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**“The Optimal Relationship Between  
Taxable Income and Financial Accounting  
Income”**

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THE OPTIMAL RELATIONSHIP BETWEEN  
TAXABLE INCOME AND FINANCIAL  
ACCOUNTING INCOME:  
ANALYSIS AND A PROPOSAL

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**Preliminary Draft**

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*The persistence of the book-tax gap, or excess of companies' reported financial accounting income over their taxable income, suggests that accounting manipulation and tax sheltering remain significant problems, even in the aftermath of the "Enron era." Some have therefore suggested making the United States a "one-book" country, in which the same income measure would be used for both purposes. This Article offers the first systematic exploration of the optimal relationship between the two income measures, based on the distinct purposes they serve and the significance of two distinct sets of incentive problems: those pertaining to corporate managers, and to the political decision-makers who make the rules.*

*Absent these incentive problems, the two ideal measures would differ, reflecting that allocating tax burdens is not the same exercise as informing investors. The incentive problems cut in favor of uniformity, however, by supporting the creation of a "Madisonian" offset between managers' and politicians' twin quests for high accounting income and low taxable income. But this offset has more promise as a device to constrain managers than politicians, given the difficulty of binding Congress and the existing partial insulation of accounting rules from direct political influence. In light of the political incentive issues, pure one-book and two-book approaches may both be inferior to partial conformity, such as that which would result from generally requiring a 50 percent adjustment by large, publicly traded companies of taxable income towards financial accounting income.*

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INTRODUCTION

One of the hallmarks of the “Enron era”<sup>1</sup> in corporate governance was companies’ increasing proficiency in reporting high earnings to investors and low taxable income to the Internal Revenue Service. Enron has passed from the scene, and so, perhaps, have the worst abuses of the Enron era, but the book-tax gap, or excess of reported financial accounting income over taxable income, persists.<sup>2</sup> While the gap’s exact causes, though much studied,<sup>3</sup> remain imperfectly understood, most analysts agree that its persistence offers suggestive evidence of two ongoing, distinct evils. The first is earnings management, or managerial manipulation of reported financial accounting income in the hope of favorably influencing one’s stock price. The second is tax sheltering, or reducing one’s U.S. federal income tax liability through various maneuvers that, even if lawful when engaged in, would likely be barred if they drew the government’s close attention.<sup>4</sup>

Earnings management undermines financial markets by reducing their transparency. Tax sheltering reduces the efficiency and equity of the tax system. The joint rise of these two problems, beginning in the 1990s and apparently persisting even as the pendulum swung back towards more cautious managerial behavior, reflects, at a minimum, elements of joint causation. Both phenomena reflect the impact of financial innovation, which has created new tools and opportunities for nuanced and aggressive planning in both areas. Both seem to have reflected as well the rise of greater competitive pressures on

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<sup>1</sup> On the “Enron era” in corporate governance, see, e.g., Kurt Eichenwald and Alexie Barrionuevo, “Tough Justice for Executives in Enron Era,” *N.Y. Times*, May 27, 2006, p. A-1.

<sup>2</sup> The growing book-tax gap was cited as one of the challenges in tax administration in the Written Testimony of Commissioner of Internal Revenue Mark Everson before Senate Committee on Finance on Compliance Concerns Relative to Large and Mid-Size Businesses, IR-2006-94, June 13, 2006.

<sup>3</sup> See Michelle Hanlon, Stacie Kelley Laplante, and Terry Shevlin, Evidence for the possible information loss of conforming book income and taxable income, 48 *J. Law & Econ.* 407 (2005); Mihir Desai, “The Divergence Between Book and Tax Income,” in James Poterba (ed.), *TAX POLICY AND THE ECONOMY* 17 (2003); George Plesko and Lillian Mills, “Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income,” MIT Working Paper 4289-03 (2003); G.B. Manzon and G. A. Plesko, The Relation Between Financial and Tax Reporting Measures of Income, 55 *Tax L. Rev.* 175 (2002).

<sup>4</sup> See Joseph Bankman, The New Market in Corporate Tax Shelters, 83 *Tax Notes* 1775, 1777 (1999) (including among the definitional characteristics of a corporate tax shelter that “it is likely to be shut down by legislative or administrative change soon after it is detected”).

corporate management, along with enhanced competition and entrepreneurialism in the markets for legal and accounting services.

Beyond just being jointly caused, however, the earnings management and tax sheltering sides of the book-tax gap appear to be synergistically linked. Absent our two-book system, in which financial income and taxable income are reported separately using distinct sets of rules, the synergy would be negative. That is, corporate executives would often be forced to choose between the earnings management goal of increasing reported income and the tax planning goal of reducing it, rather than being able, in many cases, to enjoy the best of both worlds. As things stand, however, in addition to being able to pursue both objectives independently, corporate executives may find positive synergies between aggressive tax planning and avoiding financial transparency. Both aims can be advanced through the creation of complex internal financial arrangements and special purpose entities that are rationalized on tax planning grounds, but that may aid managers not just in evading financial oversight, but in diverting corporate assets from the shareholders' pockets to their own.<sup>5</sup>

Proposed responses to the unfortunate positive synergies between earnings management and tax sheltering have taken two main forms. The first is purely informational, involving greater communication to the audience for each measure of how it differs from the other measure. On the tax side, the U.S. Treasury Department has recently increased the rigor and usefulness of the reconciliation reports that it requires from corporate taxpayers with regard to the differences between reported book and taxable income. In 2004, the Treasury began requiring large corporate taxpayers to file new Schedule M-3, explaining in detail how the two reported measures differ.<sup>6</sup> On the financial markets side, various commentators have urged that investors be given greater access to tax return information, at a minimum by requiring more specific disclosure of annually reported taxable income and tax liability.<sup>7</sup>

The second proposed type of response is more substantive. A number of commentators have urged requiring greater conformity between reported

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<sup>5</sup> See Mihir A. Desai, *The Degradation of Corporation Profits*, 19 *J. Econ. Perspectives* 171 (2005). On the nexus between tax avoidance and corporate governance internationally, see: Desai, I. J. Alexander Dyck and Luigi Zingales, *Theft and Taxes*, NBER Working Paper No. 10978 (2004). On the link between tax avoidance and high-powered incentives, see Desai and Dhammika Dharmapala, *Corporate Tax Avoidance and High Powered Incentives* NBER Working Paper No. W10471 (2004).

<sup>6</sup> See Revenue Procedure 2004-45, 2004-2 C.B. 140.

<sup>7</sup> See, e.g., Peter C. Canellos and Edward D. Kleinbard, *Disclosing Book-Tax Differences*, 96 *Tax Notes* 999 (2002).

taxable and financial accounting income. At the limit, this would involve converting the United States – like, for example, Germany until recently – into a “one-book country” in which a single measure of income is both reported to shareholders and used, with relatively few adjustments, to determine income tax liability.<sup>8</sup> Short of that, the two systems might be conformed subject only to specified exceptions. Or, less ambitiously, one could add in more piecemeal fashion to the currently short list of areas in which book-tax conformity is encouraged or required.<sup>9</sup>

This Article makes two main contributions to this debate, one theoretical and the other practical. First, as to the former, I offer a more systematic exploration than any in the existing literature of how one should think about the proper relationship between taxable income and accounting income. This requires focusing in detail on three distinct questions, both for each system and with regard to the systems’ interactions. The first, getting at the reasons for using income as a measure, is what information one would ideally want to use as the basis for imposing tax liability and for informing financial markets about a company’s current economic performance. I explore this in section I. The second question is how incentive problems on the part of corporate managers that relate to providing such information affect the optimal design of the measures. I explore this in section II. The third question is how incentive problems in the political process of setting the measures affects their optimal design. I explore this in section III.

Analysis of these issues suggests that, if one were separately designing taxable and accounting income to serve their particular purposes, the two measures would diverge significantly. Determining how tax liability should be levied over time is simply a different exercise than determining what information should be provided to investors through the number that is provided on the income line of financial statements.

Pushing against this argument for differentiation, however, is an argument for conforming the two measures that is rooted in managerial and political incentive problems. The fact that managers want low taxable income

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<sup>8</sup> See Wolfgang Schon, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 *Tax L. Rev.* 111, 116 (2005) (noting that, while Germany for more than a century primarily used the one-book approach, “[i]n recent years we find a growing tendency in Germany to abolish the principle of [such] dependence altogether”).

<sup>9</sup> See, e.g., Code section 472(c) (conditioning use of last-in, first-out (LIFO) inventory accounting on its being used for financial accounting purposes; IRS Notice 94-47, 1994-1 C.B. 357 (treating financial accounting classification of an instrument as debt or equity as relevant to its tax classification)).

and high accounting income, and that politicians are often inclined to push for this as well, supports creating what I call a “Madisonian” dilemma for one or both groups. James Madison famously described the constitutional strategy of using “[a]mbition ... to counteract ambition” such as through the separation of powers.<sup>10</sup> Here, though different parties’ ambitions are not being set against each other in classic Madisonian style, at least this is happening as to two different ambitions of the same people. Setting the goals of reducing and increasing “income” against each other, rather than permitting untrammelled pursuit of both objectives, may reduce the scope of incentive problems even if not eliminating them. I argue, however, that this approach generally is more promising for with respect to managerial than political incentive problems, with important implications for how rules advancing book-tax conformity ought to be designed.

Second, in a more practical vein, section IV offers a concrete proposal concerning the relationship between taxable and accounting income, admittedly going well beyond the determinacy of the theoretical analysis. My proposal builds on the point that, notwithstanding the familiar contours of the “one book versus two books” debate, the degree of reconciliation between taxable and financial accounting income need not be set at either 0 percent or 100 percent. In particular, while retaining separate tax and financial accounting rules for measuring income, one could require that, as a final step in computing taxable income, its amount (as otherwise determined) be adjusted by a specific percentage of the difference between it and financial accounting income. Thus, if a 50 percent adjustment were used, taxable income that otherwise equaled \$80 million would be adjusted to \$90 million if relevant financial accounting income was \$100 million, or to \$70 million if such income was \$60 million. I propose exactly such an adjustment, although the choice of 50 percent is admittedly arbitrary.

I argue, however, that the taxable income adjustment should be limited to income of the group of companies that are affiliated for U.S. federal income tax purposes, rather than reflecting differences in membership between the tax and financial accounting groups. Moreover, I conclude that the adjustment is likely to be ineffective in reducing the value of income tax preferences that Congress cares about, and thus that little would be lost if Congress followed a practice of exempting preferences (at least, prominent or new ones) from the adjustment’s reach. The proposal’s aim is to improve managerial incentives. For Congress, the best one can hope for is continuation of the current pattern in

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<sup>10</sup> See *The Federalist Papers*, No. 51 at 291 (James Madison) (Clinton Rossiter ed., 1961).

which, while doing bad things to the income tax base, it largely delegates accounting issues to the quasi-independent Financial Accounting Standards Board (FASB)

Before the promulgation of Schedule M-3, the above proposal to limit the taxable income adjustment might have been criticized as unfeasible. Schedule M-3, however, clearly makes it feasible, without adding significant compliance or administrative burdens, for all large publicly traded corporations.

#### I. OPTIMAL TAX AND ACCOUNTING MEASURES, ABSENT AGENCY COSTS IN REPORTING INCOME

The purposes that underlie requiring companies to compute taxable income and financial accounting income are quite distinct. The tax measure has direct economic consequences as an input to tax liability, while the financial accounting measure's primary purpose is merely to provide information, in particular to investors who are choosing their asset portfolios.<sup>11</sup> Nonetheless, the fact that both measures purport to be of "income" alerts one that they might indeed be aiming at the same thing.

This cannot simply be assumed, however. Before considering whether the two measures ought to be the same, or more broadly how they would optimally interrelate, one needs a fuller specification of what information is actually desirable in each realm. Taking as given (for the moment) a corporation's economic activities during a given period, what aggregate information about the consequences of those activities would we want the tax authorities and investors to have? This tells us what measures we would want to adopt for each if we were not, as will be discussed in section II, concerned about how managerial discretion in computing income might affect the optimal design of the rules.

#### A. Tax

##### 1. *Income as a Proxy for Ability or Opportunity*

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<sup>11</sup> As I discuss below, financial accounting income sometimes has direct substantive significance in corporate contracts, such as executive compensation arrangements that treat it as an input to determining the amount due. See David I. Walker, "Financial Accounting and Corporate Behavior" (March 29, 2006). Boston Univ. School of Law Working Paper No. 06-05, at 12. Walker cites therein Robert W. Holthausen & Richard W. Leftwich, *The Economic Consequences of Accounting Choice*, 5 J. ACCT. & ECON. 77, 84-88 (1983)



Although the tax system's main purpose is to raise revenue, rather than to provide information, "[i]nformation (particularly information asymmetry) is at the core of the modern normative economics approach to taxation, known as optimal tax theory."<sup>12</sup> The basic idea here starts from the premise that taxation ought to advance the twin aims, often in tension with each other, of efficiently allocating the burden of paying for government and achieving desired distributional outcomes as between individuals. (Corporations figure only indirectly in the distributional story, via the effect of the corporate tax on whichever individuals bear it.)

In optimal tax theory, the twin aims pertaining to efficiency and distribution are thought to suggest that tax liabilities should in principle "be based on an inalterable correlate of individual wellbeing, call it ability."<sup>13</sup> One could also call it opportunity, or the lifetime budget line of material resources plus leisure that are available to a given individual.<sup>14</sup> Such an attribute's stipulated inalterability means that taxing it would not inefficiently alter people's marginal incentives when they make decisions. It also would be the right measure for determining distributional outcomes if the underlying policy aim is to aid worse-off individuals relative to those who are better-off, defined in terms of their opportunity sets or budget lines.

The direct use of ability founders, however, on the fact that it cannot be directly observed. Even insofar as individuals know their own ability levels or opportunity sets, they cannot be expected to report reliably to the government regarding how much tax they ought to pay. Hence the use, as a fallback or proxy for ability, of measures such as income that indirectly evidence it, but that also reflect people's decisions to engage in observable market transactions.

Agency costs thus underlie the choice of a tax base such as income as a proxy for ability. In addition, given that people can respond to such a tax by working and earning less (in effect, misrepresenting their ability levels),

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<sup>12</sup> Douglas A. Shackleford, Joel Slemrod, and James M. Sallee, A Unifying Model of How the Tax System and Generally Accepted Accounting Principles Affect Corporate Behavior, National Bureau of Economic Research Working Paper 12873 at 3 (January 2007).

<sup>13</sup> *Id.*

<sup>14</sup> See Daniel Shaviro, Beyond the Pro-Consumption Tax Consensus 9-13 (forthcoming in Stanford Law Review); Daniel Shaviro, Endowment and Inequality, in Thorndike and Ventry (eds.), TAX JUSTICE RECONSIDERED: THE MORAL AND ETHICAL BASES OF TAXATION (2002).

agency costs constrain and lower the optimal tax rate. One can still coherently ask, however, what such a tax base would ideally look like if agency costs were limited to what one does, rather than extending as well to how one reports to the authorities on what one has done.

In this respect, one of the two leading candidates is economic or Haig-Simons income, defined as the fair market value of one's consumption plus change in net worth during the relevant accounting period (such as a year).<sup>15</sup> (The other leading measure is consumption, i.e., the first term in the Haig-Simons measure without regard to changes in net worth.) While in principle the term "income" could mean whatever one likes, Haig-Simons income is widely recognized as the logical generalization that tends to emerge from thinking about it broadly. However, before too rapidly anointing Haig-Simons income as the optimal corporate tax base, ready for comparison with whatever might emerge from the accounting analysis, further analysis is needed. The next section therefore examines possible qualifications to the claim that Haig-Simons income correctly and completely defines the tax base that should be used in determining the tax consequences of corporations' economic activity.

