard, they may well be able to agree on a negative preference—that the status quo is even worse. The FASB has compared its vision of the desired consensus around accounting principles to the rules of the road: because drivers agree that speed limits and traffic lanes make sense, they “observe traffic laws in the interest of their own and general traffic safety, so long as others do the same.” 211 Similarly, another commentator applied rational choice theory to the question of accounting standards and found that it “may be reasonable to assume a negative preference of this type”:

*1020 What might be the nature of the social will with respect to financial reporting alternatives? One possibility is that all individuals agree that all financial statements should possess certain desirable features, e.g., comparability over time and across firms. Then any particular individual, though s/he might prefer [last-in, first-out (LIFO) inventory accounting over first-in, first-out (FIFO) accounting], say, would nonetheless prefer a policy which requires that all firms use FIFO to a policy which permits some firms to use LIFO while others use FIFO. 212

The government’s primary revenue raising method forces its citizens to navigate a monstrously complex legal regime riddled with inequities and inefficiencies. As the Code and the regulations become ever more complex, compliance costs rise and business tax avoidance becomes the domain of the well-heeled and the well-advised. Ironically, if government attempts to crack down on tax shelters are successful, then “tax sheltering can be expected to become even more concentrated, available to only the most sophisticated taxpayers.” 213 Once again, one sees so-called tax reforms leading to a vicious cycle of complexity,
leading to tax planning, leading to greater complexity to outwit the planners, leading to greater perceptions of unfairness, leading to more tax planning. Book-tax conformity will stop the cycle.

Footnotes

a1 Associate, Sullivan & Cromwell, LLP; Harvard University, A.B., 1999; Yale Law School, J.D., 2006.


2 U.S. DEPT OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS, AND LEGISLATIVE PROPOSALS 32 (1999), available at http://www.treas.gov/press/releases/reports/ctswhite.pdf [hereinafter TREASURY WHITE PAPER] (“One feature of many tax shelters is that they reduce taxable income and taxes without reducing book income.”). The report acknowledges that “it is very difficult to distinguish tax shelter activity from other activity that results in a book/tax difference,” since numerous intended differences, such as the tax depreciation rules, allow companies “to ‘manage’ their book income to send positive signals to their shareholders, and [firms] apparently are apt to do so.” Id. at 32. Yet, Treasury reasons that because accounting discrepancies are a common feature of many shelter transactions, see infra notes 59-61 and accompanying text, evidence of the increasing book-tax divide provides support for the assertion that the shelter problem is growing. Id. at 32-33; see also Hearing on Penalty and Interest Provisions in the Code Before the S. Comm. on Finance 106th Cong. (2000) (prepared testimony of Jonathan Talisman, Acting Assistant Treasury Secretary for Tax Policy), as reprinted in 2000 TAX NOTES TODAY 47-63 (Mar. 9, 2000). (LEXIS, FEDTAX lib., TNT file, elec. cit. 2000 TNT 47-63).


4 Id. at 211.

5 I.R.C. § 446(a).

6 Reg. § 1.446-1(a)(1) (“The term ‘method of accounting’ includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item.”).

7 Reg. § 1.446-1(a)(1).

8 I.R.C. § 446(d).

9 See infra notes 57-71 and accompanying text.


11 American Jobs Creation Act §§ 102, 199.


15 See, e.g., Robert Schroeder, Treasury Dept. Promotes Permanent Tax Cuts, THOMSON FIN. NEWS (Mar. 7, 2005); William L. Watts, Bush Begins Long March to Tax Overhaul, THOMSON FIN. NEWS (Feb. 14, 2005) (“[T]he White House has indicated that the [reform] panel must assume that all of Bush’s first-term tax cuts ... will be made permanent.”).

16 I.R.C. § 446(a).

In 1990, the Service declared that it does not consider GAAP conformity a “controlling standard,” because to do so would impose a uniform accounting method (the accrual method) on all taxpayers in contravention of recognized tax policy and explicit regulations. P.L.R. 1991-13-003 (Dec. 18, 1990).


For a discussion of these factors, see Plesko, supra note 24, at 203-04.

For a critique of Schedule M-3 as a solution to the book-tax divide, see infra notes 121-132 and accompanying text.

