# Is Accounting Profits still an appropriate basis for Income Taxation?

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*Taxes were usually considered as 'the price we pay for living in a civilized society'. There is no inherent requirement for the tax system to follow the accounting system. However, to the extent that the government of the State chooses to impose tax on profits or income, the accounting rules and measurements provide a convenient source to tap on. Having said that, with the recent development in accounting principles and international tax rules, the question is whether accounting profits still forms an appropriate basis for taxation.*

*This paper first examines the historical link between taxable profits and accounting profits and discusses if accounting profits still serve as an appropriate basis for taxation. To a large extent, this issue also depends on the more fundamental question of whether tax is still to be imposed on profits (income) or other precepts. To this end, the paper explores briefly other possible basis (namely, turnover tax and cashflow tax) and concludes that profits may still be the preferred basis of taxation, particularly in the context of Singapore. Consequently, there is still a role for accounting to play in the area of taxation.*

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**Introduction**

1. Tax is an imposition by the State on its subjects. United States Supreme Court Justice, Oliver Wendell Holmes Jr., wrote in his opinion on a US court case in 1927 that "taxes are what we pay for civilized society". The object of a tax system is to raise revenue for the State and fund the operations of the State. Some of these operations include the provision of education, healthcare and national security.

2. The State could choose to levy tax on a range of items from income to assets to consumption. Modern tax systems generally consist of a mix of direct taxes, for example income tax and property tax, and indirect taxes like value added tax.

3. The focus of this paper is on income tax on corporates. For the purpose of this paper, income tax is synonymous with profits tax and the terms will be used interchangeably. This paper is presented in three main parts. Part I details the historical link between taxable profits and accounting profits and, the arguments for and against a complete alignment of the two systems. Part II discusses the recent developments in accounting and international tax, and whether accounting profits remains an appropriate basis for income taxation. Part III explores briefly the possibility of relying on other financial information, such as turnover or cashflow, as the basis of taxation. Having considered the object of the Singapore tax system,

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this paper argues that income taxation would still be here to stay, and accounting profits would remain an appropriate basis for income taxation.

**Part I – Relationship between Tax and Accounting**

4. The relationship between the income tax system and the accounting system has been a subject for discussion for a long time. In countries such as the United Kingdom (UK), and Singapore, there is no statutory definition of "profits" for corporate tax purposes. As such, the accounting profits have been taken as the starting point for the computation of the taxable profits.

5. Historically, the computation of trading profits for income tax purposes followed accounting practices closely. As such, as accounting practices change and progress, it becomes necessary for the State to consider the extent to which tax should converge with accounting. This exercise would sometimes require the involvement of the Courts and the legislature as well. The important rule that accounting plays in income taxation has been endorsed by the Courts. Pennycuick V-C said in the UK case *Odeon Associated Theatres Ltd v Jones*[1] that:

   "*The concern of the courts in this connection is to ascertain the true profit of the taxpayer… in so ascertaining the true profit of a trade, the court applies the correct principles of the prevailing system of commercial accountancy*".

6. Hence, it is for the Courts, with the assistance of accountants, to decide which principles of commercial accountancy to apply in determining taxable profits, subject to specific statutory tax provisions[2].

7. The decision in the UK case of *Gallagher v Jones*[3] also demonstrated the willingness of the courts to adopt accounting practice in ascertaining trading profits, and has been widely cited as offering confirmation that the commercial accounting principles should be used in the preparations of accounts for income tax purposes[4]. In *Gallagher v Jones,* an unincorporated business entered into a 25-year finance lease, with the rentals front-end loaded within the first two years and during the subsequent period, the lessee could dispose of the asset and retain 99 percent of the proceeds. The taxpayer argued that the rental payments made in the first two years were correctly charged to the accounting periods in which they were due, but the Inland Revenue contended that to do so was not in accordance with ordinary

[1] [1972] 1 All ER 681

[2] See Freedman J., 1995, 'Defining Taxable Profit in a Changing Accounting Environment', *British Tax Review*, pp.434

[3] [1993] STC 537

[4] See Weetman P. & McMahon F., 1997, 'Commercial Accounting Principles: Questions of Fact and Questions of Tax Law', *British Tax Review*, Vol. 1 pp. 6; See also Freedman J., 1998, 'Disregarding Prudence', *British Tax Review*, Vol. 2, pp. 186

accounting principles. The case went all the way to the Court of Appeal. The Court of Appeal, in allowing the Inland Revenue's appeal, laid down an important principle towards accepting accounting rules for tax purpose - the ordinary principles of commercial accounting must be used in computing trading profits for income tax purposes. Sir Thomas Bingham MR, concluded that:

"*I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy, which… was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits and losses of the business*".

8. Sir Christopher Slade, in his concluding remark, added that:

*"… the reason why the courts rightly attach so much importance to accepted principles of commercial accounting in this context is, of course, that these principles will normally afford the surest means of ascertaining the true profits or losses of a trader, as the case may be".*

9. Nevertheless, in practice, the ascertainment of profits may not always be a straight-forward exercise. This is particularly so when there may be alternative ways of preparing accounts that are equally acceptable in terms of accounting standards that may lead to different tax outcomes[5]. This problem is somewhat mitigated by the establishment of professional accounting standards setting bodies, which were given increased recognition and heightened authority to prescribe principles of accounting practices[6]. This has helped to ensure consistency in accounting treatment and that the way a transaction is reflected in the accounts is supported by sound commercial considerations.

10. At the same time, there is an increasing acceptance of accounting treatment into tax laws. The Finance Act 1998 (of the UK) explicitly recognised the legitimacy of accounting standards. It states, in section 42, that '…profits of a trade, profession or vocation must be computed on an accounting basis which gives a true and fair view, subject to any adjustment required and authorised by law in computing profits…'. Section 42 of the Finance Act was repealed with the enactment of Corporation Tax Act 2009, but the concept of tax treatment making reference to the accounting treatment is still very much relevant. Areas where there have been convergence of tax and accounting treatment in the UK include the tax treatment for foreign exchange gains and losses, the taxation of loan relationships and the taxation of financial instruments. For simplicity and ease of compliance, these rules adopt the principle of "tax follows the accounts", and are operationalised via statutory provisions.