## *2. Does Haig-Simons Income Correctly and Completely Define the Optimal Corporate Tax Base?*

a) *Income versus consumption base* – In the tax policy literature and discussions of fundamental tax reform, support for Haig-Simons income taxation has increasingly lost ground in recent years to support for consumption taxation.<sup>16</sup> This trend partly reflects concern about the difficulty of measuring income<sup>17</sup> (which for the moment I am assuming away), but also stands on more fundamental grounds.<sup>18</sup> Obviously, under a pro-consumption tax view, income is not what the tax system should be measuring, whether or not the measure has a role to play in financial accounting.

A more limited argument in favor of using Haig-Simons income as the tax base would hold that, even if a pure consumption tax would be preferable, full-blown income taxation is better than a mixed system (such as the United States now has) that creates inter-asset distortions by imposing the full burden

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<sup>15</sup> See Henry C. Simons, *PERSONAL INCOME TAXATION* 50 (1938),.

<sup>16</sup> See Shaviro, *Beyond the Consumption Tax Consensus*, *supra* at 3.

<sup>17</sup> See *id.* at 48.

<sup>18</sup> See, e.g., Joseph Bankman and David A Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 *Stan L Rev* 1413 (2006).

of income taxation on some items but not others.<sup>19</sup> From this standpoint, Haig-Simons income taxation might be the proper lodestone if fundamental consumption-based reform is ruled out as politically unrealistic, but only so long as that is the case.

b) *Individual versus corporate-level income concepts* – The income and consumption tax ideals are both concerned with the treatment of individuals. Since only individuals can bear tax burdens, the measurement of corporate income has no place in an optimal tax analysis until one starts thinking about administrative issues such as ease of measurement and collection.<sup>20</sup> Indeed, one could argue that the Haig-Simons income concept is not even meaningful as applied to a legal entity, such as a corporation, that cannot experience consumption.

That being said, one could coherently define a corporation's change in net worth (the second half of the Haig-Simons formula) as equaling the change in present value, during the relevant period, of all of the present and future net cash flows to shareholders that it is expected to generate. With efficient capital markets, this would generally equal the change in the company's market capitalization during the period, leaving aside the effects of corporate distributions and infusions of new equity capital.<sup>21</sup> The amount so determined would presumably equal the aggregate change in net worth for all shareholders by reason of their stock ownership. Thus, the only reason *not* to tax this aspect of income at the corporate rather than the individual level would be the possible effect of doing so on applicable marginal tax rates. That is, corporate-level taxation presumably could not take account of the differing marginal tax rates that one might want to apply to particular shareholders.

Defining corporate income in terms of expected cash flows to shareholders implicitly builds in a distinction, unrelated to the Haig-Simons income concept, between debt and equity. In effect, payments to debt-holders but not equity-holders are deducted from the measure. The rationale for this distinction is simply one of convenience. In the polar cases of simple debt and equity, the former is a fixed return with priority rights, while the latter is simply a right to the residual profits. Thus, the former can be measured without regard to company-level performance, apart from the question of possible default, while the latter cannot. The existing treatment of debt and

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<sup>19</sup> See Daniel Shaviro, WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY 97-98 (2000).

<sup>20</sup> See, e.g., David F. Bradford, TAXATION, WEALTH, AND SAVING 180 (2000).

<sup>21</sup> The risk profile of a company's expected future earnings may also affect the value of its stock.

equity in U.S. tax law, whereby interest but not dividend payments are deductible to the payer although both are taxable to the recipient, is difficult to reconcile with optimal tax theory.

c) *Current-year versus long-term focus* – Haig-Simons income may sound very current period-focused, because it measures what happened during the current period. However, the fact that it counts changes in net worth makes it potentially infinite-horizoned. After all, *any* change in expected future net cash flows, no matter how small and deferred, has some effect on present value. Thus, a change in expectations regarding the future can affect current-year income, if income is defined as broadly as the Haig-Simons concept suggests.

For individuals, the most striking implications relate to future earnings. We tend to think of individuals' current year Haig-Simons income as depending on their current-year earnings, plus any current year saving, defined conventionally in terms of financial assets. As Louis Kaplow has noted, however, a Haig-Simons approach to human capital would imply taxing people currently on all changes in the present value of their expected future earnings. Thus, a currently unemployed full-time law student would have current Haig-Simons income from the increase in her future earnings' present value as she moved one year closer to graduation. She would have even more current Haig-Simons income if good grades, or her making law review, increased her future earnings prospects.<sup>22</sup> This is at variance with how even strong proponents of Haig-Simons income taxation typically view the ideal income tax system.

When one thinks about corporate income, defined as above in terms of the value of corporate equity, a similar question arises with regard to how long-term the focus is supposed to be. There is potentially a gulf between (a) current-year income, as conventionally defined using income tax accounting rules (such as capitalization for outlays that create expected future benefits), and (b) changes in the present value of all expected current and future net cash flows. Thus, suppose a new study, revealing that caffeine consumption creates previously unknown health risks, has only a miniscule effect on Starbucks' current sales, but is expected to make the company significantly less profitable in the future. This would presumably have an immediate effect on the market price of Starbucks stock, and thus would reduce the Haig-Simons income of Starbucks' shareholders. It might not, however, ordinarily come to mind as an aspect of Starbucks' current-year earnings or income.

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<sup>22</sup> See Louis Kaplow, Human Capital Under an Ideal Income Tax, 80 Va. L. Rev. 1447 (1994).

As noted above, the motivation in optimal tax theory for taxing corporations pertains to the individuals who bear the corporate tax, not to the entity itself. Thus, it is easy to conclude that the relevant income measure here is infinite-horizoned, counting everything that might affect current value via future cash flows, without regard to whether it is associated with current-year transactions.<sup>23</sup> As we will see, the same conclusion may not follow, at least so readily, when we turn from the tax to the accounting uses of income.

d) *Subsidies and penalties that are levied through the income tax system* – A final important set of issues that one must consider before anointing Haig-Simons income as the optimal tax base relates to the use of the tax system to deliver subsidies and penalties that might affect behavior. For example, no one doubts that the interest earned on municipal bonds is economically income, yet it generally is not taxed, on the rationale that the exclusion provides a desirable subsidy to state and local government borrowers, whose borrowing costs it reduces. Likewise, illegal bribes that a U.S. taxpayer pays to government officials are nondeductible under the U.S. federal income tax<sup>24</sup> even though they may unambiguously be costs of earning income. More generally, the U.S. federal income tax system is shot through with “tax expenditures,”<sup>25</sup> estimated to cost hundreds of billions of dollars per year, as well as with various tax penalties from an income measurement standpoint.<sup>26</sup> While many of these might be bad policy (an issue I discuss in section III), and while they serve a conceptually distinct purpose from taxing income even if they happen to be located in the income tax rules of the Internal Revenue Code,<sup>27</sup> it is certainly conceivable that, say for administrative reasons, the income tax law would happen to be a good place for them.<sup>28</sup> Thus, it might be desirable to let Congress impose the tax on something that departed from

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<sup>23</sup> Indeed, there have been several proposals to replace the existing corporate-level tax, at least for publicly-traded companies, with a shareholder-level tax that looks simply to the change in stock price during the year. See, e.g., Joseph Bankman, A Market-Value Based Corporate Income Tax, 68 Tax Notes 1347 (1995); Michael S. Knoll, An Accretion Corporate Income Tax, 49 Stan. L. Rev. 1 (1996); Joseph M. Dodge, A Combined Market-to-Market and Pass Through Corporate Integration Proposal, 50 Tax L. Rev. 265 (1995); Daniel Halperin, Fundamental Tax Reform, 48 Emory L.J. 809, 821-22 (1999); Anthony J. Polito, A Proposal for an Integrated Income Tax, 12 HARV. J.L. & Pub. Pol’y 1009 (1989).

<sup>24</sup> Internal Revenue Code § 162(c)(1).

<sup>25</sup> On the definition of tax expenditures, see Daniel Shavero, Rethinking Tax Expenditures and Fiscal Language, 57 Tax L. Rev. 187 (2004).

<sup>26</sup> See, e.g., Budget of the United States Government, Fiscal Year 2008, at 113-116.

<sup>27</sup> See Shavero, Rethinking Tax Expenditures, *supra* at 207-210.

<sup>28</sup> See David A. Weisbach and Jacob Nussim, The Integration of Tax and Spending Proposals, 113 Yale L.J. 955, 964 (2004).

measuring economic income, even if what it was doing could conceptually be described as equivalent to taxing economic income and separately providing subsidies and penalties, the value of which happened to depend (in the case of an exclusion or deduction) on the claimant's marginal tax rate.

e) *Multi-jurisdictional coordination* – The Haig-Simons income concept has no geographical component. Income is income, no matter where derived,<sup>29</sup> and the question of where it was earned has no obvious import for its efficacy as a proxy for measuring ability. Thus, not only would a unitary world government presumably tax income on a worldwide rather than a geographically limited basis, but even with multiple governments, conventional economic wisdom holds that each, if acting unilaterally, should do the same with respect to its citizens or residents.<sup>30</sup>

This conclusion is unaffected by the possibility that countries may also decide to tax income earned within their borders by non-residents on a source basis. Duplicative taxation of cross-border investment on both a source and a residence basis inefficiently penalizes such investment, potentially leaving all countries worse off than if they cooperated to avoid penalizing it. However, reciprocity between governments in foregoing duplicative double taxation of cross-border investment may be needed for any one country to benefit from enhancing worldwide welfare by taking this course. Thus, for example, for the U.S. to benefit from granting foreign tax credits to U.S. firms that earn profits and pay income tax in France, the French government may have to reciprocate by similarly relieving the double taxation of French firms that invest in the U.S.<sup>31</sup>

Once we raise the possibility of multi-jurisdictional cooperation in reducing worldwide tax deterrence of cross-border investment, one may have reason to distinguish between domestically generated and foreign source income. In general, the two main coordination methods are (a) exempting foreign source income and (b) including it, but treating foreign taxes paid as

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<sup>29</sup> See Hugh J. Ault and David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in Assaf Razin & Joel Slemrod (eds.), *TAXATION IN THE GLOBAL ECONOMY* (2002).

<sup>30</sup> See, e.g., Peggy B. Richman, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* (1963).

<sup>31</sup> See Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, forthcoming in *Tax Law Review*. Compare engaging in free trade rather than protectionism, which generally increases national economic welfare even if done unilaterally.

creditable against domestic tax liability.<sup>32</sup> The U.S. tax system, while generally doing (b), arguably contains an element of (a) in its treatment of foreign subsidiaries of U.S. corporations. In general, such subsidiaries' foreign source income is excluded from the U.S. tax base until such time as it is repatriated to the U.S., such as through the payment of dividends back to the U.S. parent.<sup>33</sup>

This policy of deferral – which, while controversial, clearly has something to do with the U.S. approach to multi-jurisdictional coordination of double taxation issues – has consequences for tax filing by U.S. corporations. For commonly owned domestic corporations, the U.S. tax rules permit the filing of consolidated income tax returns, in effect treating the domestic members of a corporate group, for most purposes as if they were a single company. In keeping with deferral, however, foreign corporations cannot be consolidated with those in the U.S. group for U.S. tax return purposes, even if they are entirely commonly owned. Thus, the “consolidated group” concept has a special tax meaning that, as we will see, does not extend to the accounting setting.

f) *What is the reporting unit?* – The Haig-Simons income concept does not tell us who or what should be the taxpaying unit. Thus, for individuals, it does not address issues of joint tax return filing by couples, households, or family units. For corporations, it does not address such issues as whether commonly owned corporate groups should file together, and if so how the groups should be defined.

These questions only matter, however, under limited circumstances. Individual versus joint filing matters, for example, if tax rates are non-linear, as in the case where they rise progressively with income, causing two individuals' combined tax liability to depend on whether or not they file a joint return. Likewise, the taxpaying unit matters if losses are nonrefundable, as in the case where a company with a \$10 million loss pays zero tax, rather than having a negative tax liability (i.e., being paid by the government based on statutory rates). Treating multiple companies as a single taxpayer makes nonrefundability less binding if one company's losses can be deducted against another's net income.

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<sup>32</sup> Foreign tax credits are generally permitted to offset only the domestic tax liability that would otherwise have been due against foreign source income. See Code section 904. Thus, in a foreign tax credit system like that in the U.S., one must determine whether income is domestic source or foreign source even though both are includable in income.

<sup>33</sup> U.S. source income of U.S. companies' foreign subsidiaries is taxable in the U.S. on a source basis like that of any other foreign person.

g) *Coordinated adjustments* – When two taxpayers have the same marginal tax rate, it may be irrelevant whether a value flow between them is treated as both deductible and includable or as neither, so long as the parties know in advance which treatment will apply. In illustration, suppose A and B both pay tax at a 50 percent rate, and that A would pay B \$200 of compensation for a service if the payment were deductible by A (as a current cost of earning income) and includable by B. Permitting the parties to treat the payment as neither deductible nor includable, rather than as both, should not matter, and one would expect them in this case to adjust the nominal amount paid to \$100 (the after-tax cost and benefit in the case of a \$200 payment with full deduction and inclusion). If there is any planning flexibility, however, it is important to coordinate what the two sides do, so that the payer cannot elect deductibility while the recipient elects excludability (or later includability).

In these circumstances, correct treatment is therefore less important than symmetric treatment. Existing tax rules take advantage of this in the treatment of executive compensation, by generally requiring that stock option grants be included and deducted in the same year.<sup>34</sup> They also sometimes impose a deliberately incorrect rule on one party in order to undo at least partly the unavoidably incorrect treatment of a counterparty. An example is the rule generally denying 50 percent of business meal and entertainment deductions,<sup>35</sup> responding to the fact that the recipients of free meals and entertainment, even in a business setting, arguably have economic income that is difficult to tax directly.

Not quite the same point, but similarly resting on the idea of compensating adjustment, is the rationale for the current rule under which federal income taxes paid are non-deductible in computing federal income tax liability. Here is the point that allowing the deduction would make no difference if the nominal federal income tax rate were suitably adjusted. For example, a 20 percent tax on income from which the tax liability is not itself deductible is arithmetically equivalent to a 25 percent tax rate on income from which it is deducted.<sup>36</sup> Thus, denying a federal income tax deduction for federal income taxes paid, while seemingly leading to mismeasurement of the net resources truly available to the taxpayer, is substantively harmless.

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<sup>34</sup> See Code section 83.

<sup>35</sup> Code section 274(n).

<sup>36</sup> Thus, suppose pre-tax income is \$100. A 20 percent tax on this income yields a liability of \$20, leaving the taxpayer with \$80. So does a 25 percent tax on this after-tax income. Algebraically, if  $x$  is the tax rate on pre-tax income and  $y$  is the tax rate on after-tax income, the two are equivalent if  $y = x/(1 - x)$ ,



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In sum, one needs to qualify in various respects the view that Haig-Simons income provides a correct and complete specification of the optimal corporate tax base. For example, one might prefer a consumption base and consider perfecting the income tax at best a fallback approach. One also faces the questions of how well this concept about individuals fits into thinking about legal entities, such as corporations, and of whether changing expectations about future events should count as fully as current-year activities and transactions. And one might want to do things other than just pursue the revenue-raising and distributional aims of the fiscal system through the set of rules that we call the income tax. Finally, the optimal tax treatment of foreign source income depends on how domestic taxation of cross-border investment is being coordinated with that imposed by other jurisdictions, possibly leading to exclusion of all foreign source income, although the current U.S. tax system's only nod in this direction is deferral for the foreign source income of U.S. companies' foreign subsidiaries.

*B. Accounting*

Financially motivated investors who are considering what position to take in a given stock should care about two things. The first is its value, given the set of present and future cash flows to shareholders that it is expected to generate. The second is its risk profile – both how risky it is, which matters (if one cannot sufficiently hedge) to the extent of one's risk aversion, and what the specific risks are, which matters to the construction of one's overall risk position. A periodic income measure, since it provides aggregate information about an aspect of performance that affects expected payouts, presumably matters mainly in relation to assessing value, although year-to-year comparisons may conceivably be illuminating about risk issues.