Gary A. McGill & Edmund Outslay, Did Enron Pay Taxes?: Using Accounting Information to Decipher Tax Status, 96 TAX NOTES (TA) 1125 (Aug. 19, 2002).


That financial accounting information is crucial to public investors is reflected in the fact that since the 1930s, the SEC has been the “final arbiter of financial accounting rules for” public companies. GEORGE MUNDSTOCK, A FINANCE APPROACH TO ACCOUNTING FOR LAWYERS 7 (1999).


Thus, ELEMENTS OF FINANCIAL STATEMENTS, Statement of Fin. Accounting Concepts No. 6, 10 (Fin. Accounting Standards Bd. 1985), available at http:// www.fasb.org/pdf/con6.pdf, divides the elements of accounting into ten categories that roughly fall under the broader characterization of resources and transactions.


Establishment and Improvement of Accounting Statement, supra note 34. Sarbanes-Oxley perpetuated this reliance on the private sector, declaring that the SEC “may recognize as ‘generally accepted’ for purposes of the securities laws any accounting principles established by a standard setting body” that, among other criteria, “is organized as a private entity” and meets several other tests. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-24, 116 Stat. 745, 768 (codified as amended at 15 U.S.C. § 108(b)(1)(A)).

Although the courts successfully blocked late nineteenth and early twentieth century attempts to enact an income tax on constitutional grounds, ever since the Sixteenth Amendment sanctioned income taxation in 1913, “the general authority of the Congress in the field of taxation has not been significantly challenged [by the judiciary].” Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 53 (rev. 4th ed. 2002).

Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979); see also Commissioner v. Idaho Power Co., 418 U.S. 1, 10-12, 14 (1974) (denying depreciation deductions against equipment used to construct the taxpayer's own capital assets, and ordering capitalization as a clearer reflection of “accounting and taxation realities” and a means of maintaining “tax parity” with the taxpayer that hires an outside contractor to construct the capital asset); Lucas v. Am. Code Co., 280 U.S. 445, 449 (1930) (holding that the “general” rule of section 446 “is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income.”); Am. Auto. Ass'n v. United States, 367 U.S. 687, 693 (1961) (“To say that the taxpayer's 'business accounting ... method' ... is in accord with generally accepted commercial accounting principles and practices’ ... is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury.”); Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978) (“[W]e are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same.”).

The Fifth Circuit, considering an inventory write-down similar to that in Thor Power, has limited Thor Power's higher valuation to cases where “the taxpayer offer[s] no objective evidence to verify its estimate of reduced market” as mandated by the Code. St. James Sugar Coop. v. United States, 643 F.2d 1219, 1225 (5th Cir. 1981). Other courts, however, have given less weight to the reliability of the taxpayer's valuation, relying more on whether the write-down was consistent with the taxpayer's chosen accounting method. The Second Circuit has approved the Thor Power doctrine even where the taxpayer could provide objective evidence of the lower market value, but its write-down was inconsistent with the taxpayer's chosen accounting method (cost percentage of contract completion). Kollsman Instrument Corp. v. Commissioner, 870 F.2d 89, 92 (2d Cir. 1989).

I.R.C. § 446(b).

Reg. § 1.446-1(c)(2)(ii).

P.L.R. 1991-13-003, supra note 22. The four standards are (1) year-to-year accounting consistency, (2) GAAP conformity, (3) “substantially identical” results using the taxpayer's asserted method and the Service's chosen method, and (4) whether the method results in a matching of income and expenses. The Service based its rejection of book-tax conformity on section 446 and the accompanying regulations, case law, and legislative history.


Fed. Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580, 584, 587 (D.C. Cir. 1990) (“Exchange transactions do not lack economic substance even if the sole motive for entering the transactions is to obtain beneficial tax treatment of a taxpayer's losses ... where the...
taxpayer has already suffered genuine losses ... exchanges merely provide a means to recognize the losses.... [A] court finding of an 'exchange' requires that the parties to the transaction have at least a contractual interest in the property transferred.""); san antonio sav. ass'n v. commissioner, 887 f.2d 577, 591 (5th cir. 1989) ("Because the value of the mortgages depends on the performance of [certain] unique entities ... an exchange of residential mortgages is not like swapping identical fungible commodities.").