[5] See James S., 2002, *The Relationship between Accounting and Taxation*, Paper number 02/09, University of Exeter, [online], available at https://core.ac.uk/download/pdf/12824388.pdf [accessed 15 May 2020]

[6] See Freedman J., 1995, 'Defining Taxable Profit in a Changing Accounting Environment', *British Tax Review*, pp.434

11. The same position has been adopted by the Hong Kong Courts, and would be of interest to Singapore as well. In the Hong Kong case of *Commissioner of Inland Revenue v Secan Limited & Ranon Limited*[7], the Court of Final Appeal of Hong Kong held that the tax position should be based on the accounting treatment of the relevant interest expenses. The judges recognised that there is no difference between the law of Hong Kong and the law of England in relation to the deduction of the kind of expenses in question and hence a similar position should be embraced. In the Departmental Interpretation and Practice Notes issued by the Hong Kong Inland Revenue Department subsequent to the case, it was clarified that: "the principle (that tax treatment should follow the accounting treatment) should generally apply to all types of income and expense, except as otherwise provided for in the Ordinance"[8].

12. Due to the historical ties between Singapore and the UK, the case authorities would have considerable significance in Singapore as well. In fact, Singapore has adopted a similar position where the profit and loss figure from the accounting statements forms the starting point for the computation of taxable profits, and adjustments to the amount of profit and loss are made only if such tax adjustments are provided for under the Singapore Income Tax Act or are based on case law principles. Like the UK, there are also instances where Singapore has decided to align the tax treatment with the accounting treatment for the ease of administration and compliance. One such example would be the taxation of financial instruments.

***Different Systems of Alignment of Taxable Profits and Accounting Profits***

13. While it is generally accepted that accounting profits serve as the starting point for the computation of the taxable profits, and that accounting treatment provides a source of reference for income tax treatment, there exists differing opinions as to the extent to which income taxation and accounting should be aligned (the alignment between income tax and accounting is commonly referred to as "book-tax conformity"). It is observed that there exist a spectrum of regimes - some countries, like Belgium, Germany and Italy, adopt a dependency approach where there is high degree of book-tax conformity; others like Denmark, UK and Singapore, prefer the approach of selective book-tax conformity depending on tax policy considerations; and there are yet others like Estonia and Netherlands who prefers to keep the two independent of each other[9].

[7] 5 HKTC 266

[8] See Hong Kong Inland Revenue Department, 1998, *Departmental Interpretation and Practice Notes No. 1 (Revised)*, [online], available at https://www.ird.gov.hk/eng/pdf/dipn01.pdf [accessed on 23 Jun 2020]

[9] See James S., 2002, *The Relationship between Accounting and Taxation*, Paper number 02/09, University of Exeter, [online], available at https://core.ac.uk/download/pdf/12824388.pdf [accessed 15 May 2020]; See also Freedman J., 2004, 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges', *eJournal of Tax Research*, Vol. 2 No.1, [online], available at

14. Before we discuss the arguments for and against book-tax conformity, it would be worthwhile to recap on the purpose of financial reporting and taxation. The purpose of financial reporting is to provide financial information that is useful to the shareholders, lenders and other stakeholders of a company in their decision-making. On the other hand, the primary objective of any tax system is to raise revenue for the government. The four tenets of taxation, put forth by Adam Smith in his paper The Wealth of Nations (1776), are fairness, certainty, convenience and efficiency. This means that a good tax system and tax rules should: i) levy tax considering taxpayer's ability to pay; ii) be clear and understandable; iii) not impose excess excessive compliance costs on taxpayers and administrative burden on the revenue authority; and (iv) not cause unnecessarily distortions to taxpayers' economic decisions or disproportionate allocation of resources to meet the requirements.

15. The differing objectives of the two systems present much hurdle for conformity. This section below provides a literature review on the arguments for and against book-tax conformity, on the premise that income tax on companies will be based on profit figures.

*Arguments for Book-Tax Conformity*

16. Aligning the taxable profits with accounting profits can potentially lead to the achievement of economic neutrality and administrative efficiency[10]. Both the accounting system and the income tax system seek to come up with a measure of profits. With book-tax conformity, where companies report the same measure for both accounting and tax purposes, would reduce reporting costs for companies[11]. This is particularly beneficial to small businesses, which may lack both the resources and expertise to handle the discrepancies between the income tax and accounting rules.

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http://www.austlii.edu.au/au/journals/eJTR/2004/4.html [accessed 15 May 2020]; see also Prochazka D. & Molin J., 2016, 'Book-tax conformity: the review of recent research and its implication for the IFRS adoption in Europe', *eJournal of Tax Research*, vol. 14, no. 1, pp. 96-118, [online], available at https://www.researchgate.net/publication/307858341_Book-tax_conformity_The_review_of_recent_research_and_its_implication_for_the_IFRS_adoption_in_Europe [accessed 24 Jun 2020]

[10] See Macdonald G., 2002, *The Taxation of Business Income: Aligning Taxable Income with Accounting Income*, TLRC Discussion Paper No. 2, The Institute for Fiscal Studies, [online], available at https://www.ifs.org.uk/publications/1903 [accessed 15 May 2020]

[11] See Boynton C. & Mills L., 2004, 'The Evolving Schedule M-3: A New Era of Corporate Show and Tell?', *National Tax Journal*, Vol. 57, Issue 3, pp.757-772, [online], available at http://www.jstor.org/stable/41790240 [accessed 4 May 2020]; see also Hanlon M. & Shevlin T., 2005, 'Book-Tax Conformity for Corporate Income: An Introduction to the Issues', *Tax Policy and the Economy*, Vol. 19, pp.101-134, [online], available at https://www.jstor.org/stable/20061897 [accessed 4 May 2020]

17. Greater conformity would bring about greater certainty to the taxpayer. At the same time, the tax authority could ride on the rigorous work done by the accounting standard setters to seek a measurement of profitability of companies and need not duplicate the efforts expended in this area. Accounting concepts like reliability, consistency and prudence are effectively aligned with the fundamentals for income determination for tax purposes, and hence the measurement of profits for accounting purposes could serve the tax purposes well[12].