Under a sufficiently strong version of the efficient capital markets hypothesis, a stock's value, given available information, will already be fully reflected in the stock price. Thus, one might ask why an income measure is even needed, at least under the strong view. But that would beg the question of what the relevant informational inputs are. Ignoring for now managerial opportunism (which I consider in section II), the only reason to have specific composite measures of annual performance, such as income, as opposed to simply a welter of available information, is to save investors time. Those who cannot study in detail everything about a given company, or who want a basis for making convenient comparisons between companies, may benefit from

having ready access to aggregate performance measures prepared by others who have conducted a more detailed examination.

The core differences between the tax and accounting uses of income therefore go beyond the fact that the former matters substantively, while the latter merely offers information for people to use. In addition, taxable income is the sole factual input (apart from tax credits) in determining tax liability, whereas accounting income is merely one informational input for investors, potentially among many. Moreover, the proper definition of taxable income depends on applying normative policy concepts, such as those in optimal tax theory, while the optimal design of accounting income depends on the very different issue of how investors are best aided in conveniently assessing information bearing on share value. Finally, while the tax system's use of an income concept relates to the shareholders, at least if we assume that the corporate tax is simply a proxy for taxing them directly, in financial accounting the entity level is actually the point of interest, given the aim of aiding investors' evaluations.

While these differences allow for considerable overlap between the optimal contours of the income concept in the two settings, each of the five special issues noted above with respect to taxing Haig-Simons income has an analogue in the accounting area.

a) *Income versus consumption base* – Just as corporations could be taxed on either an income or a consumption basis, so they could report their annual results either way. Consumption-style reporting of annual results would involve expensing all outlays, including those that create capital assets or other sources of future value, thus converting the measure into one of annual net cash flow from the business.

From the standpoint of financial accounting, business net cash flow, like any other pertinent information, presumably is something that investors might like to know. Hence, it generally is reported. However, from the standpoint of elucidating current performance as a discrete input to the assessment of long-term value, an annual income measure plainly is more informative, as it addresses the question of whether current outlays are expected to create future returns. Annual net cash flow, unlike annual income, does not purport to offer a snapshot of how well the reporting company performed in a given year.

In the tax policy realm, the case for consumption taxation, notwithstanding net cash flow's inferiority to income as a snapshot of current

economic performance, reflects the difference between tax authorities' and investors' perspectives. The tax authorities need not make current judgments about firm value, as they are not making buy or sell decisions regarding the government's (non-tradable) claim via the tax system to a share of corporate earnings. Assuming a constant tax rate, they will get the same percentage of earnings no matter when reported. A company that invests productively would be expected to produce positive net cash flows at some point in the future, and the government therefore can wait for the money, without detriment to its fiscal interest, so long as any deferred taxes are suitably interest-adjusted. By contrast, in the financial accounting realm, while firm value depends on net cash flows over the long run, the vital thing for an investor, when deciding whether to buy or sell today, is value today insofar as it can be judged. Hence investors' need for an income measure (although, again, current net cash flows may be informative as well), if current performance is an important discrete input to gauging value today. Income would therefore continue to interest investors even if the tax system shifted to measuring consumption.

b) *Individual versus corporate-level income concepts* – The fact that financial accounting is about the firm, not the owners, potentially makes a difference in the applicable income concept. To be sure, changes in a firm's expected earnings over time should all pass through to change the net worth of shareholders (assuming that all debt has a fixed return and no chance of default). But to illustrate how the choice between an entity-level and owner-level focus might nonetheless matter, consider the recent proposals (noted above) to replace the current tax rules for publicly traded corporations with a regime in which shareholders are taxed on their shares' change in value during the taxable year.<sup>37</sup> While plausible as an approach to taxing corporate income, this would obviously be a complete non-starter from the financial accounting standpoint. The whole point of a financial accounting statement of income is to offer new information potentially elucidating share value, as opposed to simply repeating already available information about the market's current judgment of value.

The above discussion, like that concerning corporate-level taxable income, assumes a debt-equity distinction by focusing on shareholder value. Once again, the rationale is purely one of convenience. If a company's capital structure is limited to fixed-return debt with priority plus a single class of equity that claims the residual, and if the issuers of the debt, such as banks, do not need to rely on financial reporting because they can make their own inquiries into solvency, then actual and prospective equity-holders happen to

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<sup>37</sup> See note [23], *supra*.

be the main audience being served by accounting statements of income. Actual corporate financial structures (and constituencies for particular instruments) may be considerably more complicated than this, however, weakening the distinction's informational rationale.

c) *Current-year versus long-term focus* – The difference between providing firm-level information and evaluating changes in the economic positions of owners may have especially important consequences for thinking about how broadly the Haig-Simons concept ought to apply with regard to value changes that are not directly linked to current operating decisions. Thus, consider again the Starbucks example, in which firm value changes by reason of both (a) the firm's current operating earnings and capital investments, and (b) new developments illuminating likely long-term consumer demand for coffee. While prospective buyers and sellers of Starbucks stock would certainly want to know about both, it is possible that they would want a clean measure of (a), prepared without full regard to (b) so as to increase the measure's focus on the discrete issue of operating performance. Again, the question is simply one of how investors like to have available information packaged and presented, rather than turning on the logic of what a fully generalized income concept might mean.

d) *Mixing subsidies and penalties with the income measure* – Whether or not Congress chooses to place subsidies and penalties inside the income measure, it seems clear that investors would not want such intermingling in the accounting measure of income. A harder question is to what extent they would mind, if the effect of preferences and dispreferences on the official income line were easy to disentangle – for example, because the effect of specified items was also disclosed or “cleaner” income measures were reported as well.

The long-standard view, rooted in assuming rational behavior in financial markets, held that accounting presentation does not matter so long as the available underlying information is held constant.<sup>38</sup> However, compelling evidence that managers act as if accounting choices matter, even when such choices would appear to be merely cosmetic rather than affecting available information, has prompted the development of positive accounting theory, a literature devoted to explaining why this might be so within a rational behavior

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<sup>38</sup> See, e.g., Walker, *supra*; Kevin J. Murphy, Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options, 69 U. Chi. L. Rev. 847, 857-860 (2002).

framework.<sup>39</sup> The main explanation offered is contracting costs, reflecting that various corporate contracts, such as debt covenants and executive compensation agreements, have terms that depend on reported earnings, and might be costlier to negotiate or administer if permitted to diverge from the official measure. However, while positive accounting theory has some explanatory power,<sup>40</sup> it often seems descriptively inadequate. A case in point is the apparently enormous importance to corporate executives of the financial accounting treatment of their stock options.<sup>41</sup>

Until 2005, stock options were nondeductible in computing financial accounting income, although disclosed elsewhere in corporate financial statements. Only over substantial management opposition, and in the aftermath of Enron-era corporate governance scandals, was the rule changed. This drama is hard to reconcile in full with positive accounting theory. It played out against a background of reduced use of debt covenants that relied on reported financial income.<sup>42</sup> Moreover, one might think it would be easy to write contracts that treated options as deductible or not, whichever was the preferred treatment, without regard to the official rule in computing income. While the most plausible explanations for the importance of the accounting treatment of options emphasize agency costs,<sup>43</sup> which I disregard in this section, self-serving managers would have little reason to care about the official accounting treatment unless it actually mattered to investors or shareholders. Even in the case of earnings-dependent executive compensation agreements, how hard can it be to modify the treatment of stock options for this one purpose if the official accounting treatment fails to offer the parties what they want?

How much the official accounting treatment matters may vary with the circumstances, however. An instructive counter-example, in which the official income statement appears not to matter much, concerns accounting for inventory. In general, when companies sell products out of inventory, the net income consequences depend on which items, among interchangeable ones that may have been purchased for different amounts, they are deemed to have sold. The two best-known methods are first-in, first-out (FIFO), in which the oldest item is deemed to have been sold first, and last-in, first-out (LIFO), which instead assumes sale of the newest item. LIFO generally yields a lower current

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<sup>39</sup> See Ross L. Watts and Jerold L. Zimmerman, *POSITIVE ACCOUNTING THEORY* (1986); Watts and Zimmerman, *Positive Accounting Theory: A Ten Year Perspective*, 65 *Acc't. Rev.* 131 (1990).

<sup>40</sup> Cite, e.g., to Watts & Zimmerman (1986 or 1990).

<sup>41</sup> See Walker, *supra*, at 26.

<sup>42</sup> *Id.* at 16.

<sup>43</sup> *Id.* at 38.

measure of income, as more recently purchased inventory items tend to have cost more due to inflation. FIFO is generally considered the more accurate method, and is the one companies generally use for internal planning purposes.<sup>44</sup> However, taxpayers are permitted to use LIFO for tax accounting purposes, thus reducing and deferring taxable income, so long as they also use it for financial accounting purposes.<sup>45</sup>

This tax-book conformity rule was deliberately designed to “dampen the attractiveness of LIFO tax accounting”<sup>46</sup> by allowing it only at the price of reducing one’s reported financial accounting income. Companies soon learned, however, that purely nominal compliance was good enough. Thus, without jeopardizing their use of LIFO for tax purposes, they could disclose their earnings under FIFO elsewhere in their financial statements, and do whatever else they liked to direct investor attention to the FIFO measure – for example, by publicizing it in news conferences and press releases.<sup>47</sup> The end result, apparently, has been that “there is no real book-tax conformity in our tax system [with respect to] inventory accounting: it is illusory.”<sup>48</sup>

Why should the choice of inventory accounting rule in the official financial statement turn out to matter so little, when officially reported financial income appears to matter so much in other settings? Three reasons that come to mind are (1) companies’ assiduousness in emphasizing the alternative FIFO measure, (2) widespread acceptance of FIFO’s greater accuracy, and (3) the fact that use of LIFO in official financial statements not only was not dictated by generally accepted accounting practice (GAAP), but was well understood to be purely tax-motivated.

Accordingly, a question naturally arises as to whether or not it would matter if, in other instances, companies were required to use income tax preferences and dispreferences in reporting financial accounting income. The LIFO story is consistent, however, with thinking that, for the official measure not to matter, it is not enough that information that could be used to revise it be publicly available. There may also need to be a prominent, easily available alternative measure of income that management credibly argues is the superior one.

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<sup>44</sup> See Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, *Is It Time to Liquidate LIFO?*, 113 *Tax Notes* 237 (2006).

<sup>45</sup> Internal Revenue Code, § 472(c).

<sup>46</sup> Kleinbard, Plesko, and Goodman, *supra*, at 245.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

e) *Multi-jurisdictional coordination* – For financial accounting purposes, unlike for tax purposes when countries are coordinating the imposition of liability, all of the worldwide income of a given corporation or group of affiliated companies is plainly relevant. Investors might conceivably be interested in knowing where income arose, if this was pertinent to assessing long-term earnings prospects, but they surely would not want income that had been earned abroad to be excluded or even deferred for financial accounting purposes. In addition, for financial accounting purposes, all taxes paid should presumably be deductible, whereas for tax purposes one may want to treat foreign taxes as creditable against tax liability rather than as deductible in computing income.

f) *What is the reporting unit?* – Financial accounting has nothing analogous to loss limits and non-linear tax rates that would give the choice of reporting unit the same direct substantive significance that it may have in the tax context. For any given company, however, one presumably would want to know about all of its worldwide economic income. One conceivably might also want unified reporting about commonly controlled operations, without regard to formal distinctions between different legal entities unless these distinctions were themselves relevant to expected value.

g) *Coordinated adjustments* – Nothing in accounting is analogous to the coordinated adjustment points in defining the tax base. Compensating mis-measurement of the income of transactional counter-parties does not lead to a proper result because the aim is to provide an accurate measure of each reporting company's income, not merely to report the right amount of income overall. There also is no analogy to the income tax rationale for treating federal income taxes paid as nondeductible, given that the income measure itself, rather than the tax liability imposed, is the point of ultimate interest.

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In sum, Haig-Simons income may come closer to being a core reporting ideal in financial accounting than in tax policy. “True” income is more likely to be one thing (among many) that investors want to know about, than it is to be the one and only thing that the tax authorities should want to know about. However, in the accounting setting there may be a stronger argument than in the tax setting for construing income relatively narrowly as a performance measure with regard to current operations, in lieu of interpreting it more broadly to embrace all changes during the year in the expected value of earnings over the long run. The proper breadth of the income concept in this regard depends on how investors happen to like having information packaged

and presented, rather than on how the income concept is most logically generalized.

With regard to whether correct financial accounting income measurement even matters, assuming the availability of all relevant information that investors can use as they like, the evidence is mixed. In notorious examples such as the accounting treatment of stock options, it appears that well-informed actors concluded that the official measure really did matter. However, inventory accounting is a counter-example, albeit one possibly dependent on special circumstances that included the prominent publication of non-official income measures.

### *C. Interactions Between Taxable and Accounting Income*

Given that the term “income” is used in both the tax and accounting fields, it should not be surprising that the underlying aspirational concepts have a lot in common. The concepts are not identical, however, reflecting the two system’s different aims both in general and in how they use income.

Absent agency costs in reporting income – that is, if companies could be expected to engage in completely honest and neutral reporting of the income consequences of what they had done – there would be no reason for concern about tax versus book reporting differences that emerged. These would simply reflect that the two systems are not doing exactly the same thing. However, agency costs, which give rise to tax sheltering and earnings management in lieu of unbiased reporting, are at the heart of arguments for addressing the tax-book gap, and I consider them next.

## II. AGENCY COSTS IN REPORTING INCOME

### *A. Opposite Incentives, Same Optimal Rules?*

Harry Truman once complained that Richard Nixon “can lie out of both sides of his mouth at the same time.”<sup>49</sup> Whether or not this was fair comment as to Nixon, it captures the essence of concerns about income reporting by the managers of U.S. corporations. Serving the shareholders’ interests as well as their own, managers may favor using tax sheltering to reduce the taxable income they report to the Internal Revenue Service (IRS). At the same time, serving their own interests potentially at the shareholders’

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<sup>49</sup> Cite.



expense, managers may favor using earnings management to increase the financial accounting income that they report to the public. Or, more neutrally over time, but still potentially misleadingly unless markets irrationally overreact to earnings volatility, managers may seek to “smooth” reported earnings by raising them just in otherwise low periods in exchange for lowering them in otherwise high periods.<sup>50</sup> Accordingly, even short of fraud, both taxable and accounting reports of income may end up being inaccurate insofar as managers can employ planning tools and reporting discretion to achieve desired results. Managerial incentives in reporting income accordingly have important implications for how the income reporting rules in each arena ought to be designed.

The incentive issues posed in the tax and accounting realms are considerably more parallel than the underlying reasons for potentially using an income measure in each realm. Understatement and overstatement of income are symmetric problems. Moreover, the basic responses that the rules can offer are parallel, involving the same two components. The first is to reduce discretion by grounding the reported measures on information that is more objectively verifiable than a generalized value assessment. The second is to do what I call “leaning against the wind,” by biasing the tax measure towards over-measurement and the accounting measure towards conservatism or under-measurement, thus attempting to offset and reduce the net effect of the underlying bias.<sup>51</sup>

Thus, if nothing else affected the analysis, the two systems might optimally be identical in limiting reporting discretion, while simply requiring opposite biases in discrete areas. Or, in keeping with the one-book concept, they might be coordinated to require identical treatment of items that otherwise would optimally be reported with opposing biases. However, there is one important potential difference between the optimal design issues in tax and in accounting. It relates to the question of how comparatively serious the incentive problems are in the two areas.

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<sup>50</sup> Further complicating the normative analysis of earnings smoothing, if market observers are rational but expect managers to smooth earnings, then volatility may function as a signal of more serious problems that made effective smoothing impossible. This might even cause success in earnings smoothing to be genuinely informative about a firm’s performance, although at the cost of making current-period reports in other respects less accurate and meaningful.