48 cottage sav. assoc. v. commissioner, 499 u.s. 554 (1991); united states v. centennial sav. bank fsb, 499 u.s. 573 (1991) (cottage savings controls). these two cases were decided on the same day, with both majority opinions written by justice thurgood marshall.

49 for an example of the importance of tax planning to business life, see myron s. scholes & mark a. wolfson, taxes and business strategy: a planning approach (1992).

50 memorandum # r-49 from l. david taylor, director, federal home loan bank board, office of examination and supervision (oes), to oes professional staff (june 29, 1980) (on file with the office of thrift supervision). criteria included identical interest rates, same terms to maturity, similar fair market value, single-family residential homes as collateral, and nearly equal aggregate principal amounts (with a de minimis exception).

51 although r-49 could only speak to the accounting treatment that the fhlbb would accord to such sales, fhlbb executives had consulted with members of the aicpa and "obtained agreement with our stance from prominent cpas serving the industry."

memorandum from the director of the office of examination and supervision, federal home loan bank board (fhlbb), to the fhlbb executive staff director, cited in first fed. sav. & loan ass'n of temple v. united states, 694 f. supp. 230, 234 (w.d. tex. 1988) [hereinafter oes memorandum]. thus, it was understood that the reciprocal sales would not trigger a loss under gaap either.

52 according to one of the fhlbb executives involved in planning memorandum r-49, the “substantially identical” criteria “represented our attempt to [ensure no change in the] types of risks in a loan portfolio .... in our opinion, a change in any of these risks would change the economic factors underlying an association's loan portfolio and, as a result, require recording the resulting gain or loss.” oes memorandum, cited in first fed. sav. & loan ass'n 694 f. supp. at 234. as long as none of these three factors differed between the exchanged properties, r-49 would apply.

53 first fed. sav. & loan ass'n, 694 f. supp. at 238 n.7.

54 i.r.c. § 1001(c).

55 reg. § 1.1001-1(a) (emphasis added).

56 cottage sav. ass'n v. commissioner, 499 u.s. 554, 603 (1991) ( “[m]ortgages can be substantially identical for memorandum r-49 purposes and still exhibit ‘differences’ that are ‘material’ for purposes of the ... code.”).

57 temp. reg. § 301.6111-2t (temporary regulation effective feb. 28, 2000) (adding “transactions lacking economic substance” to the definition of reportable shelter transactions, defined as transactions in which the “present value of the participant's reasonably expected pre-tax profit [or pre-tax deductions in the case of a financing transaction] ... is insignificant relative to the present value of the participant's expected net federal income tax savings from the transaction.” reg. § 301.6111-2t(b)(3).

58 staff of joint comm. on tax'n, 106th cong. comparison of recommendations relating to corporate tax shelters made by the department of treasury and the staff of the joint committee on taxation (jcx-25-00 (mar. 7, 2000)) (listing five “corporate tax shelter indicators,” including the same criteria listed in temporary regulation section 301.6111-2t, for transactions “lacking economic substance.”).

59 treasury white paper, supra note 2, at 12, 14.

60 id. at 14 n.50.

61 id. at 14.

62 staff of joint comm. on tax'n, supra note 58 at 5.
HOW TO BUILD A BRIDGE: ELIMINATING THE BOOK-TAX..., 59 Tax Law. 981


65 TREASURY WHITE PAPER, supra note 2, at 32.


69 Plesko, Corporate Tax Avoidance and the Properties of Corporate Earnings, supra note 67, at 731-33, 735 (Plesko's data begin in 1995, when the book-tax difference was a little over $100 billion).

70 Id. at 733-34, figs.2, 3.


73 The concept of tax deferral as an interest free loan is discussed in GRAETZ & SCHENK, supra note 36, at 288.

74 John R. Graham & Alan L. Tucker, Corporate Tax Shelters and Debt Policy, Aug. 17, 2005, at 15, available at http://ssrn.com/abstract=633042. The authors postulate that the decreasing debt-to-assets ratios in the years leading up to the identified sheltering activity is consistent with increasing use of tax shelters rather than debt and with the oft noted fact that the government will catch only the most egregious shelters. Id. at 16.