18. Another argument put forth by the proponent of book-tax conformity is that the alignment would possibly reduce or even eliminate the temptation on the part of management to produce misleading information for financial reporting or income tax purposes[13]. The artificial inflation of profits will lead to higher taxable income whilst an understatement of taxable income will mean a lower income figure being reported to shareholders and the capital market, which is not to the company's advantage. If the two systems are aligned, there will be less scope for abusing the differences that existed between them and fewer opportunities to manoeuvre in and out of the two systems[14]. In this way, the two systems work to ensure that commercial transactions are more likely to be entered into for genuine reasons and not of tax or financial reporting purposes, and will improve the quality of accounting information reported under the financial reporting system in terms of value-relevance and the ability to reflect economic reality[15].

19. A study in the US examined the relationship between accounting profits and taxable profits and finds that the gap between tax and accounting income is associated with increased tax shelter activities, that is, the creation of tax deductions without a corresponding increase in accounting income[16]. Another US study argued that an increased divergence between accounting income and taxable income has an adverse impact on the quality of the incomes reported by companies for accounting

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[12] See Broke A., 1995, 'Accounting Standard and Taxable Profit: an Accountant's View', *British Tax Review*, pp. 457

[13] See Hanlon M. & Shevlin T., 2005, 'Book-Tax Conformity for Corporate Income: An Introduction to the Issues', *Tax Policy and the Economy*, Vol. 19, pp.101-134, [online], available at https://www.jstor.org/stable/20061897 [accessed 4 May 2020]

[14] See Hanlon M. & Shevlin T., 2005, 'Book-Tax Conformity for Corporate Income: An Introduction to the Issues', *Tax Policy and the Economy*, Vol. 19, pp.101-134, [online], available at https://www.jstor.org/stable/20061897 [accessed 4 May 2020]; see also Tang T., 2014, *Does Book-Tax Conformity Deter Opportunistic Book and Tax Reporting? An International Analysis*, [online], available at https://www.uts.edu.au/sites/default/files/ACCconf14TTang.pdf [accessed 15 May 2020]

[15] See Ali A. & Hwang L-S., 2000, 'Country-Specific Factors related to Financial Reporting and the Value Relevance of Accounting Data', *Journal of Accounting Research*, Vol. 38, Issue 1, pp.1-21 [online], available at https://www.jstor.org/stable/2672920 [accessed 4 May 2020]; see also Freedman J., 2004, 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges', *eJournal of Tax Research*, Vol. 2 No.1, [online], available at http://www.austlii.edu.au/au/journals/eJTR/2004/4.html [accessed 15 May 2020]

[16] Desai M.A., 2003, *The Divergence between Book and Tax Income*, Harvard University and NBER, [online], available at https://mihiradesai.wixsite.com/mihir-desai/articles [accessed 14 May 2020]

and tax purposes respectively[17]. In the study, Desai traced the development of the dual reporting system and assessed the quality of corporate profits reporting by looking at the degree to which profits reported to capital markets and tax authorities were related and by identifying the accuracy of the forecasts and the initial estimates of corporate profits. It was found that the divergence in accounting and tax profits is related to the loss of accuracy in earning forecasts[18].

20. A more recent study looking at companies in Germany also affirmed that where book-tax conformity is strong, companies would focus on both tax and financial reporting concurrently and are less inclined to manipulate accounting earnings[19].

*Arguments against Book-Tax Conformity*

21. Nevertheless, there are also strong arguments against conformity. The basis for this view is the fundamental differences in the objectives of the accounting system and the tax system. Accounting principles and rules are a set of constructs used to present information relating to the financial performance and position of a company. The target users of the financial statements are mainly the investors and creditors of the company, who need the information for the purpose of performance evaluation and decision-making, including decisions to invest in the company.

22. On the other hand, the objective of the tax system is to raise revenue for the government and possibly to influence economic and social behaviours. It is used by the government to maintain fiscal balances and to ensure the economic health and stability of the country. In this respect, income tax rules are usually legislated and leave far less discretion to the taxpayer over the important issue of income and expense recognition. Concepts like reliability of information (thus verifiable transactions), fairness and ability to pay (thus taxation on realised basis) feature more prominently in the area of taxation. The differences in objectives present real obstacles for conformity.

23. Accounting standards are not developed with the objectives of the tax system in mind. For financial reporting to provide relevant and timely information, some degree of estimation, prediction or subjective judgment may be required. With a growing emphasis on fair values and an increasingly heavy reliance on the management's and the accountant's subjective judgments, it is doubtful if the

[17] See Desai M.A., 2005, *The Degradation of Corporation Profits*, Harvard University and NBER, [online], available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=758144 [accessed 14 May 2020]
[18] See footnote 17.
[19] Watrin C., Pott C. & Ullmann R., 2012, 'The effects of book-tax conformity and tax accounting incentives on financial accounting: evidence from public and private limited companies in Germany', *International Journal of Accounting Auditing and Performance Evaluation*, Vol.8, No.3, pp. 274-302, [online], available at https://www.researchgate.net/publication/24234308 [accessed 15 May 2020]

accounting system can meet the criteria of a good tax system satisfactorily. The unrealised gains or losses as reported in the accounts do not reflect the company's true ability to pay tax and assessing taxpayers to tax before the gain is realised may be seen to be unfair to taxpayers. Subjecting the determination of taxable profits to potentially volatile bases such as market valuation of asset and liabilities may render the revenue stream to government less predictable and less stable. In addition, accounting standards tend to adopt a conservative stance in the sense that foreseeable outgoings or losses could be recognised as provisions and be deductible as expenses while the recognition of anticipated revenue is generally not allowed. This asymmetry could cause distortions in tax outcomes if taxation is to follow accounting.