<sup>51</sup> See, e.g., *Thor Power Tool v. Commissioner*, 439 U.S. 522, 542 (1979) (“[F]inancial accounting has as its foundation the principle of conservatism, with its corollary that ‘possible errors in measurement [should] be in the direction of understatement, rather than overstatement of net income and net assets. In view of the Treasury’s markedly different goals and responsibilities, understatement of income is not destined to be its guiding light.’”)

Inherently, limiting discretion by barring the use of information that is not sufficiently verifiable sacrifices potential accuracy on the view that incentive problems would prevent its being achieved. It therefore involves a tradeoff, and the optimal tradeoff depends on how serious the incentive problems are. As they get worse, the extent to which one should try to lock in the managers to making income reports that are less potentially accurate, but also less manipulable, increases. Accordingly, discretion, in the sense of allowing the exercise of judgment about factual issues that are hard to verify, should be more limited in one area than the other if that area presents greater risks of managerial manipulation.

As it happens, income reporting in the tax area is often considered more problematic than that in the accounting area. In illustration, consider *Thor Power Tool Co. v. Commissioner*,<sup>52</sup> the leading U.S. Supreme Court case comparing tax and financial accounting rules, which develops this point in detail. In *Thor Power*, the taxpayer had argued that certain write-downs for excess inventory and expected bad debt losses, permissible under GAAP, should be allowed for income tax purposes as well. Nothing in the Internal Revenue Code or regulations specifically authorized these deductions, but the inventory rules in particular gave some relevance to the taxpayer's method of accounting. The Supreme Court's opinion, holding that GAAP could not be used to justify otherwise impermissible income tax results, is best known for stating that "financial accounting has as its foundation the principle of conservatism ... [and leaning] in the direction of understatement rather than overstatement of net income," whereas, for the Treasury, given its "markedly different goals and responsibilities, understatement of income is not destined to be its guiding light."<sup>53</sup> This is simply the "leaning against the wind" idea. *Thor Power* also, however, adds the following:

This difference in objectives is mirrored in numerous differences of treatment. Where the tax law requires that a deduction be deferred until "all the events" have occurred that will make it fixed and certain, ...

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<sup>52</sup> See *id.*

<sup>53</sup> 439 U.S. at 542. To illustrate that *Thor Power* is best known for distinguishing between tax and accounting on the ground of the latter's conservatism, see, e.g., Erik M. Jensen, *The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers*, 22 *Ga. L. Rev.* 229, 269 n. 163 (1988); Lee A. Sheppard, *Financial Accounting Conformity: Not the Silver Bullet*, 101 *Tax Notes* 676 (2003); Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 *Va. Tax Rev.* 301, 350 n. 130 (2004).

accounting principles typically require that a loss be accrued as soon as it can reasonably be estimated. Conversely, where the tax law requires that a liability be recognized currently under “claim of right,” “ability to pay,” and “control” rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched. Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.<sup>54</sup>

Why would one conclude that financial accounting can reasonably be made more discretionary than tax reporting, when both invite managerial bias? The existing rules clearly reflect such a view, being to this day far more discretionary and less uniform or rigorously specified for accounting than for tax. *Thor Power* appears to rely on a belief that accountants have sufficient motivation and clout, in performing the audit function, to “protect [those relying on financial statements] from being misled.”<sup>55</sup> Accountants are, after all, potentially liable to investors if they certify overstated measures of income or assets. However, even if one is skeptical about accountants’ ability and willingness to restrain aggressive earnings management, there remains the fact that financial statements, apart from their use in various corporate contracts, are simply one source of information among many that investors may use in formulating beliefs about firm value, whereas taxable income has direct economic consequences via its impact on tax liability. Thus, taxable income arguably matters more, at least if increasingly aggressive financial earnings statements would end up being increasingly discounted by observers.

I mean to argue here only that the claim that incentive problems are worse for tax than for accounting, permitting greater discretion in the latter area, is plausible and widely accepted – not that it is necessarily true. As evidence to the contrary, a recent study of firms that had to restate reported financial income after the Securities and Exchange Commission (SEC) charged them with fraud found that these firms had been so eager to overstate such income that they actually were willing to pay more income tax as a byproduct of doing so. The extra tax liability, reflecting the tax consequences of transactions that were designed to inflate reported earnings, averaged \$11.85

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<sup>54</sup> 439 U.S. at 542-543.

<sup>55</sup> *Thor Power*, 439 U.S. at 542.

million per firm, or about eleven cents per dollar of inflated earnings.<sup>56</sup> Accordingly, the managers of these firms, whether or not representative of the broader group, evidently cared more about inflating earnings than about reducing tax liability.

Despite doubts about its truth, the plausibility and widespread acceptance of the *Thor Power* claim that incentive problems are worse for tax than for accounting make its implications if true worth exploring. Accordingly, I next consider how the optimal measures of tax and accounting income, in light of agency costs, might differ if the incentive problems are generally greater for tax than for financial reporting.

## *B. Optimal Income Reporting Rules in Light of Agency Problems*

### *1. Reliance on Readily Observable Information*

The most obvious and direct consequence of agency problems in reporting income is their discouraging any serious effort to measure Haig-Simons income, such as by having businesses report unrealized fluctuations in the value of all of their assets and liabilities. This discouragement is not merely a function of the difficulty and costliness of accurately measuring unrealized value changes. If there were no agency costs, and managers could therefore be expected to offer completely unbiased and neutral measures, the tax and accounting authorities might have no reason not to use rough estimates, on the ground that they were the best and most accurate information available at a reasonable cost. Similarly, managers are presumably expected to use their best estimates, rather than just historical information and mechanical formulas for determining value, when they are formulating business plans.

Given agency costs, however, tax and accounting rules presumably need to rely, and in fact do rely, on information that is less potentially accurate so far as gauging current value is concerned, but more verifiable. In particular, both systems tend to rely on observable transactions and cash flows, and on mechanical formulas for measuring value changes, such as from asset depreciation or accrual of interest on debt instruments, that have a predictable direction. Only in limited cases, pertaining to fungible, frequently traded assets that have a readily observable fair market value, do mere value fluctuations have immediate reporting consequences in either system.

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<sup>56</sup> See Merle Erickson et al, How Much Will Firms Pay for Earnings That Do Not Exist?: Evidence of Taxes Paid on Allegedly Fraudulent Earnings, 79 ACCT. REV. 387 (2004).

Accounting rules do, however, differ from tax rules in offering considerably more discretion to defer reporting net income, both by treating amounts received for future services as future rather than current gross income, and by accruing losses before they have been realized through an observable transaction. Indeed, financial accounting rules require accruing losses whose occurrence remains uncertain as soon as they are probable and can be reasonably estimated.<sup>57</sup>

Such an approach may make sense in accounting but not tax, given the rationale for leaning against the wind. In accounting, a rule requiring the exercise of discretion to determine when losses must be accrued before they are realized cannot systematically aid earnings management, even if incentive problems cause the provision to be under-utilized, except insofar as managers aim to smooth, rather than systematically exaggerate and accelerate, earnings. In tax, by contrast, one would expect such a rule to be over-utilized in light of its consistency with tax sheltering objectives.

If accounting and tax base design issues were entirely symmetric, the analogous rule of presumptively equal merit in the tax context would be one requiring the advance accrual of still-uncertain gains as soon as they were probable and could be reasonably estimated. Such a rule might be undesirable, however, even assuming that the loss rule makes sense in accounting, if allowing for the exercise of reporting discretion is generally a worse idea in tax given the relative severity of the incentive issues. Moreover, even if advance income accrual was merely under-utilized rather than never invoked, it would sometimes advance, rather than harm, managerial tax planning incentives. Just as smoothing considerations can induce managers to want to defer net income for accounting purposes, so they occasionally have tax reasons for wanting to accelerate it. For example, one may want to report taxable income before the effective date of an increase in statutory marginal rates, or to prevent time-limited tax benefits such as net operating loss deductions from expiring unused.

## *2. Rules Addressing Managerial Responses to Reliance on Readily Observable Information*

Once a set of rules is in place that causes income reporting largely to depend on readily verifiable information, such as observed transactions, the rules generate predictable and undesirable responses from corporate managers. Some effects, such as income tax deterrence (albeit presumably alongside accounting encouragement) of sales of appreciated assets, are difficult to address directly. They may constitute unavoidable social costs of departing from Haig-Simons income measurement, even if on balance justified by the

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<sup>57</sup> See, e.g., Sheppard, *supra*, at 680-681.

administrative benefits. In a number of respects, however, the rules can be given second-order adjustments, designed to counter and reduce the ill effects of managerial responses to the first-order constraints on attempting fully accurate measurement.

a) *Non-recognition rules to limit deterrence of otherwise desirable behavior* – The U.S. federal income tax law has long included a set of non-recognition rules that permit gain from an otherwise taxable realization event to be ignored for current tax purposes, almost as if nothing had happened to begin with.<sup>58</sup> Whether or not all (or even many) of these rules are in fact good ones, they have a clear rationale that responds to the behavioral effects of generally limiting tax consequences to realizations.

The rationale is as follows. Suppose that a relatively trivial change, such as reissuing securities to lower administrative costs, would have a high tax price if treated as a taxable realization when the shareholders formally trade their old instruments for new ones. The seeming disproportion between the degree of economic significance and the tax price might suggest that imposing the tax would simply deter the transaction from occurring in the great majority of cases. Insofar as this happened, efficient business operations would be inconvenienced without any significant revenue payoff. The proper policy response might then be to permit non-recognition of the gain from such transactions. The merits depend, however, on the ratio of transactions that would be tax-deterred to those that would go forward anyway.<sup>59</sup>

The symmetric rule for accounting would hold that loss is not recognized on particular, relatively inconsequential transactions that presumably would simply be deterred, rather than leading to improved information about preexisting declines in asset values, if they had accounting consequences. One example of this approach, permissible at one time under GAAP but more recently barred, permitted pooling of assets without restatement of their value from historic to current when companies used stock to acquire other companies.<sup>60</sup>

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<sup>58</sup> See, e.g., Internal Revenue Code §§ 368 and 1031. Non-recognition rules for gain generally apply to loss as well, and other non-recognition rules apply exclusively to transactions in which a loss is realized. However, as the rationales for disregarding gains and losses are different, I discuss the latter below.

<sup>59</sup> See Daniel Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1 (1992).

<sup>60</sup> See Dennis R. Beresford, *Congress Looks at Accounting for Business Combinations*, 15 Accounting Horizons 73, 74 (2001).

Similarly rationalized accounting non-recognition underlay the transaction in *Cottage Savings Association v. Commissioner*,<sup>61</sup> one of the more controversial tax cases of recent decades to involve an interplay with accounting rules. In *Cottage Savings*, banks holding mortgage loans that had declined substantially in value were permitted by banking regulators at the Federal Home Loan Bank Board (FHLBB) to swap substantially identical mortgage pools, each including several hundred such assets, without having to recognize the losses under FHLBB accounting regulations. The FHLBB's rationale was that the swaps would provide tax benefits from loss recognition but were not otherwise economically significant. (Why the losses did not otherwise have to be recognized under a principle of accounting conservatism, when their occurrence was so definitely known, is unclear.) In addition, loss recognition for accounting purposes would have had significant banking law consequences, as it would have made the banks insolvent on paper (as they already were in fact). The IRS challenged the deductions, but lost in the U.S. Supreme Court.

Again, while the tax rationale for allowing non-recognition of gain is identical to the accounting rationale for allowing non-recognition of loss, it is plausible that one set of rules would frequently make more sense than the other. Thus, if the prospect of taxing gain typically had a greater deterrent effect on managerial willingness to engage in otherwise desirable transactions than the prospect of reporting a financial accounting loss, tax non-recognition rules might typically fit the underlying rationale better than accounting non-recognition rules, although for each this would always depend on the particular circumstances.

b) *Reliance on economic substance to disregard or re-label transactions* – Once Haig-Simons income measurement is rejected in favor of a transaction-based system, income measurement rules inevitably depend on what Edward Kleinbard, in the tax context, has called a “cubbyhole” approach. That is, the rules “work[] by describing a finite number of idealized transactions and attaching to each set of operative rules – what might be termed a set of tax [or accounting] cubbyholes.”<sup>62</sup> For example, a change in one's legal and economic relationship to an item of property may be characterized as involving a sale, a lease, a secured borrowing, or nothing cognizable whatsoever. A financial instrument may be characterized as either debt or equity, among other possibilities. Given the infinity of possible transactions and instruments with gradually shifting terms, the rules for defining income are inevitably discontinuous. That is, at some point an

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<sup>61</sup> 469 U.S. 554 (1991).

<sup>62</sup> Edward D. Kleinbard, “Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System,” 69 *Tex. L. Rev.* 1319, 1320 (1991).

infinitesimal change in terms leads to a significant change in income measurement consequences.<sup>63</sup>

These discontinuities, while likely to cause inefficiency and to impede accurate measurement of income in any event, dictate not making it too easy for corporate managers to achieve desired tax or accounting results. Suppose, for example, that either set of rules defined a cognizable sale of property purely in terms of whether title had been transferred under applicable local law. Suppose, moreover, that the occurrence of a legal title change could be completely separated from the economics of one's relationship to a given asset – permitting one, for example, completely to eliminate one's physical possession and risk exposure with respect to the asset while retaining title, or to retain them while disposing of title. Then, for whichever system (tax or accounting) one was manipulating, the decision to have a cognizable sale would effectively be completely elective, inviting the tax-minded to realize losses but not gains and the accounting-minded to do the opposite.

Given managerial incentives, pure electivity is unlikely to be optimal in either system, and both respond similarly to impede it. Through a variety of specific rules and broader interpretive standards, both systems impose an economic substance requirement on companies' characterizations of their transactions. Thus, an ostensible sale may fail to qualify as such if it has too little economic significance (as in *Cottage Savings*, had the government won the tax case). Instruments denominated as debt may be recharacterized as equity, or leases and secured loans recharacterized as sales. Elaborate paper-shuffling transactions that serve no purpose beyond generating tax losses or accounting income are subject to being disregarded on the ground that they lacked sufficient economic substance or business purpose. Such an assessment may either be qualitative, reflecting an overall assessment of particular transactions, or it can depend on applying black-letter rules, such as the tax provision disallowing losses from wash sales, or those in which the taxpayer buys the same type of property it has ostensibly sold within a thirty-day period.<sup>64</sup>

Economic substance requirements make effective electivity costlier, by requiring companies that seek a tax loss or an accounting gain to bear real economic consequences that they otherwise would prefer to avoid. This, in turn, has mixed effects on companies' transaction choices. In some cases, companies may give up on seeking to generate tax or accounting benefits, as the cost in terms of undesired economic effects has become too high. In other cases, the companies may go ahead anyway, accepting undesired economic

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<sup>63</sup> Cite Strnad, Weisbach.

<sup>64</sup> See Internal Revenue Code § 1091.



effects as the price of success in manipulating the income measure. The effect of economic substance requirements, in the latter set of cases, is simply to increase tax or accounting-induced waste, but the requirements may nonetheless do more good than harm on balance if they succeed often enough in deterring income manipulation.