76 The methodology used by Wertz and repeated herein is as follows:

1. Pretax book income is derived from the financial statement by adding back to posttax net earnings state and federal income taxes paid. State taxes are calculated as 18% of the federal income tax provision, per the Compustat database on U.S. public corporations.

2. Certain deductions from pretax book income are made to reflect those tax deductions that would still be available under a conformed book-tax accounting system. Wertz deducts state taxes paid, interest received on state and local government bonds, dividends received, and operating losses. I do not deduct state income taxes paid, as per the 2005 Code. I.R.C. § 164 (individuals and corporations may deduct either state income taxes or state sales taxes paid, but not both).

3. A credit for foreign income taxes paid is then added to the total. Unlike Wertz, I also add back the credit for research and development expenses.

4. The applicable tax rate is then calculated as the rate at which the resulting figure would yield the same amount of tax as the actual tax provision in that year.
See id. at 315. For more on the tax base recommended in this article, see infra Part VI.


Murray, supra note 1, at A4.


TREASURY WHITE PAPER, supra note 2, at 14 n.53.


Sarbanes-Oxley Act § 101 (“There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws ... in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports .... The Board ... shall not be an agency or establishment of the United States Government.”).


See PERMANENT SUBCOMM. ON INVESTIGATIONS REPORT, supra note 82, at 9 (“By 2003, dubious tax shelter sales were no longer the province of shady, fly-by-night companies with limited resources. They had become big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks.”). See generally Joseph Bankman, The New Market in Corporate Tax Shelters, 83 TAX NOTES (TA) 1775 (June 21, 1999); Janet Novack & Laura Saunders, The Hustling of X Rated Shelters, FORBES, Dec. 14, 1998, at 198.

See, e.g., Jonathan R. Macey, Efficient Capital Markets, Corporate Disclosure, and Enron, 89 CORNELL L. REV. 394, 396 (2004) (“Enron's collapse demonstrates the strength of the U.S. system of corporate governance, namely the intensely competitive environment in which U.S. management teams operate. However, in rare cases like Enron, the “pressure-cooker” environment leads managers of U.S. corporations and their advisors to take shortcuts and mislead investors about corporate performance.”); TREASURY WHITE PAPER, supra note 2, at 28 (“Effective tax rates may be viewed as a performance measure, separate from after-tax profits.”).


See infra notes 168-177 and accompanying text.

In mid-1999, Treasury released a white paper on corporate tax shelters that attempted both to define with new precision the distinction between tax shelters and tax planning and to provide a comprehensive survey of corporate tax shelter techniques. Although the white paper largely focused on enforcement of existing tax laws, it concluded by offering suggestions for legal reform outside the strictures of the Code designed to shut down the corporate tax shelter industry. One such proposal was to establish a book income floor, such that a corporation's taxable income in any given year could be no lower than its reported book income for that period. TREASURY WHITE PAPER, supra note 2, at 114-17. Treasury, however, acknowledged that this “approach would add significant complexity,” id. at 116, indeed, the proposal raised more questions than it answered. The precedent for the white paper proposal lay in the 1986-1989 experiment with a book income preference adjustment in place of the traditional corporate AMT. This short lived
system, created in the comprehensive tax reforms of 1986, penalized corporations whose book income exceeded their alternative minimum taxable income in any given year by increasing AMT income by 50% of the difference between AMT income and book income. Like Treasury's white paper proposal, the 1986-1989 book income preference recognized that the essence of corporate tax sheltering is reducing a corporation's effective tax rate, which by definition involves reducing taxable income relative to book income. Yet, the 1986-1989 AMT exponentially increased the compliance costs for corporations and the administrative and enforcement costs for the Service, and it quickly gave way to an AMT adjustment relying on earnings and profits rather than book income. For more on the complexity of the 1986-1989 AMT, see Slemrod & Blumenthal, supra note 87; Lee A. Sheppard, The Book Income Preference in the Corporate Minimum Tax, 33 TAX NOTES (TA) 616, 616 (1986); and Terrence R. Chorvat & Michael S. Knoll, The Case for Repealing the Corporate Alternative Minimum Tax, 56 SMU L. REV. 305 (Winter 2003).