24. Moreover, the alignment of the two systems means that the tax liabilities of companies will be affected by changes in accounting practices, as determined mainly by accounting standard setting bodies and players in the market, rather than the government. A book-tax conformity will limit the ability of the government to use tax as a policy tool. As Broke has observed: "as a matter of policy, no government can hand over control of its revenue to accountants; as a matter of emotion, no court can permit accountants to be the arbiter of taxable profits"[20]. Arising from the convergence, the government may attempt to influence the accounting standards boards or challenge existing accounting treatment to ensure that the government's objectives are properly met. Given the inherent differences in the objectives of the two systems and the tension that may exist, it is questionable if such interference will result in lower quality of reported information. Having very comprehensive and prescriptive accounting legislation or accounting standards that meet the needs of both systems may not work either, as the cost involved could be very high and result is doubtful[21]. Instead of forcing a convergence, a better approach could be to allow divergence and to achieve the government's intent through specific tax legislation.

25. An empirical study done by Ali and Hwang demonstrated that the value relevance (i.e. the ability of the information to capture value of the firm) of information presented in financial reports is lower when tax rules significantly influence financial accounting measurements[22]. This finding is consistent with the observation that tax laws are being influenced by political, social and economic objectives rather than the information needs of investors. Another interesting US study also showed that the conformation of the two income measures may lead to a "race to the bottom" of the effective tax rates between companies. Instead of reducing the use of

[20] See footnote 12.

[21] See footnote 12.

[22] See Ali A. & Hwang L-S., 2000, 'Country-Specific Factors related to Financial Reporting and the Value Relevance of Accounting Data', *Journal of Accounting Research*, Vol. 38, Issue 1, pp.1-21 [online], available at https://www.jstor.org/stable/2672920 [accessed 4 May 2020]

corporate tax shelters, companies may be motivated to compete based on tax rates and tax payments, which could yield higher cash flows for shareholders[23].

*Summary of arguments*

26. To summarise, the perceived advantages of the book-tax conformity are simplicity and certainty, and possibly reduced scope for earning management and tax avoidance. However, accounting standards are not developed with the needs of the tax system in mind. Traditionally, the government has limited role to play in the accounting standards setting process. Adopting the accounting profits basis without a corresponding control over the standards setting process means that the government will lose control over the tax system as a policy instrument. Given the internationalisation of accounting standards and increasing reliance on management's judgement, the outcome may not be desirable from the perspective of the government.

27. In this respect, the middle ground approach that has been adopted by Singapore, where the determination of taxable profits is driven primarily by tax statute, making reference to accounting principles and reserving the flexibility for alignment where appropriate, seems the most practical and desirable from the perspective of the State. Historically, the Singapore tax system is used as part of the tools for the government to achieve social and economic objectives. To the extent that the achievement of such objectives would not be compromised, and where book-tax conformity could facilitate compliance with little revenue loss, there is room to consider alignment in tax and accounting treatment. Examples of such instances would be the treatment for financial instruments under FRS 109 and accounting for leases under FRS 116.

28. This approach seems to have served Singapore well thus far, and in the author's view, such opportunity for alignment could continue to be explored when the differences between tax and accounting rules present mainly timing differences only.

**Part II – a Relook at Accounting Profits as the Basis of Income Taxation**

29. Having outlined the historical link between taxable profits and accounting profits, this Part of the paper discusses the recent accounting and the international tax developments, and whether accounting remains an appropriate basis for income taxation.

30. Recent developments in the arena of accounting that are pertinent to the question of whether accounting profits can still serve as an appropriate basis for income

[23] See footnote 13.

taxation are the convergence of accounting standards globally, the use of principle-based accounting system and the heightened importance of fair value accounting.

***Internationalisation of Accounting Standards***

31. The review above focuses mainly on the relationship between taxation and accounting rules in a domestic setting. However, besides domestic considerations, there is also an international dimension to the issue of whether taxable profits should be aligned with accounting profits. The work to develop a single set of globally acceptable accounting standards has been driven by the International Accounting Standards Board (IASB) with considerable success. Since its establishment in 2000, the IASB has been actively working on harmonisation of national accounting standards and the issuance of International Financial Reporting Standards (IFRS) that provide a standardised way of reporting a company's financial performance and position. To date, IFRS is required in more than 140 jurisdictions and is accepted in many more.

32. The heightened interest in the international harmonisation of accounting standards posed further complications that require serious deliberations in the study of the relationship between taxation and accounting.

33. Some have argued that the globalisation of accounting standards is the signal to delink taxable profits and accounting profits[24]. Governments would be reluctant to hand over control of their tax base to the IASB, which is not accountable to any government. The imposition of tax is a jurisdiction's sovereign right, whilst IFRS is necessarily international-focused. The need for IFRS to be globally acceptable would mean that the process of standards setting could be relatively even more political, long-drawn and complex, as compared to national standards. It will also mean that it is quite unlikely for the standards to be able to address every single jurisdiction's tax policy requirements.

***Use of Principle-based Accounting Standards***

34. Since the early 2000s, financial reporting has moved away from a rule-based system that would best lend itself to being used as a tax base. The shift away from rule-based accounting standards to more principle-based accounting rules was, in a large part, a response to major corporate finance scandals such as the highly publicised collapse of Enron Corporation (Enron) in 2001[25]. There were many contributing

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[24] Freedman J., 2004, 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges', *eJournal of Tax Research*, Vol. 2 No.1, [online], available at http://www.austlii.edu.au/au/journals/eJTR/2004/4.html [accessed 15 May 2020]

[25] For discussions on Enron, see inter alia:

i) Bratton W.W., 2003, 'Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents', Georgetown University Law Centre, European Corporate Governance Institute, *Villanova Law* factors to Enron's downfall. One such flaw identified was the ability to use special purpose vehicle and off balance sheet accounting to hide debts and toxic assets from investors relying on financial statements for information. The United States' response to the scandals was the introduction of the Sarbanes-Oxley Act, which required stringent corporate governance oversight, in-depth disclosure in financial accounts and a mandate to study the adoption of a principle-based accounting system.