In any given setting, the optimal stringency of an economic substance requirement depends on the underlying empirics, including those related to the social value of accurate income measurement, how readily companies be deterred from engaging in tax or accounting-motivated transactions, and how overall transaction costs are affected as stringency changes. Obviously, these factors may differ for tax and accounting, as well as between substantive areas. Thus, there is no reason to assume that the optimal stringency of the economic substance requirement will generally be the same for tax and accounting purposes.

c) *Disregard of potentially unrepresentative transactions* – Tax but not accounting rules contain a further backstop against companies’ ability to distort income measurement through transaction choice. The tax rules provide that net losses from certain categories of transaction cannot be deducted against other types of income. For example, capital losses generally can be deducted only against capital gains, causing net capital losses to be nondeductible (although they can be carried over to other taxable years). Absent this rule, taxpayers with large capital asset portfolios would be able to create large losses each year, potentially misrepresenting the overall performance of their portfolios, by selling loss assets while continuing to hold gain assets.<sup>65</sup>

While the rationale for such rules applies symmetrically to the accounting treatment of gain transactions, there are no analogous accounting rules requiring disregard of net gain. One possible rationale for this distinction, apart from the usual possibility that the incentive problems in tax and accounting differ in severity, might be that gain is more common than loss, given that interest rates and expected investment returns are generally positive. Thus, net losses from reported transactions might be considered more likely to be unrepresentative than net gains.

In addition to denying deductions for particular categories of net losses, the tax rules make overall net operating losses nonrefundable. Again, a company with, say, a \$10 million loss pays zero tax, rather than having a negative tax liability (i.e., being paid by the government based on statutory rates). This “heads we win, tails you lose” approach to tax liability is best

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<sup>65</sup> So long as the sales are bona fide, an economic substance requirement cannot deter this strategy.

rationalized on the view that tax planning possibilities make reported net losses suspect. To limit the burden imposed on companies that have losses in some years and net income in others, taxpayers generally are allowed to carry over net operating losses from one year to offset taxable income in other years. The use of net operating loss carryovers, whether or not viewed semantically as creating a distinction between the tax and accounting rules for income measurement, can lead to differences in the net income reported for a given year under the two systems.

d) *Additional issues raised by the choice of reporting unit* – As we saw in section I, absent agency costs in reporting income, the choice of reporting unit matters due only to special features of the tax system such as loss limits and non-linear rates. With such agency costs, however, both the tax and the accounting effects become more important. Even without regard to reporting units, the practice of focusing on observable transactions becomes problematic if related parties, such as commonly controlled corporate entities, can anticipate a tax or accounting benefit from setting a fictional transaction price. An example is the perennial “transfer pricing” problem in the taxation of U.S. multinationals, which can manipulate the prices they purport to pay or charge their foreign affiliates so as to increase foreign relative to domestic income. In both tax and accounting, however, the problem grows worse if related parties can report their income separately. Thus, in tax, transfer pricing problems are made worse by the fact that foreign subsidiaries’ income generally is not included in their domestic parents’ consolidated income tax returns.<sup>66</sup>

In accounting, as usual, the game goes the other way, involving shifting losses rather than income outside of the group that is required to report its income jointly. An example is the games Enron played in shifting losses and liabilities to off-balance sheet “special purpose entities” that existing accounting rules permitted it not to consolidate with the overall Enron group, in some cases despite as much as 97 percent related party ownership.<sup>67</sup>

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<sup>66</sup> If worldwide consolidated groups were taxable as such in the U.S., the only advantage to shifting taxable income to foreign affiliates through non-arm’s length transactions would be increasing the amount of worldwide group income that can be offset by foreign tax credits, which generally are only allowed against the U.S. tax liability on foreign source income. Lack of worldwide consolidation, and resulting deferral of foreign subsidiaries’ income until treated as realized by the U.S. parents (such as through the receipt of dividends) makes transfer pricing games tax-beneficial even absent concern about foreign tax credit limits.

<sup>67</sup> See George Mundstock, *The Trouble With FASB*, 28 N.C.J. Int’l L. & Com. Reg. 813, 835-836 (2003).

In both tax and accounting, therefore, agency costs in reporting income create grounds for wanting to treat commonly controlled entities as a single reporting unit (in addition to scrutinizing reported related-party transaction terms and prices). In practice, the two systems use very different consolidation rules, although the normative reason for their doing so, in terms of different needs or tradeoffs, is unclear.

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In sum, agency costs in reporting income have similar types of implications for tax and accounting measures. In both, managerial incentives to report opportunistically counsel relying on information, such as that from observed transactions, that is relatively objectively verifiable. However, such reliance in turn gives managers the opportunity to choose and design transactions that will generate false or unrepresentative tax losses or accounting gains. These managerial opportunities, in turn, may motivate second-order responses in the income measurement rules, such as permitting non-recognition of gain or loss, applying an economic substance approach to ostensible transactions, and disregarding even clearly genuine transactions that may have been unrepresentative. The motivation for imposing such rules applies symmetrically to claimed tax losses and claimed accounting gains, but the merits and optimal design of the rules may vary in the two contexts due to empirical differences, such as in the social value of measuring income accurately or in managerial responsiveness to the underlying incentives.

### C. *Using Instrumental Accounting in Lieu of Tax Preferences*

#### 1. *The Basic Idea*

A further possible response to managerial agency costs in reporting income, identified by David Walker, is “instrumental accounting,” or the adoption of purposeful deviations from attempting accurate income measurement in the accounting rules, with the aim of influencing companies’ economic behavior. An example, structured to avoid diminishing publicly available information, might be providing that particular outlays, which the rule-setter wants to encourage, will merely to be footnoted in companies’ financial statements, rather than being deducted from reported earnings.<sup>68</sup>

A precursor to instrumental accounting, frequently prominent in debate about accounting standards, is the claim that their design should take into account “economic consequences,” meaning the impact that adopting one standard or another could have either on various private parties or on national

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<sup>68</sup> See Walker, *supra*, at 59-60.

policy goals.<sup>69</sup> Thus, a 1978 decision by FASB that would have required oil and gas companies to amortize rather than expense intangible drilling costs was blocked by the Securities and Exchange Commission (SEC) on national energy policy grounds after intense industry lobbying that emphasized the hardship and discouragement of exploration that the accounting rule ostensibly would cause.<sup>70</sup> If there is any difference between instrumental accounting and economic consequences accounting, it is that support for the latter sometimes focuses more on ex post hardship claims than on ex ante incentive effects, but in practice (as in the case of intangible drilling costs) these two lines of argument may be advanced interchangeably anyway.

Using instrumental accounting is analogous to creating tax incentives and disincentives that deliberately cause taxable income to diverge from economic income, with the aim of influencing economic behavior. As usual, however the directions are reversed in the accounting context, with income over-measurement constituting the intended reward and under-measurement the penalty. Thus, just as one might accelerate the depreciation deductions allowable for tax purposes, increasing their present value, in order to encourage a given investment through the tax system, so one would decelerate them for accounting purposes in order to pursue the same policy through instrumental accounting.

While instrumental accounting is impermissible under FASB's official policy stance, there are a number of historical examples, generally reflecting outside intervention. For example, Congressional enactment of an investment tax credit twice was accompanied by the issuance of a command (once from the SEC and once from Congress itself) that companies be permitted to claim the entire tax benefit in the year when it was realized, rather than being required to spread it out over the useful life of the underlying asset. Likewise, FASB's refusal for many years to make stock options deductible from financial income reflected intense political pressure, including threats of Congressional intervention, that often were rationalized on the policy ground that options should be encouraged as tools for promoting better corporate governance.<sup>71</sup> Other examples include the dispute over intangible drilling costs, and efforts by

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<sup>69</sup> See, e.g., Stephen A. Zeff, *The Rise of "Economic Consequences,"* \_\_ J. Accountancy 56 (December 1978).

<sup>70</sup> See William Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. Rev. 5, 32 (2007). Ironically, in the tax realm, the capitalization rule for intangible drilling costs that the oil and gas industry successfully demanded, in effect as an accounting preference, is widely regarded as correct from the standpoint of income measurement, albeit not followed due to the industry's political influence. [Cite AMT rules?]

<sup>71</sup> *Id.* at 68.

FASB or its predecessor to impose undesired accounting rules on public utilities, banks, and the securities industry.<sup>72</sup>

Intense pressure has also occasionally failed to sway FASB. A recent example concerns its announcement in 1999 that it was eliminating the “pooling of interests” method for business combinations, under which companies that made stock purchases of other companies could avoid recognizing changes in the targets’ asset values. The technology industry, still riding high pre-2001 and emboldened by its apparent success in blocking expensing of stock options, complained that this change would gravely undermine the “efficiency of our capital markets, technological innovation, and the entrepreneurial drive of our workforce.”<sup>73</sup> However, FASB stood firm, reaffirming its stance in early 2001<sup>74</sup> despite the introduction of adverse legislation, not to mention its representatives’ having been summoned to both House and Senate hearings where they were berated for endangering the “New Economy.”<sup>75</sup> Conceivably, this story’s happy ending, if one is glad that FASB resisted the political pressure, reflects that, once Enron collapsed in late 2001, Congressional intervention became politically unfeasible. In the end, therefore, FASB’s opponents on this issue arguably did not so much lose as run out of time.

FIN 48,<sup>76</sup> a recent FASB pronouncement concerning accounting for uncertainty in federal income taxes, arguably includes a component of instrumental accounting, although not one that is overtly acknowledged as such. This pronouncement, which aimed to standardize more than to change the methods that companies were using, states that one cannot claim any financial benefit from taking a tax position that falls short of being “more likely than not” to be sustained on its technical merits by the relevant taxing authority. In making this assessment, one must presume that the taxing authority has full knowledge of all relevant information – and thus, for example, will not fail to challenge a dubious tax position by reason of having failed to identify it as such.

In illustration, suppose a company claims a \$100 tax benefit that has only a 20 percent chance of being spotted on audit and that, if challenged, has a 40 percent chance of being sustained. Economically speaking (and disregarding possible penalties if the taxpayer loses), the expected tax saving is

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<sup>72</sup> See Zeff, *supra*, at 57-60.

<sup>73</sup> Statement of venture capitalist John Doerr, quoted in Beresford, *supra*, at 76.

<sup>74</sup> See FASB Statement 141 (June 2001).

<sup>75</sup> See Beresford, *supra*, at 74-81.

<sup>76</sup> Financial Accounting Standards Board Interpretation 48, “Accounting for Uncertainty in Income Taxes – An Interpretation of Statement of Financial Accounting Standard 109 (June 2006).

\$88,<sup>77</sup> yet the company is instructed to value the expected tax benefit at zero. From the standpoint of accurately measuring expected after-tax earnings, the only possible rationale for this approach is that aiming at greater realism might leave management too much scope to engage in optimistic over-statement of the likely odds. Conceivably, however, the rule may also have an unacknowledged ethical component, reflecting unease with encouraging companies to play the “audit lottery,” whereby they take aggressive positions on the gamble that the IRS will not detect what they are doing. Denying any positive earnings effect to the prospect of non-detection and to long-shot prospects of victory on aggressive tax positions has the arguably beneficial effect of discouraging managers from playing the audit lottery even where doing so would increase expected share value.<sup>78</sup> Perhaps this instrumental objective seemed more palatable, from a traditional accounting standpoint, by reason of its mainly inducing under-measurement rather than over-measurement of expected earnings.

## *2. The Differential Mechanics of Tax Incentives and Instrumental Accounting*

Despite the design symmetry between tax incentives and instrumental accounting, their mechanisms are quite different, making their analysis in some respects non-parallel, and the likely effects of instrumental accounting harder to determine. The difference in mechanism reflects the distinction between the roles that an income measure plays in the tax and accounting settings.

In tax, the effect of incentives is easy to understand in a conventional economic model. Suppose that Activities A and B are initially equally profitable both before and after-tax, reflecting the economic equilibrium that one would expect if the tax system treated them neutrally. (If A were initially more profitable, investment would shift from B to A, increasing the marginal return for those who continued to hold B while driving it down for those who held A, until the two returns were equalized.) Then a new tax preference is

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<sup>77</sup> This reflects that, on average, the tax benefit would be lost 12 percent of the time, or in 60 percent of the cases, themselves 20 percent of the whole, in which there was an audit challenge.

<sup>78</sup> A further aspect of FIN-48 is more neutral as between overstatement and understatement of expected tax benefits. It provides that the tax benefit that one recognizes cannot exceed the largest amount that one is considered more than 50 percent likely to realize. For an example where this leads to under-estimation of value, suppose one claims a \$100 tax benefit and has a 60 percent chance of realizing exactly \$60 and a 40 percent chance of realizing zero. One can deduct \$60 from reported earnings (see FIN 48 at 16) even though the expected tax saving is only \$36. The method leads to over-estimation, however, if one has a 60 percent chance of realizing exactly \$60 and a 40 percent chance of realizing the full \$100. Here the permissible deduction once again is \$60, but the expected tax saving is \$76.

unexpectedly enacted, favoring A relative to B. This makes A more profitable than B after-tax at the old equilibrium, so investment shifts from B to A until they again offer the same return after-tax (with B now being more profitable before-tax).

This little story fails to hold, at least as straightforwardly, for instrumental accounting, because the choice of accounting rule has no direct effect on a given company's actual pre-tax or after-tax returns. It affects only how those returns are publicly reported on the company's financial income statement, thereby altering one datum among many that investors may use in assessing value. Thus, suppose slower depreciation is allowed for investments in pollution-scrubbing equipment, on the view that managers will respond to the more favorable earnings treatment by buying more such equipment. Not only will investors presumably know that the cost recovery rule departs from accurate income measurement, but they may even be able to reconstruct the true income measure, depending on what other information is disclosed.

One might be inclined to say that instrumental accounting therefore cannot possibly matter – other than, perhaps, in relation to contracting costs that induce use of an unadjusted “financial accounting income” term in instruments such as debt covenants and executive compensation arrangements. There is evidence, however, that the official income line actually can matter, and not just due to contracting costs, even when all of the information needed to construct a more accurate measure is publicly available. Again, the non-deductibility of stock options, until 2005, for purposes of computing financial income appears to have significantly affected behavior even though information about the options was disclosed in financial statement footnotes.<sup>79</sup>

Thus, in evaluating instrumental accounting, one does not want to act like the economist in the old joke who says that he does not care if a given idea works in practice, as he knows that it does not work in theory. Still, if the independent influence of the income measure, and thus the potential efficacy of instrumental accounting, is hard to explain theoretically given its tension with a strong view of rationality in capital markets, then instrumental accounting's effects on market outcomes, even if accepted as potentially genuine, are harder to specify than the effects of tax preferences.

Suppose we start again with Activities A and B, initially equally profitable before and after-tax and reported as such for financial accounting purposes. Then, instead of enacting a tax preference for A such as faster cost recovery, we create an accounting benefit, such as slower cost recovery. With corporate managers who care about financial accounting income, even holding

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<sup>79</sup> See *infra* at text accompanying notes \_\_; Walker, *supra*, at 59.

constant the set of all available public information, the implication is that they will shift towards A, reducing its pretax and after-tax return relative to that from B. If they are the only relevant economic actors, then presumably there is a new equilibrium, violating standard economic reasoning, in which free money is being left on the table, in effect, through the failure to shift marginal investment from A back to B. One can make sense of this, however, by positing that the managers, taking advantage of shareholders' imperfect monitoring, rationally optimize under a utility function in which boosting accounting income is equivalent to receiving a side payment.

Now suppose, however, that not all of the economic actors who are choosing between A and B have the same taste for boosting reported earnings at the expense of actual expected earnings. Then one has the equivalent of a situation where some parties but not others get a tax benefit from making a given investment (or where the benefit is greater, as in the case of deductions that are worth more to taxpayers with high marginal rates). Now, if the marginal investor at equilibrium does not get the benefit, there is a clientele effect but no activity level effect. In other words, rather than an increase in aggregate investment in Activity A, all we get is a shift in who holds A.

Thus, instrumental accounting, like the selective provision of tax benefits, will not always achieve the presumably intended activity level increase. This limitation to its effectiveness will not apply, however, where the special accounting rule applies to decisions about what costs to incur, as opposed to what investments to choose. Thus, an accounting preference for compensating executives with stock options rather than cash makes the use of options "cheaper" (in terms of its reported effect on earnings) without thereby directly affecting overall supply and demand in such a way as to drive down the pre-tax return to using the preferred compensation structure. Likewise, accounting preferences for using pollution scrubbers in one's production activities or for making charitable contributions simply lower the perceived cost of particular outlays, without creating the same sort of offset mechanism that can prevent accounting subsidies from increasing the quantity invested in a given activity.