See infra Part VI; see also Michael J. Graetz, The 1982 Minimum Tax Amendments as a First Step in the Transition to a “Flat-Rate” Tax, 56 S. CAL. L. REV. 527, 566 (1983) (“Proceeding to a broad-based, low-rate tax by first expanding the minimum tax base should provide important information concerning the tax base that will ultimately be made generally applicable and should eliminate a vast number of disputes over transitional issues.”). Although Professor Graetz wrote this article in reference to the individual AMT imposed in 1982, he observed that the same transitional, base-broadening approach could be used with respect to corporate taxes. Id. at 564-65. Indeed, by 1986, before the corporate AMT was restructured, he lamented that the corporate AMT had been the mere “stepchild” of base-broadening reforms under the Reagan administration. Eric C. Kracov, Finance Hears Policy Arguments for Reform of the Minimum Tax, 29 TAX NOTES (TA) 120 (Oct. 14, 1985).

I.R.C. § 472(c), (e) (1954) (current version at I.R.C. § 472(c) & (e)).

I.R.C. § 166(a)(2) (1954) (current version at I.R.C. § 166(a)(2)).

Reg. § 1.451-5.


The Senate report to the 1958 act that created section 455 justified the section by remarking that “it is proper to defer subscription income, since the expenses related to this income are largely incurred when the periodical is published, while deducting circulation expenses currently, since these expenditures are related to the advertising rates which are currently being charged.” S. REP. No. 85-1983, at 44 (1958). Similarly, lawmakers discussed the enactment of section 456 in the context of “the relationship of income tax accounting to generally accepted accounting principles.” H. Rep. No. 86-2099, at 2 (1960).

When Congress first permitted the use of LIFO accounting in 1938, it made the new method available only to those companies that were permitted to use LIFO by the accounting standards authority of the time. Revenue Act of 1938, Pub. L. No. 502, §22(d), 45 Stat. 791, 83 CONG. REC. 5043-44 (in the industries in which the Act permits the use of LIFO accounting, “LIFO is recognized by the leading accounting authorities as most accurately reflecting income.”). A year earlier, the Senate had proposed allowing all companies to use LIFO, regardless of whether they were using it for their financial accounts, but Treasury had objected. Permitting LIFO only in instances where its use in tax accounting would create conformity with financial accounting represented a compromise between the Senate and Treasury positions. Knott & Rosenfeld, supra note 31, at 1047-48.

When Congress first permitted the use of accrual accounting rather than cash basis accounting in 1916, the statute applied to “a corporation ... keeping accounts upon any basis other than that of actual receipts and disbursements” and required that such corporation “make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.” Revenue Act of 1916, § 13(d), 39 Stat. 756.

Roger Russell, For Better or Worse, Jobs Creation Act of '04 Is Here, ACCT. TODAY, Nov. 8, 2004, at 10.
American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418, at 1562-1660 (codified as amended in scattered sections of the Code). The Act also includes 71 other revenue related and tax avoidance provisions under Title VIII.


Of the 39 tax shelter provisions in the American Jobs Creation Act, supra note 10, 14 deal with penalties and tax administration and enforcement. In addition, eight Senate provisions that would have “clarified” the economic substance doctrine and increased or created a host of new penalties died in conference. H.R. REP. NO. 108-755, at 8587-93 (2004) (Conf. Rep.).

PERMANENT SUBCOMM. ON INVESTIGATIONS REPORT, supra note 82, at 4.

FY 2005 PROPOSALS, supra note 102, at 111-38.

PERMANENT SUBCOMM. ON INVESTIGATIONS REPORT, supra note 82, at 6-7.


Shevlin, supra note 107, at 438.

Hanlon et al., supra note 107, at 10-11.

Id. at 33.

David M. Maloney & Robert H. Sanborn, Interactions Between Financial and Tax Accounting Caused by the Tax Reform Act of 1986, ACCT. HORIZONS, Dec. 1988, at 25. The authors used the specific AMT provisions to deliver a more general message about the dangers of “increas[ing] the interaction between the ... GAAP concept of financially reported income and the federal tax system's definition of income.” Id. at 21.