35. The move away from profit measurements and focus instead on the balance sheet items, which provide information on shareholder's net worth, are considered to be of greater relevance to users of financial statements. The emphasise is no longer on finding a unique bottom-line profits figure. In order to provide more relevant and timely information to users of financial statements, the hard, objective concept of realisation or historical cost is being abandoned and the more subjective fair value accounting is being promoted. Consequently, unrealised gains or losses arising from the revaluation of assets and liabilities will be included in the accounts to present a more accurate picture of a company's financial position. The value reported under fair value accounting is much dependent on management's assumptions and expectations. As a result, greater reliance has been placed on management's discretion and accountant's professional knowledge and judgments.

36. The move towards a more principle-based accounting system can also be seen from the issuance of the revised version of the Conceptual Framework for Financial Reporting ("Conceptual Framework") by IASB in 2018. The first Conceptual Framework was issued in 1989 by the then-International Accounting Standards Committee (IASC). IASC was restructured into IASB in 2001 and the Conceptual Framework was adopted by IASC in 2001. Some edits were made to the Conceptual Framework in 2010, with a revised version published in 2018.

37. The Conceptual Framework sets out the fundamental concepts that underpins the development of IFRS. It also aims to help financial accounts preparers to develop consistent accounting policies for areas that that are not covered by a standard or to assist in the interpretation of IFRS. In the Conceptual Framework, the IASB has clearly articulated that "the primary users of general purpose financial reporting are present and potential investors, lenders and other creditors, who use that information to make decisions about buying, selling or holding equity or debt instruments, providing or settling loans or other forms of credits, or exercising rights to vote on, or otherwise influence, management's actions that affect the use of the

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*Review*, Vol. 48, No. 4, pp.1023 - for a discussion on the consequences of the Enron failure, and in particular, the Sarbanes-Oxley Act and the use of rule-based versus principles-based accounting;

ii) Fusion P. & Miller R. M., 2002, *What Went Wrong at Enron*, John Wiley & Sons, First Edition – for a documentation of the Enron debacle, a road map to its failure and an explanation of how less than full disclosure and off balance sheet accounting leads to its downfall.

entity's economic resources". In this regard, relevance and faithful representation are identified as the fundamental qualitative characteristics of useful financial information[26].

38. According to the Conceptual Framework, for information to be relevant, it should have predictive and confirmatory value. A faithful representation of the information means that the information represents the substance of an economic phenomenon instead of its legal form only, subject to a tolerable level of uncertainty.

39. In this way, the accounting system appears to have departed from the central principles that have always been thought of as suitable for taxation purposes in the past. One such key principle is the traditional concept of realisation, which sits well with the tenet of a fair tax system that levies tax considering the taxpayer's ability to pay and when it is most convenient to pay the tax[27].

40. Being principle-based instead of rule-based would also mean that IFRS could be subject to interpretation, and this does not gel well with the need for a tax system to be clear and certain so that there is no ambiguity as to how taxpayers would be taxed. Interestingly, it has been observed that countries with high degree of book-tax conformity, such as Germany, have chosen not to adopt IFRS and continue to rely on domestic accounting standards[28].

***Should accounting profits remain as the basis for taxable profits?***

41. Considering the above, the question is whether profit measurement as derived from accounting rules could still serve as an appropriate basis for income tax purposes.

42. To answer this question, one may consider the issue from two perspectives: (i) what could be an alternative measurement of taxable profits and how does it fare against accounting profits; (ii) the developments in tax rules and principles, particularly in the area of international tax during recent years.

*Alternative measurement of taxable profits*

43. Besides accounting profits, another commonly used profits measure would be the concept of economic profits.

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[26] See https://www.ifrs.org

[27] See footnote 24.

[28] See Board of Taxation, 2018, *Exploring the Potential to Align Accounting and Tax Systems in Australia*, Australia, [online], available at https://cdn.tspace.gov.au/uploads/sites/70/2018/10/180726-FINAL-Report-Exploring-the-potential-to-align-accounting-and-tax-systems-in-Australia-1.pdf [accessed on 22 May 2020]

44. Whilst accounting profit measures the difference between monetary revenue and the explicit costs that a company has to incur to carry on the business operations, economic profits considered not only the explicit costs but also the implicit gains and implicit costs of the business operations. In economics terms, implicit costs refer to opportunity costs, that is, what the company has forgone in order to use its resources in a particular manner[29]. For example, when a manufacturer owns the factory in which the products are manufactured, he needs not pay rent and there is no rental cost in accounting terms. From an economic point of view though, the implicit cost from using the factory is the potential gains the company could obtain from renting out the factory or even from selling it. The loss of such gains will be the opportunity cost of putting the factory in its current use and would be considered as an economic cost. Economic profit is generally considered a better indication of whether a company should enter or exit a market as it takes into account all the costs involved in a business operation. As such, it is a more relevant decision-making criterion for businesses and investors.

45. Although the economic profits may present a better representation of the true return from an investment, the concept of economic profits is subjective, complex and hard to verify. In this respect, it does not lend itself to be a stable and appropriate basis of taxation. In fact, it does not consider factors such as ability to pay and lacks clarity, which are important considerations for taxation purposes.

*Developments in International Tax*

46. Just as the accounting system is advancing with the times, the tax system is also evolving as economy progresses. Over the last decade, a major disruption to income tax systems around the world would undeniably be the Base Erosion and Profit Shifting ("BEPS") project. The BEPS project was conceived by the OECD in 2013 to tackle the issue of multinational corporations ("MNCs") exploiting mismatches in tax rules across jurisdictions to reduce their taxable profits or artificially shifting profits to locations where they enjoy more favourable tax treatment[30]. The project consists of 15 action plans and is based broadly on 3 principles – coherence, substance and transparency:
    a. Coherence - domestic tax rules should be aligned to prevent mismatches that result in double non-taxation or excessive deduction of expenses.
    b. Substance – taxing rights should be given to the locations where substantive value-creating activities are located.

[29] See Boundless Economics, 2015, *Difference Between Economic and Accounting Profit*, [online], available at https://www.boundless.com/economics/textbooks/boundless-economics-textbook/production-9/economic-profit-65/difference-between-economic-and-accounting-profit-245-12343/ [accessed on 11 August 2020]

[30] See OECD, 2013, *Action Plan on Base Erosion and Profit Shifting*, [online], available at http://www.oecd.org/ctp/BEPSActionPlan.pdf

c. Transparency - there should be greater disclosure of information between taxpayers and tax administrators, and among tax administrators.