The analysis also becomes more complicated if a given accounting preference aims to address agency problems in the managers' economic decision-making on behalf of shareholders, rather than serving aims, such as pollution abatement, that are external to the firm itself. Thus, suppose managers were thought to under-invest in creating long-term profitability because their incentive structure invites focusing on the short run. Slowing down cost recovery, so the managers would be willing to invest more, might in theory increase expected profitability. Still, it is unclear in this scenario whether investors should be expected to take their cues from the (deliberately



inaccurate) income measure itself, or from any more direct evidence that long-term profitability is being addressed.<sup>80</sup>

### 3. *Why Might One Use Instrumental Accounting?*

Instrumental accounting has long been controversial within the accounting profession,<sup>81</sup> and is expressly disclaimed as an approach by FASB.<sup>82</sup> The main complaints about it are twofold: that it would open the door to heightened political gamesmanship in setting accounting standards, and that it would undermine financial accounting's informational role. The former of these concerns, while compelling, I ignore until section III, which considers agency costs in setting the income rules. This leaves, for now, only the concern that instrumental accounting would worsen information. It should be clear that this concern alone would not prevent some use of instrumental accounting from being optimal. Or, more specifically, the optimal level of use, ignoring agency costs in defining accounting income, is unlikely to be zero.

It is true that any use of instrumental accounting degrades the informational value of the official measure of financial accounting income (even if overall available information is unaffected). However, tradeoffs between socially valuable objectives are commonplace. The use of tax preferences, government outlays, regulatory commands, and other means of influencing companies' economic behavior may in practice commonly present tradeoffs as well.

In some instances, accounting incentives may happen to be the best tools available to influence particular companies. Thus, suppose that some managers respond more to reported earnings than to tax liability, while for

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<sup>80</sup> A further complication here is that a true Haig-Simons measure of income would in theory include the present value of all enhancements to expected future profitability. The hypothesized managerial bias reflects that conventional, historical cost-based income tax accounting excludes these aspects of value on the ground that they are hard to observe and verify. Slower cost recovery to account for this oversight could be viewed as improving the income measure, rather than as sacrificing it to advance other purposes in the manner of instrumental accounting.

<sup>81</sup> See, e.g., David Solomons, MAKING ACCOUNTING POLICY 233-235 (1986); Victor H. Brown, Accounting Standards: Their Economic and Social Consequences, ACCOUNTING HORIZONS 95-96 (1990).

<sup>82</sup> FASB's Mission Statement states the goals of being "objective in its decision making and to ensure, insofar as possible, the neutrality of information resulting from its standards" and of "report[ing] economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction." See Facts About FASB, available on-line at [http://www.fasb.org/facts/facts\\_about\\_fasb.pdf](http://www.fasb.org/facts/facts_about_fasb.pdf).

others it is the other way around.<sup>83</sup> This is one reason why, in general, using many different instruments tends to be optimal, thus permitting each to reach the circumstances where it works best.<sup>84</sup>

If some use both of tax preferences and of instrumental accounting (along with other tools) is optimal, then managerial agency costs, in this regard, weigh against establishing 100 percent book-tax conformity. Thus, suppose again that purchases of pollution scrubbers could be encouraged through rapid cost recovery for tax purposes and/or slow cost recovery for financial accounting purposes. Even if only one of these two instruments was selected, rather than both, it would seemingly be self-defeating to maintain conformity, thereby partially undoing the behavioral response, by requiring that both measures be changes in the same direction.

*D. Interactions Between the Tax and Accounting Rules in Light of Agency Problems*

So far, this section has considered how managerial agency costs affect optimal tax and accounting rules, in parallel but mainly in isolation from each other. The question for each system has been how it would optimally be designed, taking the other system as given. We have seen that the optimal systems would differ not just in direction – with tax rules responding to minimization of reported income while accounting rules respond to its maximization – but also in how they would optimally trade off competing approaches such as using more information versus relying on that which is more verifiable.

Policymakers have the option, however, of causing income under the two systems to be partly or wholly jointly determined. A “one-book” approach to income reporting takes this approach all the way to the limit, while requiring LIFO conformity does it in a particular area. A rule that was in the corporate alternative minimum tax (AMT)<sup>85</sup> from 1987 through 1989 illustrated another approach to partial joint determination. This rule provided that the taxpayer’s initial computation of alternative minimum taxable income or AMTI (generally, regular taxable income as adjusted to eliminate the effect of various tax preferences) would be compared to the taxpayer’s reported financial

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<sup>83</sup> See Walker, *supra*. This distinction could reflect heterogeneity either in managerial preferences and corporate culture, or in companies’ circumstances. Thus, a company with large tax losses may respond less to special deductions and exclusions, while one with volatile earnings may respond more to opportunities to smooth earnings for financial accounting purposes.

<sup>84</sup> See generally Joel Slemrod and Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, NBER Working Paper No. W7473 (2000).

<sup>85</sup> See Code section 56.

accounting income for the same period and adjusted by one-half of the difference between the two. Thus, if AMTI, as computed prior to this last adjustment, equaled \$100 million while the taxpayer's book income was \$120 million, the amount of AMTI would be adjusted to stand, for purposes of determining AMT liability, at \$110 million.

Conceptually speaking, this approach amounts to burdening managers' achievement of desired results under either system by causing an improvement (given their preferences) under one measure automatically to trigger a worsening under the other. As noted above, I therefore call it the "Madisonian" approach to income measurement, reflecting James Madison's famous constitutional strategy of using "[a]mbition ... to counteract ambition" such as through the separation of powers.<sup>86</sup>

It would be quite fortuitous if the Madisonian approach succeeded in eliminating income manipulation. Such an outcome would require perfect equipoise between the advantages that managers attributed to increasing book income on the one hand and reducing taxable income on the other, such that they were actually indifferent to matched changes. But causing a desired change in one of the measures to trigger an undesired change in the other reduces the net advantage to managers from manipulating them. The Madisonian offset thus would tend to reduce the overall waste that managers were willing to occur in the pursuit of manipulation, and it might conceivably result in causing both measures to be more accurate in practice.

One example of socially wasteful planning effort that full conformity would eliminate is tax-accounting "arbitrage," such as through the creation of tax versus accounting "hybrid" instruments or entities. Such strategies are familiar in the international tax literature, where they involve playing one country's tax system against another's, but they are equally applicable to planning under a single country's tax and accounting systems. The basic idea is to take a concept that the two interacting systems share but apply slightly differently – for example, the debt-equity distinction, or the view that each asset has a unitary owner who may not be the party holding legal title – and to respond by structuring one's transactions so as to achieve semantic inconsistency between the systems' characterizations of what one is doing. An example would be creating "hybrid" financial instruments that the tax system defines as debt, thereby generating interest deductions that reduce corporate taxable income, and yet that the accounting rules define as equity, thereby avoiding comparable reduction of accounting income.<sup>87</sup>

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<sup>86</sup> See text accompanying n. \_\_, supra..

<sup>87</sup> I can testify from personal experience in tax consulting that this is a frequent tax planning objective. I once heard an investment banker comment about such deals, in the

Where tax-accounting arbitrages rely on wholly arbitrary and fortuitous distinctions between the two systems' definitions of shared concepts, they present a particularly strong case for requiring full tax-accounting conformity, almost without regard to which system's rule is applied to both. The arbitrages also, however, can serve to illustrate a broader point about the interaction between the two measures. This is the lack of a general answer, applying across all possible income items, as to how much conformity is desirable, and as to which of the two systems should be conformed more to the other (which scarcely matters in the case of purely arbitrary differences in the debt and equity definitions).

Thus, suppose that the disparate treatment of a given hybrid debt instrument (one that was debt for tax purposes only) reflected good policy reasons for defining debt more narrowly in the accounting than in the tax context. This would immediately weaken the case for full conformity, by creating a disadvantage to moving either system off the rule that would have been best for it considered in isolation. Likewise, from the standpoint of requiring conformity in general, suppose taxable income is lower than accounting income due to the exclusion from the former of foreign source income, or due to the operation of socially desirable tax or accounting preferences. Once again, full conformity might have significant disadvantages from the perspective of whichever system was changed (or both if they met in the middle). Moreover, while the optimal degree and manner of reconciliation is hard even to define in theory, much less identify in practice, there is no theoretical reason to expect that all differences should be reconciled either zero percent or one hundred percent, rather than to some intermediate degree.

An obvious rationale for requiring full book-tax conformity is that it offers a much simpler and more determinate approach than trying for greater nuance based on some complex underlying definition of optimality. This, however, is a claim about political economy – that is, about how to induce good political decisions about the mandated relationship between taxable and accounting income. Thus, it cannot be evaluated before exploring my next topic, which is how agency costs in setting tax and accounting rules might affect the optimal approach.

### III. AGENCY COSTS IN SETTING THE RULES

If the only agency costs affecting taxable and accounting income were managerial, responses to the resulting design issues might long ago have been

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context of whether the tax or the accounting objectives were more important, that “saving taxes is all very nice, but earnings per share make the world go round.”

optimized. Unfortunately, however, there are also huge agency problems relating to the authorities who get to make the tax and accounting rules. These agency problems affect not only what rules end up being adopted, but also what types of rules we ought to aim for aspirationally. In particular, any move to increase book-tax conformity raises the question of whether this would tend to worsen decisions in either or both areas. One important objection to moving substantially towards conformity is that this would increase Congress's involvement in setting financial accounting rules, by making such involvement more of a byproduct of its strong interest in controlling the tax base. This, it is feared, would worsen the accounting rules, by causing them to use tax preferences that would degrade their informational content.<sup>88</sup>

Given such concerns, it is important to ask more generally how political agency cost problems affect the relationship between tax and accounting definitions of income that one should aim for aspirationally. This section conducts this inquiry in three stages, by examining in turn (1) the problems with tax politics, (2) the structural similarities and differences between tax politics and accounting politics, and (3) the implications for the optimal relationship between taxable income and financial accounting income.

#### *A. The Problems With Tax Politics*

Although the U.S. Treasury Department has significant interstitial authority over the development of tax law, and although the courts matter from time to time as well, fundamentally U.S. tax policy is made directly through the legislative process, and thus by Congress with input from the President. One could imagine a situation where the prospect of extending such direct political control from tax to accounting, which (as we will see) has a more indirect and delegated process via FASB's partial autonomy, was viewed as a good thing. Why not increase direct political accountability and the public's ability, through elected officials, to set the course and make the tradeoffs? That this is *not* the view one often hears reflects the extremely low regard in which Congressional tax policymaking is widely (and rightly) held.

For many decades, observers ranging from tax policy experts to political scientists to politicians and ordinary voters who view the tax code as a "mess" or a "disgrace," have repeatedly concluded that tax politics is extremely flawed.<sup>89</sup> The basic problem is well understood: "dominat[ion] by interest

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<sup>88</sup> See, e.g., John McClelland and Lillian Mills, *Weighing Benefits and Risks of Taxing Book Income*, 114 *Tax Notes* 779 (2007).

<sup>89</sup> *Cites.*

groups that seek favors for themselves and that, through a norm of logrolling, almost never oppose favors for each other ... These interests need not be small in membership – consider homeowners, who benefit from deducting home mortgage interest while excluding the related imputed rental income from their homes – but they nonetheless skew political outcomes given underrepresentation of the general revenue interest that is always the other side of the coin. This diffuse general interest remains unorganized and little heard.”<sup>90</sup>

Important though the balance of political forces seeking to influence tax policy may be, the institutional structure for decision-making is vital as well. The fact that Congress controls the tax base directly through its own enactments, rather than, say, telling the Treasury Department to define taxable income, is no mere historical accident. Legislative interest in controlling exercise of the power to tax goes back at least to the Magna Carta, if not the Roman Senate, reflecting that decisions over revenue are at the heart of government operations as well as having enormous societal effects. Direct Congressional control over the income tax base may not be entirely inevitable – Congress has, for example, ceded to the executive branch much of the direct control that it used to exercise over tariff policy<sup>91</sup> – but its surrender would certainly come as a surprise.

From the standpoint of the general public, Congress’s inclination, when shaping the income tax base, to cater to interest groups is an example of a political agency cost. Interest groups, however, face their own agency cost problems in dealing with Congress. One example is aggressive rent-seeking by politicians, who can seek to extort tribute from the well-organized in exchange for slowly parceling out favors (or forbearing to execute threats), rather than simply waiting to be bribed.<sup>92</sup> More generally, however, politicians have considerable discretion to do what they like, not just what they are told by the people with the most money. Thus, they seek power and prestige as ends in themselves, not just as means of insuring reelection, by trying to show that they are important players. This creates a “tendency to legislate for legislation’s sake.”<sup>93</sup>

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<sup>90</sup> Daniel Shaviro, *WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY* 86-87 (2000).

<sup>91</sup> See Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. Pa. L. Rev. 1, 114 (1990).

<sup>92</sup> See, e.g., Edward J. McCaffery and Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. Rev. 1159 (2006).

<sup>93</sup> Shaviro, *Beyond Public Choice and Public Interest*, *supra*, at 86.

Even just from the standpoint of being reelected, politicians do not benefit just from delivering the goods. They benefit as well from position-taking, or “the public enunciation of a judgmental statement on anything likely to be of interest”<sup>94</sup> to one’s audience, and from credit-claiming, or “acting so as to generate a belief ... that one is personally responsible for causing the government ... to do something ... desirable.”<sup>95</sup> Each of these objectives can encourage them to engage in posturing, whether directed at interest groups or the general public, possibly without great concern for the actual effects of what they do.<sup>96</sup> As we will see, this may prove important with regard to the interaction between tax and accounting political agency costs.

### *B. Comparing Tax Politics to Accounting Politics*

So far as the balance of social forces is concerned, accounting politics would be expected look a lot like tax politics. In both areas, highly interested parties can pursue benefits for themselves, secure that only a diffuse general interest leans the other way. If taxpayers’ general revenue interest does little to generate active political opposition when particular interest groups seek to lower their own tax liabilities, it is hard to see how investors as a group could be expected to resist effectively when well-organized managerial groups seek favorable accounting treatment. The interest in good financial information, or just in the informational content of the income line in accounting statements, is general and diffuse. The one important difference between the alignment of interests in the two fields – which is that shareholders and managers should both prefer reducing companies’ taxes,, but only managers should generally favor increasing reported earnings – may not matter much, given evidence of shareholders’ ineffectiveness in tax politics when the two groups’ interests diverge.<sup>97</sup>

This view of the two areas’ political similarity is largely borne out by the record of SEC and Congressional interventions in the design of accounting rules. While Congress’s insistence on having investment tax credits treated more favorably for accounting purposes might be viewed simply as backing up its exercise of tax policy discretion, its interventions with regard to stock

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<sup>94</sup> David Mayhew, CONGRESS: THE ELECTORAL CONNECTION 61 (1974).

<sup>95</sup> *Id.* at 52-53.

<sup>96</sup> See Shaviro, *Beyond Public Choice and Public Interest*, *supra*, at 90-92.

<sup>97</sup> See Jennifer Arlen and Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 *Yale L.J.* 325 (1995) (suggesting that, while corporate integration, eliminating the double taxation of corporate income, would be good for shareholders, it is bad for managers, who benefit from the lock-in of corporate earnings that results from taxing dividend distributions, and that managers’ political clout is an important reason for the non-adoption of corporate integration).

option expensing, as well as various items dear to the energy, public utilities, banking, and securities industries,<sup>98</sup> should have an all too familiar flavor to anyone who follows tax politics. The key difference is that, despite the occasional ominous statement by a member of Congress that “[a]ccounting standards are too important to be left to accountants,”<sup>99</sup> leaving them to the accountant-run FASB is exactly what Congress has mostly done.