FuseAction=PressReleases.Detail&PressRelease_id=3706&Month=7&Year=2002 [hereinafter Grassley Letter to O'Neill] (asking whether, in light of “recent events” in corporate finance, “the information contained in the corporate tax returns of publicly traded companies could be of benefit to government regulators as well as shareholders and workers”).

Murray, supra note 1, at A4.

But see Nordhaus Statement, supra note 112 (corporations should disclose their full tax returns and reconcile the tax and financial accounts, largely because the growing use of employee stock option compensation and ever more aggressive financial profit reporting have reduced the value of financial statements for the capital markets).

In response to Senator Grassley’s July 2002 query, SEC Chairman Pitt replied that public tax return disclosure would have only “marginal” benefits. David Lenter, Joel Slemrod, and Douglas Shackelford, Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Considerations, 56 NAT'L. TAX J. 803, 806 (2003) (quoting SEC Chairman Pitt). Lenter, Slemrod and Shackelford also dismiss arguments that full public disclosure of tax returns could improve financial regulation, enhance capital market efficiency (by improving the quality of publicly available information), or improve the quality of income reporting on corporate returns. Id. at 815-27.

Grassley Letter to O'Neill, supra note 113.


Canellos & Kleinbard, supra note 112, at 1000 (proposing consolidated disclosure of an improved Schedule M, Schedule L, and the book-tax reconciliation currently included in the footnote to the tax provision in the financial statement).

Corporate Accountability Tax Gap Act of 2003, H.R. 1556, 108th Cong. (2003) (bill introduced by Lloyd Doggett proposing that corporations electronically file a report with the Service, which would be made publicly available and searchable, laying out specific items of the book-tax disclosure on the full tax return); Grassley Letter to O'Neill, supra note 113 (“summary version” disclosure); Canellos & Kleinbard, supra note 112 (Schedule M-1 disclosure); O'Neill Letter to Grassley, supra note 118 (greater tax disclosure on financial statements).

Lenter et al., supra note 116, at 817, 827.

The transactional accounting approach ought to help auditors detect misstatements in the tax return. A 1998 study found that because corporations do not just misstate the bottom line when attempting to avoid taxes, “component” reporting that allows auditors to look at the separate components of reported income should help catch tax evasion. Shelley C. Rhoades, The Impact of Multiple Component Reporting on Tax Compliance and Audit Strategies, 74 ACCT. REV. 63, 64 (1999).


The Schedule M-3 instructs corporations that file a Form 10-K with the SEC to use the net income from the Form 10-K income statement. See Instructions for Schedule M-3 (Form 1120). For all other corporations, the form retains the old, vague “books and records” language.


Taxpayers that do not file a Schedule M-3 (i.e., those businesses with assets of less than $10 million) may satisfy their significant book-tax difference disclosure obligation either by following the return disclosure regulations, Reg. § 1.6011-4(b)(6), or by following the Schedule M-3 disclosure procedures. Line 12 in Part II of the Schedule M-3 requires an accounting of any Regulation section 1.6011-4(b) reportable transactions (aside from those that fall under the (b)(6) definition), including not only the separate book and tax amounts of each reportable transaction, but also a division of those amounts into temporary and permanent differences.

Murray, supra note 1, at A4.

Yin, supra note 112, at 227.

Murray, supra note 2, at A4.

Id.


See id. at 573.

Lenter et al., supra note 116, at 819-20.


This was the theory in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979) (in light of the tax system's major goals—“the equitable collection of revenue” and “protect[ing] the public fisc”—the conservatism-induced “understatement of income is not destined to be [Treasury's] guiding light.” Thus, “any presumptive equivalency between tax and financial accounting would be unacceptable.”).

See, e.g., Alvin D. Knott & Jacob D. Rosenfeld, Book and Tax: A Selective Exploration of Two Parallel Universes (Part Two), 99 TAX NOTES (TA) 1043, 1061 (May 19, 2003) (it is “likely that aligning tax and book income would serve to generally erode the quality of financial statements, without actually changing the incentives to deter abusive management.”); Shevlin, supra note 107, at 434 (“how long will it be before we are back to the current system (which already could be characterized as book income being the starting base with many modifications to arrive at taxable income)?”).

