Accounting and taxation: Conjoined twins or separate siblings?

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ABSTRACT

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

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1. Introduction

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

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

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

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

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

2. Profit shifting and erosion of tax base

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

The intensification of contemporary corporate tax avoidance has coincided with the rise of neoliberalism, which has encouraged mobility of capital. Historically, liberalism has been a complex amalgam of contradictory ideas, concepts and philosophies from the left and the right of the political spectrum. Some elements promoted ideologies about the rule of law, democratic governance, egalitarianism and an antipathy towards unrestrained capitalism (Gray, 1995). It also encompassed progressive thinkers, such as John Maynard Keynes and William Beveridge,2 who envisaged progressive taxation, constraints on the movement of capital and a key role for the state in redistributing wealth to create a more equitable and just society. However, since the 1970s, under the influence of writers such as Milton Friedman and Friedrich August von Hayek, liberalism has been rapidly transformed into neoliberalism (Harvey, 2005). The neo or newer elements are strong faith in free markets, pursuit of economic efficiency through cost reductions, global mobility of capital and a restricted economic role for the state. Competition is a key concept and is to be applied to every sector of society, including corporations, nations, government departments, schools and hospitals because this somehow secures efficient allocation of resources and opens the door to wealth and riches.

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2 See Harris (1997) for further details.
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