This, in turn, appears (like Congress’s contrary insistence on controlling the definition of taxable income) to be no accident even if not historically inevitable. One important reason for Congress’s historical forbearance here may be that all of the key constituencies for accounting rules – investors, managers, and the accountants themselves – strongly favor its avoiding a regular role, evidently fearing a loss of control were it to step in more fully.<sup>100</sup> Even managers, while not shy about trying to get Congress to block FASB initiatives that they find unpalatable, seek only an effective case-by-case veto, not a shift to more regularly exercised direct political control over accounting standards.<sup>101</sup>

Politicians as well have evidently been willing to live with this limitation. Even when threatening FASB with the reversal of a particular initiative, they are prone to saying such things as that “nobody [is] more committed to the independent setting of accounting standards than I am,”<sup>102</sup> or that “I would like to begin by reaffirming my belief that FASB ... is best suited to set accounting standards.”<sup>103</sup> Exerting ongoing control over accounting income not only lies much further from core government functions and legislators’ expected prerogatives than deciding on the income tax base, but brings the risk of drawing blame for subsequent stock market problems and accounting scandals.<sup>104</sup> Significantly, even when the recent accounting scandals created a widespread public sense that financial accounting and

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<sup>98</sup> See text accompanying notes \_\_\_, *infra*.

<sup>99</sup> Beresford, *supra*, at 73 (quoting unnamed member of Congress).

<sup>100</sup> Mohamed Elmuttassim Hussein and J. Edward Ketz, Accounting Standards-Setting in the U.S.: An Analysis of Power and Social Exchange, 10 *J. of Accounting and Public Policy* 59, 69 (1991).

<sup>101</sup> Bratton, *supra*, at 34.

<sup>102</sup> Beresford, *supra*, at 75 (quoting Senator Phil Gramm).

<sup>103</sup> *Id.* at 77 (quoting Representative Michael Oxley).

<sup>104</sup> Thus, Senator Joseph Lieberman, who led the charge to prevent FASB from requiring that stock options be deducted, subsequently was accused of “laying the basis for the accounting scandals of the stock bubble era.” Dean Baker, *The Joe Lieberman Nobody Knows*, available on-line at

[http://www.prospect.org/csnc/blogs/beat\\_the\\_press\\_archive?month=08&year=2006&base\\_name=the\\_joe\\_lieberman\\_nobody\\_knows](http://www.prospect.org/csnc/blogs/beat_the_press_archive?month=08&year=2006&base_name=the_joe_lieberman_nobody_knows) (posted 8/9/06).



auditing were not working properly, Congress's main response, the Sarbanes-Oxley Act of 2002,<sup>105</sup> aimed at structural reform of existing processes, rather than at expanding Congress's ongoing role.

Congress's initial decision, when it created the SEC in 1934, was simply to give that agency the power to set accounting standards.<sup>106</sup> However, the SEC swiftly decided that the job was too hard,<sup>107</sup> and created further delegation by announcing that it would accept any accounting practices that had "substantial authoritative support" within the accounting profession.<sup>108</sup> Accountants swiftly accepted this open invitation to create authoritative industry standards, creating a succession of review boards charged with doing so, although not until 1973 did the current FASB structure emerge. FASB was deliberately given more independence from the profession than its predecessors, reflecting negotiation among all of the interested parties (representing investors, managers, and accountants) based on their agreement that this would lead to accounting standards that were more credible.<sup>109</sup> Thus, rather than being controlled directly by accountants' main professional association, FASB reports to the Financial Accounting Foundation (FAF), an independent not-for-profit entity controlled by a set of accountant, managerial, and state and local government organizations.<sup>110</sup>

FASB, despite its foot in the private sector, has been described as epitomizing the model, dating back to the New Deal era, of an independent agency that bases its decisions on sound professional expertise.<sup>111</sup> Others, less sanguine, argue that the current structure still amounts to "letting accountants regulate the rules they apply[, which] is a very bad idea."<sup>112</sup> Even such critics agree, however, that FASB has the incentive of an independent bureaucracy to

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<sup>105</sup> Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>106</sup> See Securities Exchange Act of 1934, Pub. L. No. 73-290, 4, 12-13, 19, 14 Stat. 881, 885, 892-95, 898-99 (1934); David Solomons, *MAKING ACCOUNTING POLICY: THE QUEST FOR CREDIBILITY IN FINANCIAL REPORTING* 25 (1986).

<sup>107</sup> See Joel Seligman, *The SEC and Accounting, A Historical Perspective* 16, in Robert H. Mundheim and Noyes E. Leech (eds.), *THE SEC AND ACCOUNTING: THE FIRST 50 YEARS, 1984 PROCEEDINGS OF THE ARTHUR YOUNG PROFESSORS' ROUNDTABLE* (1986).

<sup>108</sup> *Administrative Policy on Financial Statements*, Accounting Series Release No. 4, 11 Fed. Reg. 10913 (Apr. 25, 1938).

<sup>109</sup> See Bratton, *supra*, at 12-14; Hussein and Ketz, *supra*, at 76.

<sup>110</sup> See Bratton, *supra*, at 13-15. Until 2002, FASB depended on voluntary contributions from private organizations to fund its operations, but in 2002 Congress provided mandatory funding through fees levied on reporting companies. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 108, establishing 15 U.S.C. § 77s.

<sup>111</sup> Bratton, *supra*, at 16-18.

<sup>112</sup> Mundstock, *supra*, at 817.

guard its ongoing decisional role.<sup>113</sup> Moreover, the accusation of serving accountants' professional interests is importantly different from that of responding to industry and managerial interest groups, as Congress would evidently be inclined to do if more regularly exercising direct control over accounting standards.

The key to FASB's relative independence from industry-specific and managerial influence is a fortuitous alignment between (1) the grounds on which it can most persuasively claim professional expertise, and (2) the interests of investors. Its stance as a nonpolitical expert decider could not easily be squared with the instrumental accounting-style exercise of balancing interests and evaluating competing social objectives.<sup>114</sup> Instead, the claim to an expert stance invites purporting to apply "neutral accounting principles" that seek to embody the underlying concept of economic income.<sup>115</sup> This, in turn, is best rationalized by reference to informing investors, the protection of whom also jibes with the SEC's institutional mission.<sup>116</sup> FASB identified investor protection as its core mission early on, issuing a "Conceptual Framework" that "broke with past accounting theory to raise external transparency – 'decision usefulness' for the users – over internal control [by the managers] as the system's goal."<sup>117</sup>

In short, once FASB had been given sufficient independence, its incentive structure followed the classic Madisonian approach of using ambition to counteract ambition,<sup>118</sup> here by aligning its institutional goals with investors' diffuse general interests and against those of managers and specific industries. To be sure, the offset is imperfect. For example, empirical research suggests that industries such as oil and gas find it worthwhile to lobby FASB,<sup>119</sup> and that corporations' influence on FASB decisions is positively correlated with their

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<sup>113</sup> I infer this from the statement in Mundstock, *supra*, at 836, that FASB's 1995 retreat in the face of Congressional opposition to its proposal to make stock options deductible shows that, "[l]ike a textbook bureaucracy, FASB valued its existence more than its mission." Mundstock does not explain how FASB could have preserved its mission had its independence been taken away, as Senator Lieberman made clear would be the consequence of its not retreating. See Michael H. Granof and Stephen A. Zeff, *Unaccountable* in Washington, N.Y. Times, Jan. 23, 2002, at A-19.

<sup>114</sup> See Bratton, *supra*, at 28-30.

<sup>115</sup> See Mundstock at 822-823.

<sup>116</sup> See Bratton, *supra*, at 26-27.

<sup>117</sup> *Id.* at 26.

<sup>118</sup> See text accompanying notes \_\_\_, *supra*.

<sup>119</sup> See Edward B. Deakin, *Rational Economic Behavior and Lobbying on Accounting Issues: Evidence from the Oil and Gas Industry*, 64 *Accounting Rev.* 137 (1989).

size and diversification.<sup>120</sup> Still, the difference between FASB's and Congress's levels of responsiveness to interest group pressures is clear.

The main complaint about FASB is that, despite its at least nominal independence from direct control by the accounting profession, it nonetheless unduly serves accountants' interests relative to those of investors. From this perspective, "[o]ne would expect rules that justify large fees, while requiring little work and reducing legal risk."<sup>121</sup> Critics argue that FASB has done exactly this in a number of respects, such as by making GAAP overly complex and rule-bound at the expense of requiring auditors to make contestable judgments,<sup>122</sup> and by refusing even to try to measure income accurately where this would require estimates that would raise the risk of auditor liability.<sup>123</sup>

Many though not all<sup>124</sup> observers accept this critique of GAAP, and suggest that its flaws, especially if viewed as contributing to the accounting scandals of recent years, show dysfunction on the part of FASB. From the standpoint of comparative agency costs in defining income, however, a compelling response is "dysfunction compared to what?" Congress's track record when it seeks to influence accounting income, and in setting the parameters for taxable income, suggest that there are worse things than control by practicing professionals,<sup>125</sup> even given the gap between their interests and

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<sup>120</sup> See Lawrence D. Brown and Ehsan H. Feroz, Does the FASB Listen to Corporations?, 19 J. of Business, Finance, and Accounting 715 (1992).

<sup>121</sup> Mundstock, *supra*, at 817.

<sup>122</sup> See, e.g., Harvey L. Pitt, Filling in the GAAP [Forbes Magazine] (calling GAAP "hopelessly complex and convoluted"); Alex J. Pollock, From Making Judgments to Following Rules: The Evolution of U.S. Accounting [AEI publication] (similar).

<sup>123</sup> Mundstock, *supra*, at 830-832 (criticizing on this ground rules requiring research and development expenditures to be expensed rather than amortized, and permitting certain contingent liabilities to be ignored).

<sup>124</sup> For an at least partial defense of FASB's pro-rule orientation, see Bratton at 43-47.

<sup>125</sup> Tax lawyers, like accountants, have been criticized for over-valuing the importance of legal certainty, perhaps reflecting their risk aversion with respect to offering legal advice. See, e.g., David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215 (2002). However, when institutions of the tax bar involve themselves with legal reform, they generally take a much broader perspective than that of members of Congress serving campaign contributors' interests. The Tax Section of the New York State Bar Association, for example, is well known in Washington for offering proposals that, even if reflecting some tincture of professional or client interest, reasonably relate to its stated mission to act "for the furtherance of the public interest in a fair and equitable tax system." See New York State Bar Association, Tax Section Purpose, available on-line at [http://www.nysba.org/MSTemplate.cfm?Section=Mission\\_Statement6&Site=Tax\\_Section1&Template=/ContentManagement/HTMLDisplay.cfm&ContentID=2736](http://www.nysba.org/MSTemplate.cfm?Section=Mission_Statement6&Site=Tax_Section1&Template=/ContentManagement/HTMLDisplay.cfm&ContentID=2736).

those of the diffuse public (be it that of investors or taxpayers) that the income measures are supposed to serve.

*C. Implications for Setting the Relationship Between Tax and Accounting Rules*

If Congress were already exercising direct control over both taxable and accounting income, the case for moving towards a one-book system, in which the same rules generally applied to both, would be compelling.<sup>126</sup> In such a scenario, accounting income would presumably look a lot like taxable income in reverse, with numerous arbitrary preferences adopted at the behest of managers in favored industries, causing accounting income regularly to exceed economic income just as taxable income frequently is less. Moving towards conformity of the two measures might therefore be expected to improve them in both a static and a dynamic sense. Statically, the overall error in the two systems might have to be less if they were constrained from erring in opposite directions. Dynamically, conformity would have the Madisonian advantage of creating political as well as reporting tension between managers' goals of reducing taxable income on behalf of shareholders and increasing accounting income on behalf of themselves.

Things are less clearcut than this, however, given Congress's relative lack of participation to date in regularly shaping accounting income. Getting it more involved in this process, when its incentives may on balance be worse than FASB's, could conceivably worsen the measurement of accounting income over time. Thus, suppose Congress continued to care more about tax, and that conformity's main effect was to induce it to add tax preferences to the accounting measure.

Existing one-book countries, such as Germany until it recently backed substantially away from such an approach, have not necessarily enjoyed positive tax policy effects from the joint determination. Moreover, such countries may rationally have been more willing to accept the adverse informational effects on accounting, because their stock ownership patterns rely less on diversified public holdings and more on block ownership by inside players, such as banks, that have less need to rely on public reporting.

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<sup>126</sup> Even in this scenario, however, it is not clear that one would want complete conformity between taxable and accounting income, given such issues as whether foreign source income should be exempted for tax purposes as a way of coordinating different countries' taxation of multinationals.

If the social harm from involving Congress more in accounting outweighed the social gain from bringing the Madisonian offset to bear on its tax policymaking, increasing the conformity between the two measures would on balance be undesirable. In moving towards conformity, therefore, the aim should be to try to tilt the odds in favor of Congress's continuing to control only taxable income while still largely leaving accounting income alone. I next explore how this might conceivably be done.

#### IV. A MODEST PROPOSAL

Precisely determining the optimal relationship between taxable income and financial accounting income is not just a daunting task, but verging on an impossible one. The underlying considerations are not merely numerous and diverse, but in many cases fuzzy and amorphous. Both managerial and political behavior, for example, are difficult to model crisply without unduly sacrificing real world complexity. In addition, the weight of various considerations may change over time. For example, if Congress moved towards using a consumption tax base, or started interfering more regularly with FASB's work, or if investors stopped relying as much on the income line in financial statements, the balance between competing considerations would change.

Nonetheless, on the view that normative ambiguity should not be treated as a ground for defaulting to the current status quo, I propose in this section a possible reform of the relationship between the two measures. I aim to show, not that this proposal is the best one possible, but that it would be better than what we now have and reflects the analysis in this Article, subject to its making various reasonable judgment calls with which one could, equally reasonably, disagree. I view it as a starting point for further discussion, rather than as a definitive solution.

The following parameters appear to me to follow reasonably from the analysis in the prior three sections:

1. Limit the direct effects of an adjustment rule to taxable income – Congress should continue to exercise direct legislative control only over taxable income, not over accounting income. This suggests applying a methodology like that in the AMT from 1987 through 1989, in which the book income preference required a 50 percent adjustment of AMTI (as otherwise determined) through financial accounting income.

Obviously, if the adjustment factor were 100 percent, and if, for some reason, Congress could not create exceptions – i.e., it had to change accounting income in order to get the tax results it wanted – one doubts that it (or anyone else) would be fooled. Congress might be expected to make decisions on a joint or one-book basis, without leaving accounting issues alone on the view that they were formally merely a byproduct. If the adjustment factor is significantly below 100 percent, however, the irrelevance of formally leaving accounting issues to FASB is far less clear. If members of Congress only cared about substantive, bottom-line results, the formality of continuing to involve it only in tax base definition, while FASB made accounting determinations that had tax consequences, might indeed remain irrelevant. However, the importance of position-taking and credit-claiming to Congressional behavior raises the possibility that limits on what it formally and actively controls actually might matter. In particular, in areas where it does not have a strong interest, the tax consequences of rules chosen by another actor (such as FASB) may nonetheless have a good chance of not being changed. Congress might even, in some cases, not mind the adverse effects of accounting rules on those seeking favors from them, so long as these effects could be blamed on someone else and one suitably affected to deplore them.

2. Ensure that Congress can avoid effects on tax preferences without having to alter financial accounting income – In considering how an automatic adjustment of taxable income towards financial accounting income would affect Congressional tax base decisions, a key underlying distinction to keep in mind is that between deliberate tax preferences and other causes of divergence between the two measures. As to the former, while position-taking and credit-claiming conceivably could induce members of Congress to disregard the actual net effect of new enactments on taxable income given the accounting adjustment, it is hard to be too sanguine.