Calvin Johnson, Using GAAP Instead of Tax Accounting is a Bad Idea, 83 TAX NOTES (TA) 425, 425 (Apr. 19, 1999).

See supra notes 65-71 and accompanying text. Although the figure fell sharply to negative territory by 2001, led by firms with aggregate book losses, it rebounded in 2003, the latest year for which data are available. Hanlon & Shevlin, supra note 71, at 12-13.


88-89 (1992) (during 1986-1989, “[f]irms subject to a high marginal tax rate ... managed their earnings downward relative to firms subject to a low marginal tax rate”).

145 One scholar has found that conservatism—defined as the “tendency to require a higher degree of verification for recognizing good news than bad news in financial statements”—makes earnings reporting three times more sensitive to negative returns than to positive returns. Sudipta Basu, The Conservatism Principle and the Asymmetric Timeliness of Earnings, 24 J. ACCT. & ECON. 3 (1997).


147 The FASB defines a “temporary difference” (known as a “timing difference” prior to the promulgation of Statement of Financial Accounting Standards No. 109 in 1992) as that difference “(sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in financial statements.” ACCOUNTING FOR INCOME TAXES, Statement of Fin. Accounting Standards No. 109, at 5 (Fin. Accounting Standards Bd. 1992).

148 Phillips et al., supra note 146, at 492.


150 FASB, FINANCIAL ACCOUNTING CONCEPTS STATEMENT NO. 1, supra note 137, ¶ 33.

151 In his seminal article on how industries may capture their regulators, George Stigler noted that the “only way” to ensure that regulators will not be subservient to the industries they serve “would be to change the political support for the [regulatory body], and reward [regulators] on a basis unrelated to their service to the” industry. George J. Stigler, The Theory of Economic Regulation, 2 BELL J. ECON. & MGMT. SCL 3, 17-18 (1971).

152 Knott & Rosenfeld, supra note 31, at 868.


155 Ashiq Ali & Lee-Seok Hwang, Country-Specific Factors Related to Financial Reporting and the Value Relevance of Accounting Data, 38 J. ACCT. RES. 1, 2 (2000). The value relevance of reported income is also lower in bank-oriented countries rather than in market-oriented systems such as the United States. Id. at 1-2.

156 See, e.g., Hanlon & Shevlin, supra note 71, at 18; Knott & Rosenfeld, supra note 140, at 1060-61.


158 Russell, supra note 100.

159 Luppino, supra note 112, at 177-78.


161 See infra Part VI.


163 Hearings Before the Subcomm. on Priorities and Econ. in Gov't of the Joint Econ. Comm., 92d Cong., 48-59 (1972) (statement of Stanley S. Surrey), quoted in GRAETZ & SCHENK, supra note 36, at 43.

165 Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *READINGS IN THE ECONOMICS OF TAXATION* 54, 59 (Musgrave & Shoup eds., 1959) (income is “the money value of the net accretion to one's economic power between two points of time.”); HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938) (“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”); see also Nancy C. Staudt, *The Political Economy of Taxation: A Critical Review of a Classic*, 30 L. & SOC’Y REV. 651, 652-53 (1996) (reviewing HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM IN FISCAL POLICY* (1938), and noting that although his definition of income is “classic” among tax theorists, it is only a “starting point”).

166 Professor David Bradford has classified these types of complexity as “rule complexity,” “compliance complexity,” and “transactional complexity.” DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 266-67 (1986).

167 *Corporations and Society, supra* note 112, at 2271. As of July 2006, the table of contents of Title 26 listed 9,833 sections. This number, however, includes several section numbers that are not currently operative, having been repealed or reserved for future use. Conversely, many section numbers are further divided into subsections denoted by letter; for example, section 6050 is actually sections 6050A, 6050B, and 6050C through 6050T. For more on the definition of income as the net change in a person's economic power see Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *READINGS IN THE ECONOMICS OF TAXATION* 54, 59 (Musgrave & Shoup eds., 1959).


169 *Id.* at 520.