47. Underpinning the above is the principle that the tax outcome should not be divorced from the substance of the transaction. Profits should be taxed where the economic activities generating the profits are conducted and aligned to the location where value is created. However, what constitutes "substance" has not been clearly defined in the BEPS reports. In this regard, the author has, in another paper[31], explored the concept of "substance" and concluded that the concept as used in this context requires a measure of economic realities by some norm justified by some concept of proportionality. Such an analysis would necessarily be multi-faceted and subjective and would not be void of conflicts.

48. On 29 Jan 2019, the OECD announced a new programme of work[32] (commonly referred to as BEPS 2.0) to introduce further reforms to the framework of international taxation, particularly in response to tax challenges arising from the digitalisation of the economy. There are two main pillars of work. Pillar 1 focuses on how the existing profit allocation rules (i.e. rules that divide up the right to tax the income of multinational enterprises among jurisdictions) could be modified to take into account the changes from digitalisation. Pillar 2 relates to proposals that aim to address remaining BEPS concerns and explores rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation. These rules would effectively give jurisdictions the right to "tax back" profits that are taxed at low effective tax rates and would, effectively, drive profits to be taxed at the agreed minimum effective tax rate regardless of where the profits are derived. In this way, BEPS 2.0 went a step further than the BEPS project. It looked beyond substance represented by traditional measures of economic realities and considered allocating taxing rights to markets where value is perceived to be created. At the same time, it sought to curtail tax competition through enforcing a minimum effective tax rate to be applied worldwide.

49. The BEPS and BEPS 2.0 projects are significant in at least two aspects. Firstly, the measurement of economic realities and substance, and consequently the acceptable tax outcome, is inherently subjective. Searching for a "sufficient" level of taxation, particularly in the context of international tax, is not simply a matter of scientific or financial calculation. Whether a multinational enterprise has paid a fair

[31] See Wong S.C.C.& Tang S. Y., 2017, *'Substance' – A Singapore's Perspective*, Singapore Management University School of Accountancy Research Paper No. 2018-S-76, Vol. 6, No. 1, Special Issue: Tax, [online], available at http://ssrn.com/abstract=3104981

[32] See OECD, 2019, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy,*[online], available at https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf

share of tax in all the jurisdictions that it operates from may well be as much a political question as a technical question. This is particularly obvious with the advancement of the BEPS 2.0 project where jurisdictions are no longer satisfied with the tax outcome achieved through the application of traditional concept of substance as represented by headcount and business spending. In this regard, what each jurisdiction is looking for, is not a precise measurement of profits, but a tax outcome that is reasonable from a fiscal perspective and supportable by a set of commonly accepted tax principles.

50. Secondly, in order to achieve international consensus on the tax rules and the tax outcomes, a degree of convergence or even harmonisation will be required. The process is, again, inevitably political. To introduce a level of objectivity into the process, international accounting standards (which having itself been subject to a political process and deemed acceptable) present an attractive basis for seeking agreement. The development of globally accepted accounting standards, with the accompanying accounting principles and concepts, offers a robust starting point on which profit measurement for income tax purposes can be based on and a common language for negotiation. In this regard, accounting rules are still very much relevant in the realm of income taxation.

***Accounting Profits remains a valid basis for Income Taxation***

51. Given the primary objective of any tax system is to raise revenue for the government, the author would argue that the exercise of profits determination for tax purposes is not to find a precise and exhaustive definition of income, but a construct that can be ascertained with reasonable ease and reliability, and on which tax may be imposed.

52. In this regard, accuracy or comprehensiveness of the construct in the economic sense may not be of prime consideration. Accounting profits provide a convenient basis for tax to work off. Accounting information is easily accessible from the accounts and is commonly accepted.

53. Hence, in the author’s view, the answer to the question of whether accounting profits is still a desirable measure of income on which tax is to be levied would be in the affirmative. While the internationalisation of accounting standards and the use of principle-based accounting may pose challenges for book-tax conformity, to the extent that tax is still to be imposed on a measure of profits or income, accounting profits remain a good starting point for taxation.

## Part III – Use of Other Accounting Information as Basis of Taxation

54. In this last part, the paper attempts to take a step further to consider whether, apart from accounting profits, there could be other accounting construct or information

that could work as an alternative basis on which tax can be levied. The discussion in this Part is intended to be at the high level and is not meant to be an in-depth evaluation, which could be the subject of future research.

***Inefficiency of Corporate Income Tax***

55. There exists a general view that corporate income tax is an inefficient form of taxation. Corporate income tax is seen as distortive, particularly if a level of taxation is imposed on the corporate itself and then another level of taxation is imposed on the owners of the corporate. In addition, a corporate income tax regime favours investment funded by debt over investment funded by equity, as only interest expense is deductible and not dividends. However, an imposition of tax at the corporate is seen as necessary as it acts as a "backstop" to personal income tax through avoiding excessing shifting of income between labour income and capital income.

56. Alternatives to income tax has been proposed and adopted by some jurisdictions. Two such alternatives, namely turnover tax and cashflow tax will be explored below.

***Turnover Tax***

57. Turnover tax, as the name suggests, is a tax on turnover. Generally, a single tax rate is applied regardless of business activity. The difference between a turnover tax and a value-added tax is that it does not allow for crediting of input tax and thus, would levy tax multiple times on the same economic value through the production process, leading to cascading in the price structure[33].

58. Based on a survey in 2018, turnover tax is more prevalent in the less developed countries in Africa or transition economies, such as Albania and Ukraine. A turnover tax system is said to be stable and simple to administer. Due to the broad tax base, the rate imposed could be low.