In illustration, suppose that, for a given asset, “correct” economic depreciation was initially being used for both the tax and accounting measures, but that Congress wanted to accelerate tax depreciation in such a manner as to increase the present value of depreciation deductions by 30 percent. If taxable income (as otherwise determined) were automatically adjusted by 50 percent of the difference between it and the taxpayer’s book income, enactment of a 30 percent acceleration would end up increasing the deductions’ present value by only 15 percent. Perhaps, in some cases, this would actually be allowed to happen, reflecting that the extra deductions would not directly be reversed, but instead would merely feed into a broader set of differences between the two composite income measures. It also is plausible, however, that Congress would take the effect of the adjustment into account when enacting the new

preference. One obvious response would be boosting the deductions' pre-adjusted increase in present value to 60 percent, so that the net increase would still end up being 30 percent. A second possibility would be requiring that the effect of the new preference be exempted from the accounting adjustment (for example, by requiring that accounting income be revised to use it before being compared to taxable income). Either way, the accounting adjustment would have failed to stop Congress from doing what it evidently wanted to do.

With respect to tax preferences pre-dating the hypothetical adoption of an adjustment towards financial accounting income, the case for this irrelevance result is weaker. Various provisions, even if too strongly rooted politically for direct repeal or weakening to be politically feasible, might not have sufficient champions to resist the indirect effects of a general book income adjustment, which (for position-taking and credit-claiming purposes) did not literally have their names on it. On the other hand, it is difficult to believe that tax depreciation, for example, could be significantly changed this way without significant political resistance, given the continuing strength before Congress of affected industries.

Given the poor prospects for limiting tax preferences through an adjustment to financial accounting income in cases where Congress has in mind a target level of preferentiality, one should not seriously object to its specifying that such income, for purposes of the adjustment to taxable income, be revised to use particular preferences. This at least has the virtue of avoiding degradation of actual financial accounting income. Admittedly, it amounts to surrender with respect to subjecting Congress to the Madisonian dilemma in defining income. However, such surrender may be the best we can do given the fox-in-the-henhouse problem if Congress gets to decide whether, when, and how it will conform the two sets of rules, and given as well the advantages of the FASB decisional structure for accounting income. And it leaves in place the capacity of the taxable income adjustment to subject corporate managers to the Madisonian dilemma.

3. Keep the adjustment relatively simple and uniform – In principle, one could imagine the use of a wide range of reconciliation percentages between taxable and financial accounting income. For example, perhaps the taxable income adjustment ought in principle to be close to 100 percent for interest deductions on hybrid debt instruments, and considerably lower for accruals of future income or expense. In practice, however, simplicity and uniformity are often best. Even leaving aside the possible implementation difficulties of applying a wide range of reconciliation percentages to different items, Congressional decision-making is unlikely to use greater discretion well.

Thus, in general the use of a single adjustment percentage may be best, leaving aside items that are expressly left out of it altogether. I will pick 50 percent, admittedly arbitrarily, simply because it is a salient midpoint.

4. Base the adjustment on financial accounting income of the tax reporting group – As discussed in section I, U.S. federal income taxation and financial accounting use different rules to determine what group of companies should be amalgamated as a single reporting unit. While there might be good reasons for using different consolidation rules in the two systems given the different stakes, it is not clear whether the actual divergences have anything to do with this. Still, once the two systems use different consolidation rules, a taxable income adjustment can have untoward consequences if applied without adjustment for the membership differences. For example, suppose the two measures were identical except that a given U.S. company, earning \$10 million of income each year, were part of the financial accounting group but not the tax group. Use of a 50 percent taxable income adjustment might cause the tax group to include \$5 million of extra taxable income per year, thereby either discouraging broader financial than tax consolidation or requiring some sort of complicated reconciliation between the amounts included by the separate taxpayers. Preventing this would surely be desirable via an adjustment of financial accounting income to include only that of members of the tax group.

A possible alternative to excluding all income of non-group members would be to include that of foreign subsidiaries, thereby indirectly partly repealing deferral.<sup>127</sup> This, however, is arguably a substantive legislative policy change (like reducing straightforward tax preferences) of a sort that is hard to advance through the taxable income adjustment, and that would unduly complicate the politics of a provision that most profitably is aimed at managerial incentives.

5. Consider permitting a limited number of other modifications to the financial accounting measure that was used in the taxable income adjustment – Given the modification of actual financial accounting income to reflect only the income of the tax reporting group, and perhaps to back out specified tax preferences, a question would naturally arise as to whether other modifications should be made as well. An example would be modifying actual financial accounting income to eliminate deductions for federal income taxes, which are not allowed in determining federal income tax liability. The rationale for the modification would be to prevent such taxes from effectively becoming 50

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<sup>127</sup> This might suggest allowing foreign tax credits to offset the U.S. tax on the foreign source income of foreign subsidiaries that became currently taxable through the adjustment.



percent deductible via their effect on the taxable income adjustment. This, in turn, might be undesirable, even if allowing the deduction is in a design sense potentially a matter of indifference, because it might require a nominal rate adjustment and complicate coordinating the relative taxation of corporate taxpayers subject to the adjustment and other taxpayers.

Various other modifications might arguably be desirable as well. For example, if denying 50 percent of business meal and entertainment deductions is desirable as proxy taxation of those enjoying the benefits, adjusting halfway towards 100 percent allowance through the effect of the taxable income adjustment might rightly be criticized. Likewise, if a key aim of the tax rules concerning executive compensation is to ensure that the corporation's deduction and the employee's inclusion take place in the same year, with mutual deferral rightly being viewed as harmless, the taxable income adjustment could anomalously result in allowing half of the deductions too soon. In each case, rather than changing the regular tax rules and having to deal with the fact that not all taxpayers were subject to the taxable income adjustment, it might be easiest simply to modify the measure of accounting income that is used in computing it.

My own view, however, is that going down this road would likely be a mistake, as it would invite wholesale item-by-item modification of actual financial accounting income, until at some point the modified measure ceased to resemble the actual measure sufficiently. One key reason for the suggested structure of the taxable income adjustment is to avoid encouraging Congress to look inside it, other than in instances (pertaining to tax preferences that it considers important) where this seems unavoidable. The significance of this "slippery slope" problem is an open empirical question, however. One who felt that allowing a few clearly rationalized modifications would not greatly affect Congress's inclination to add others might favor reversing, for purposes of the adjustment, the treatment of selected items such as federal income taxes.

6. Take advantage of Schedule M-3 in designing the taxable income adjustment – At one time, such as when the AMT book income preference was enacted in 1986, getting a handle on the income of tax versus accounting group members might have been very difficult. Recently, however, it has gotten much easier. Since 2004, the IRS has required companies with at least \$10 million in assets to file Schedule M-3, reconciling taxable and financial accounting income in much greater detail than had previously been necessary.<sup>128</sup> To date, the main purpose served by Schedule M-3 has been to

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<sup>128</sup> See Revenue Procedure 2004-45, 2004-2 C.B. 140.

provide the IRS with a vital roadmap for tax audits, by helping to identify the most potentially questionable areas on corporate tax returns.<sup>129</sup> However, the Schedule also is readily adaptable to the task of making feasible a properly tailored adjustment of taxable income towards financial accounting income.

Schedule M-3, like Gaul according to Julius Caesar, has three parts.<sup>130</sup> Part I identifies the relevant income statement, such as SEC Form 10-K for companies that are required to file it, and then adjusts the bottom line income (or loss) amount on this statement for differences in membership between the tax and financial reporting groups, and for the use of different accounting periods (such as a tax year). The final line in Part I (Line 11 on the 2006 form), entitled “Net income (loss) per income statement of includible corporations,” gives the net result of all these adjustments. It thereby offers the most correct comparison number for taxable and financial accounting income, making it a good starting point for application of the taxable income adjustment.

Parts II and III of Schedule M-3 then complete the reconciliation between the two measures. Part II breaks down the sources of difference as to income items, while Part III addresses expense and deduction items.<sup>131</sup> Each of these parts further requires the reporting taxpayer to distinguish between permanent and temporary differences between taxable and accounting income. Examples of permanent differences are those resulting from the tax system’s exclusion of municipal bond interest and denial of any deduction for certain meal and entertainment expenses. Examples of temporary differences are those relating to depreciation and to the timing of write-offs when assets or businesses become worthless or are abandoned.

Many of the adjustments to Part I, Line 11, that one might want to make for purposes of the new rule could come directly out of Parts II and III of Schedule M-3. Part III, for example, provides information about U.S. current and deferred income tax expense (deductible for financial accounting but not U.S. federal income tax purposes), and about foreign tax expenses that may give rise to credits rather than deductions under the income tax. It also reports timing differences under depreciation and various other cost recovery rules.

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<sup>129</sup> See Daniel Shaviro, Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters, forthcoming in Wolfgang Schon (ed.), *TAX AND CORPORATE GOVERNANCE* (2008).

<sup>130</sup> See Schedule M-3 (Form 1120), Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More. [Note 2006 version is available at IRS website

<sup>131</sup> For technical reasons, certain losses, such as on the sale of an asset, are handled in Part II rather than Part III.

Since Schedule M-3 provides a comprehensive reconciliation between taxable and accounting income, any item that one wanted to exclude for purposes of the adjustment in the new rule would necessarily appear on it somewhere. The only case in which new information would be needed in order to apply the new rule would be if the desired exclusion was amalgamated on a line of Schedule M-3 with other items that one did not want to treat specially. Additional breakdowns for this limited purpose should not, however, add significantly to the existing reporting burdens that Schedule M-3 places on taxpayers. Nor should the extra purpose being given to Schedule M-3 greatly add to the compliance stakes, given that the form already serves as an IRS “audit map” and that the adjustments it requires making generally are mechanical rather than judgmental.

7. Address issues raised by companies that do not currently file both Schedule M-3 and SEC Form 10-K – Schedule M-3 filing requirements depend on asset size rather than (like SEC Form 10-K) public offering status. Thus, one would have to determine whether the taxable income adjustment should apply to companies that, under current law, do not file both documents. The problems for those currently required to file only SEC Form 10-K is one of compliance burden if they now were required to file Schedule M-3, and of disparate tax treatment based on asset size if they were exempted. One possible argument in favor of exemption is that smaller companies, even if publicly traded, are less likely than bigger ones to have the sorts of managerial agency costs that potentially make the taxable income adjustment both desirable and (in Madisonian terms) efficacious.

The problem for those currently required to file only Schedule M-3 is that the methodology and non-tax purposes behind a privately held company’s income statement may differ substantially from those more easily assumed for publicly traded companies. Thus, one might be less confident about the existence of a Madisonian offset between taxable and accounting income, and more reluctant to give tax significance to the income statements. A possible solution would be simply to exempt all non-publicly traded companies from the taxable income adjustment, whether they file Schedule M-3 or not.

One downside to exempting non-publicly traded companies is that this would lead to a disparity between the tax bases applied to the two groups. One should keep in mind, however, that there already are disparities in how publicly traded and other companies are taxed, given that only the former generally are

subject to the two-level corporate tax.<sup>132</sup> In addition, even without disparate tax treatment, publicly traded companies may act as if they face different incentives than other businesses if managers are influenced by accounting rules. Thus, it is not clear that this disparity would worsen economic distortions resulting from differential tax and accounting treatment of the two groups.

8. Address use of the taxable income adjustment as a device for reducing income tax liability – Even among the managers of publicly traded companies, not all are equally concerned about reported financial accounting income. For example, where ownership is relatively concentrated, managers may themselves be large shareholders, or at least may be catering to a well-informed audience, and therefore may care more about economic fundamentals and less about cosmetics. Such managers might actually welcome the taxable income adjustment as a device inviting them to reduce taxable income by deliberately understating financial income.

One possible response would be to reduce the gain-loss symmetry of the taxable income adjustment. So far, by referring to a 50 percent adjustment of taxable income towards financial accounting income, I have assumed that taxable income can be reduced as well as increased. Such gain-loss symmetry clearly is needed to prevent tax liability from depending on whether one's financial accounting income fluctuates up and down relative to one's taxable income, or stays more in equipoise with it. One could, however, limit aggregate use of the adjustment to lower one's taxes, without overly burdening companies with a more fluctuating annual relationship, by limiting negative adjustments to the amount of prior positive adjustments, with reductions that were disallowed on this basis being carried forward for possible use against positive adjustments in subsequent taxable years. In other words, shortfalls in financial accounting income relative to pre-adjustment taxable income could be treated in much the same manner as net operating losses under existing tax law.

Even with this limit on taxable income reductions, taxpayers could use the adjustment to shift taxable income between years. Suppose, for example, that Congress passed a law increasing corporations' marginal tax rates, effective the following January 1. Increasing reported earnings for the year in progress, in exchange for reducing them for the following year, would have the effect of accelerating taxable income into the low-rate year. Taxpayers also have other ways of shifting income between years, however, and it is not clear how much worse this opportunity makes the overall problem.

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<sup>132</sup> [Note the publicly traded rule, Blackstone.]

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In summary, the proposed taxable income adjustment would work as follows. Publicly traded corporations with at least \$10 million of assets, which under current law must file both Schedule M-3 and SEC Form 10-K, would be required to adjust taxable income (as otherwise determined) by 50 percent of the difference between such income and modified financial accounting income, which would be the financial accounting income of the tax group as recomputed to use whichever income tax preferences Congress specified. However, reductions in taxable income through the adjustment would be limited to previous increases, with a carryforward for amounts thus disallowed. Application of the taxable income adjustment to corporations that do not file one or both of the above forms might also be considered.

Lest the proposal's effects seem too abstract, consider three representative scenarios in which it would apply. In the first, a taxpayer is considering engaging in a corporate tax shelter that would reduce taxable income by \$10 million while having no effect on financial accounting income. Under the adjustment, the shelter's effect on taxable income would immediately decline in half, to \$5 million. This is a significant effect if scaling up the nominal size of tax shelters is costly.

Second, suppose a company is considering playing accounting games of some kind in order to increase its reported financial income by \$10 million without affecting taxable income. Rather than being potentially tax-free, the strategy would now have a current-year tax cost equal to the product of the company's marginal tax rate and \$5 million.

Finally, for a joint-causation example, suppose a company that needs to raise capital is considering using hybrid debt that would generate \$10 million of interest deductions for tax purposes, without giving rise to interest deductions against financial accounting income. Using the hybrid form instead of straight debt would cost the company the tax on losing \$5 million in interest deductions, significantly reducing the payoff to managers from using hybrid debt. A reduction in the perceived payoff to tax-accounting arbitrages presumably would reduce the resources invested in this socially wasteful activity.

## V. CONCLUSION

Taxable income and financial accounting income, while using a shared concept, serve very different purposes – determining current year tax liability on the one hand, and providing a particular informational input to investors on the other. It is not surprising, therefore, that the two measures both ideally and actually have differences.

Yet the persistent book-tax gap, or excess of reported financial accounting income over taxable income, reflects, not these differences, but corporate managers' incentives to engage in two socially undesirable activities: tax sheltering on behalf of shareholders, and earnings management on their own behalf. Moving in the direction of requiring book-tax conformity would have the desirable feature of creating Madisonian tension between the managers' twin aims, reducing the incentive to play games and the scope of what they could accomplish.

Absent political incentive problems, it might indeed make sense adopt a one-book system or something close to it, notwithstanding the differences between the two measures' purposes. However, the fact that Congress, for the most part, currently confines its dark arts to the design of taxable income, while largely leaving accounting income to FASB, helps make the Madisonian strategy less promising with respect to its decisions than those of corporate managers. A more directly involved Congress might be expected to worsen financial accounting income more than it improved taxable income, and in any event could not be required to keep the two measures in lockstep when it wanted to add opposite tax and accounting preferences to each.

My suggested proposal, generally requiring a 50 percent adjustment of taxable income towards financial accounting income for large, publicly traded companies, clearly is not a perfect solution to the competing considerations in this complicated yet important area. Yet it would substantially improve current law if adopted, and even if just seriously considered may help to advance the ongoing debate.