174 Sheppard, *supra* note 89, at 616 (“The corporate income tax can usefully be thought of as three taxes, according to [Professor Michael] Graetz and economist Emil Sunley... There is a regular corporate income tax with a 34 percent top marginal rate and accelerated depreciation. There is an alternative minimum tax with slower depreciation and a flat 20 percent rate. Finally, there is a tax on excess book income with financial accounting depreciation and a flat 10 percent rate.”). Since 1989, the third component of the tax has been corporate earnings.

175 Slemrod & Blumenthal, *supra* note 87, at 426, 428.


177 Chorvat & Knoll, *supra* note 89, at 324-25; see also Slemrod & Blumenthal, *supra* note 87.

178 JCT ENRON REPORT, *supra* note 64, at 102 (“Arguably, the primary reason for engaging in most of [Enron’s] structured transactions after 1996 was for the financial accounting benefits they generated rather than the Federal income tax benefits. Indeed, many of the structured transactions were designed to permit Enron to start reporting the financial accounting benefits of a transaction immediately
even though the Federal income tax benefits (which generated the financial accounting benefit) would not occur until significantly into the future.”).

179  Id. at 16; see also id. at 9-10, tbl.3.

180  Id. at 26.


182  Schedule M-3 applies for the 2004 tax year only to companies with total assets of at least $10 million at year's end. In addition, such firms have the option in the first year of filing the Schedule M-3 to report only temporary and permanent differences, not the actual dollar amounts of book and tax income or loss for each type of transaction that creates such a difference. See Corporations Urged to Use 2004 M-3 Transition as Trial Run for Compliance, DAILY TAX REP. (BNA), Aug. 2, 2004, at GG-1.

183  Id. (quoting a former Treasury official as saying, “there is a very real cost for taxpayers—especially in the first year—to modify their existing systems to capture data in a way that would allow them to complete the form”).


187  See Part VI, infra. One existing difference between tax accounting and financial accounting occurs in the context of mergers and acquisitions (M&A). Since the 1986 repeal of the General Utilities doctrine, General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935), financial accounting for M&A has differed from tax accounting, which requires the recognition of gain or loss on dispositions of appreciated or depreciated property, I.R.C. § 336. Congress will have to decide whether to preserve this rule and legislate accordingly.

188  Heflin & Kross, supra note 138, at 15.

189  Mills & Plesko, supra note 112, at 869 (from the Schedule M-1, “[r]esearchers cannot easily determine the sources of consolidation differences, even when tax return and financial statement are available.”).

190  CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Fin. Accounting Standards No. 94, ¶ 2 (Fin. Accounting Standards Bd. 1987), available at http://www.fasb.org/pdf/fas94.pdf. If a firm owns between 20% and 50% of another company, it includes its percentage holding as a net equity interest on its balance sheet; for holdings below 20%, the firm includes only the income from dividends received.

191  I.R.C. § 1501.


193  Helvering v. Morgan's Inc. 293 U.S. 121, 127 (1934).


195  Id. ¶ 2.

196  Id. ¶ 5.

197  Id. ¶ 9.
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198 Id. ¶ 5.


201 I.R.C. § 901.

202 Cf. Engler, supra note 186, at 549 (stating that the exemption of interest on state and local bonds is a “[c]lassic example” of a purposeful deviation from economic income enacted to “stimulate desirable activity by reducing the effective rate of tax on such activity”).


205 “The most obvious book-tax difference that could be conformed is that for depreciation.” Hanlon & Shevlin, supra note 71, at 29.

206 Id. at 29.

207 Slemrod & Blumenthal, supra note 87, at 428.

208 See also Engler, supra note 186, at 549 (stating that accelerated depreciation is a “[c]lassic example” of a purposeful deviation from economic income enacted to “stimulate desirable activity by reducing the effective rate of tax on such activity”).


212 Barry E. Cushing, On the Possibility of Optimal Accounting Principles, 52 ACCT. REV. 308, 312-13. The author criticizes previous literature applying rational choice theory to accounting standards, which generally reached pessimistic conclusions about the possibility of social consensus, and uses rational choice principles to explore how either positive or negative consensus could be reached.

213 Corporations and Society, supra note 112, at 2271.

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