59. In the context of transition economy in Central and Eastern Europe and the countries of the Former Soviet Union, the motivation for the use of turnover tax is to facilitate the taxation of small and medium size businesses that emerged as a result of the privatisation and breakup of the large previously state-owned

[33] See Tanzi V., 1993, *Chapter 6 Romania: Assessment of Turnover and Income Taxes*, [online], available at https://www.elibrary.imf.org/view/IMF071/07491-9781557752758/07491-9781557752758/ch06.xml?redirect=true&language=en [accessed 4 May 2020]; see also Watson G., 2019, *Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences*, [online], available at https://files.taxfoundation.org/20190205153928/Resisting-the-Allure-of-Gross-Receipts-Taxes-An-Assesment-of-Their-Costs-and-Consequences.pdf [accessed 4 May 2020]

enterprises[34]. The intent of introducing a simplified tax regime for small businesses is to draw such new private businesses into the tax net and to compile information that will eventually allow the jurisdiction to bring these businesses into the standard tax system[35].

60. The negative effect of a turnover tax as alluded to above is that it creates tax pyramiding. The inclusion of business-to-business transactions causes tax to be imposed multiple times on the same economic value, which distorts economic activities and magnify effective tax rates[36]. Consumers will face higher prices. It ignores a company's profitability and consequently, the ability to pay and is thus regressive in nature. It violates the principle of fairness and efficiency.

61. Start-ups, as well as firms with high production volumes would be disproportionately affected and their tax burden is driven solely by the gross receipts with no regard to the profitability. The tax system may also lead to economic inefficiencies as it encourages companies to integrated vertically purely for tax reasons.

62. However, to rectify the problem, granularity will have to be introduced into the system, which would lead to complexity for taxpayers and defeat the very purpose of having a simple turnover tax in the first place. Setting different tax rates for different industries or different turnover threshold may amplify distortions and add to the complexity[37]. More fundamentally, in order to restructure the tax and calibrate the tax rates, information relating to business activities and business profit margins would be required, which will not be available under the system in the first place. Data collection and data analytic capabilities would have to be put in place[38].

63. Based on countries' experience with turnover tax systems, the determination of an appropriate system threshold is imperative. Inappropriate threshold could result in serious under-taxation. At the same time, benefit in terms of reduce compliance burden can only be achieved to the extent that the simplified tax acts as a substitute for a multitude of taxes[39]. Otherwise, the impact and the reduction in overall compliance costs may be marginal.

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[34] Engelschalk M., 2005, *Small Business Taxation in Transition Countries*, the World Bank, [online], available at http://documents.worldbank.org/curated/en/151041468331754316/pdf/351090Business0taxation0SME0paper1ME2.pdf [accessed 4 May 2020]

[35] See footnote 34.

[36] See Watson G., 2019, *Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences*, [online], available at https://files.taxfoundation.org/20190205153928/Resisting-the-Allure-of-Gross-Receipts-Taxes-An-Assesment-of-Their-Costs-and-Consequences.pdf [accessed 4 May 2020]

[37] See footnote 36.

[38] See footnote 34.

[39] See footnote 34.

64. In the context of Singapore, we do not face the same issues as the transition economies. In this regard, if we were to consider a turnover tax, the impetus will likely be to reduce compliance efforts for small and medium size businesses. Considering that Singapore's tax system is relatively simple and administrative rules have been introduced in recent years to make it easy for taxpayers to comply with their tax obligations (e.g. simplified Form C filing), it is doubtful if the introduction of turnover tax could bring about significant benefits.

***Cashflow tax***

65. Another alternative to income tax, which has gained some traction in recent years, particularly in the US, is a cashflow tax.

66. The idea of taxing company on the net cash flow from its real business activities is not new. It can be traced at least as far back as the 1940s, with active discussions relating to its practical implementation, such as by the Meade Committee[40], in the 1970s.

67. Under the cashflow tax system, no distinction is made between capital and income in the calculation of a company's tax base. The tax base can be measured as the difference between the receipts from sales of goods and services and the purchases of all real goods and services required in the production process, including purchases of capital goods. At the same time, the tax base would disallow any deduction for the financing of the investment. This means that interest payments and dividends would not be deductible. There is immediate expensing of all investment expenditure and thus achieve fiscal neutrality and create incentive to invest[41]. This is because, with immediate expensing, the government is effectively subsidising investment at the same rate is it taxes profits (assuming no change in tax rate) and tax would not cause a distortion to investment decisions[42].

68. The version proposed in the US is a destination-based cashflow tax ("DBCFT"). As the name suggests, the DBCFT comprises two distinct elements: a cash-flow tax base and a destination basis. Under a DBCFT, capital expenses are immediately deductible instead of being deductible over the lift of the asset; interest expenses

[40] See Meade Committee, 1978, The Structure and Reform of Direct Taxation, [online], available at https://www.ifs.org.uk/publications/3433

[41] See King M., 1987, *The Cash Flow Corporate Income Tax*, [online], available at https://www.nber.org/chapters/c11355.pdf [accessed on 22 May 2020]

[42] See King M., 1987, *The Cash Flow Corporate Income Tax*, [online], available at https://www.nber.org/chapters/c11355.pdf [accessed on 22 May 2020]; see also Aurebach A., Devereux M.P., Keen, M., Vella J., 2017, *Destination-Based Cash Flow Taxation,* Working paper series 2017 WP 17/01, Oxford University Centre for Business Taxation, [online], available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2908158 [accessed 22 Jun 2020]

are not deductible; export sales are tax exempt and import purchases are not deductible.

69. The advantage of a cashflow tax over corporate income tax is that the return on equity and debt are both not effectively taxed at the corporate level. In this way, it does not distort the choice between debt and equity, and between internal or external equity. The reduction in cost of investments in machinery and buildings would also be likely to attract more capital from overseas[43].

70. In the international setting, the added destination dimension of DBCFT also brings significant attractions[44]. The location of final purchasers of goods and services (i.e. the destination) is relatively immobile. Taxing business income in the place of destination could improve economic efficiency and could overcome certain forms of tax avoidance through intercompany transactions, such as lending from a low-tax country to a high-tax country, locating intangible assets in a low tax country from where a royalty is earned, and mis-pricing intercompany transactions. This is possible because there will be no deduction for interest, no deduction for imported goods and no taxation for exports. In this way, there is no real tax consequence from the transfer of business assets overseas[45].

71. An IMF study showed that effect of replacing corporate income tax with cashflow tax boosts output in the country undertaking the reform and results in positive spillovers to the rest of the world[46]. A study conducted by the US Office of Tax Analysis, which simulates the impact of DBCFT on US companies, showed that a border adjusted cash flow tax (i.e. exports would not be subject to the tax, but imports would be) would have enlarged the tax base, and the tax base is slightly less cyclical in aggregate than income tax[47].

72. While there are empirical studies that demonstrate the benefits of a cashflow tax, there are important limitations to the studies. The earlier studies in the 1970s are more relevant to a closed economy and a single economy. The analysis and

[43] See Toder E., 2017, *What is the Difference between the Current Corporate Income Tax and a Destination-Based Cash Flow Tax?*, Urban Institute, [online], available at https://www.urban.org/research/publication/what-difference-between-current-corporate-income-tax-and-destination-based-cash-flow-tax [accessed 4 May 2020]

[44] See Aurebach A., Devereux M.P., Keen, M., Vella J., 2017, *Destination-Based Cash Flow Taxation,* Working paper series 2017 WP 17/01, Oxford University Centre for Business Taxation, [online], available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2908158 [accessed 22 Jun 2020]

[45] See footnote 44.

[46] See Carton B., Fernandez-Corugedo E. & Hunt B., 2019, 'Corporate Tax Reform: from Income to Cash Flow Taxes', *IMF Working Paper*, WP/19/3, [online], available at https://www.imf.org/en/Pub;ications/WP/Issues/2019/ [assessed 15 May 2020]

[47] Patel E. & McClelland J., 2017, 'What Would a Cash Flow Tax Look Like for U.S. Companies? Lessons from a Historical Panel', *Office of Tax Analysis*, Working Paper 116, [online], available at: https://home.treasury.gov/system/files/131/WP-116.pdf [accessed 4 May 2020]

modelling may not have taken into account behavioural impact adequately, and may not have considered sufficiently the impact of globalisation[48]. A company that operate in numerous countries may modify transfer prices, financial structure or relocate production to countries with less distortionary tax systems.

73. In addition, the DBCFT also has significant drawbacks. It impairs the progressivity of the tax system as investment income is not taxed and such income is generally concentrated among the hands of upper-income taxpayers. Economic distortions could be created as importers are disadvantaged but exporters are favoured. The non-deductibility of interest expense will also impact companies that are highly leveraged[49]. Special rules would have to be devised for financial institutions as profits derived from financial transactions are exempt from tax. This issue is especially pertinent for financial centres like Singapore.

74. There exist important legal and political challenges to the implementation of DBCFT as well, for example the possible incompatibility with WTO rules[50]. One potential issue relates to deduction for labour costs. Take for example a product that can be both imported or domestically produced. The labour costs relating to the one produced locally could be given a deduction in the country of sale since it is also the country of origin; whilst the labour costs relating to the imported one would be ignored as no deduction is allowed for imports. This is arguably incompatible with WTO rules.

75. Possibly because of the above considerations, there are still limited experiences with cashflow tax worldwide. Consequently, there is little information to guide policy makers on design questions or the help understand the possible dislocations caused by moving to this alternative base for business taxation[51].

76. The impetus for introducing a cashflow tax in Singapore is not obvious at this point. A cashflow tax system is not necessarily superior to an income tax system and there is no obvious flaw of the Singapore income tax system that needs to be addressed specifically by a cashflow tax, and not any other modifications to the existing tax system.

77. Hence, overall, neither turnover or cashflow presents an alternative to accounting profits as a viable and robust basis of taxation.

**Conclusion**

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[48] See footnote 46.
[49] See footnote 43.
[50] See footnote 44.
[51] See footnote 47.

78. This paper sets out to consider whether accounting profits still serves as an appropriate basis for taxation. Having considered the developments in both the areas of accounting and taxation, and having explored some other possible basis for taxation, the author concludes that accounting profits remain a suitable, and may perhaps be, the preferred basis for taxation. In particular, with the changes in the international tax system brought about by the BEPS projects, it is expected that, going forward, the tax system is likely to be used primarily as a fiscal tool for raising of revenue and countries will rely more on non-tax factors to attract foreign capital and investments. In this regard, there may not be strong impetus to overhaul the basis upon which tax is being levied under the existing tax system. Instead, the focus could be on making the environment more conducive for businesses while keeping in view the need to explore new revenue sources.

79. In terms of alignment between accounting and taxation, to the extent the tax system continues to be used to advance economic and social objectives, and considering the distinctiveness of Singapore's tax system (e.g. the territorial basis of taxation and has no capital gains tax), the justification for aligning the tax system with the accounting system seems weak. The current approach of using accounting profits as the starting point, turning to accounting treatment where appropriate, but maintaining separate taxation rules for policy reasons, remains the most pragmatic approach.

80. This approach is supported by a study done in Australia in 2018. The Board of Taxation in Australia has, in 2018, undertaken a consultation exploring the potential to align accounting and tax systems in Australia. The Board reached a similar conclusion – that broad-spectrum alignment between the accounting and tax system within Australia's current taxation framework would neither be workable or desirable, given the disparate purposes of the taxation and accounting systems. Similar to Singapore, the tax laws in Australia provide a legal basis for raising revenue to fund government expenditure as well as, in some case, serving as a policy implementation tool. Having said that, the Board accepted that there could be areas where greater book-tax conformity could lead to benefits such as reduced compliance costs and greater certainty, without impinging tax policy objectives. These rules could be considered on a case-by-case basis (Board of Taxation, 2018). For example, in the area of thin capitalisation rules, the accounting measurement of assets and liabilities can be relied upon instead of prescribing valuation rules specifically for tax purposes.

81. In the author's view, the conclusion drawn by the Board of Taxation in Australia makes a lot of sense. Accounting, while serving its own unique purposes, will certainly continue to have a role to play in the area of taxation. Accounting profits is still a preferred basis for taxation.

***Disclaimer***

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