Income taxation and accounting: conceptual tools for comparing European systems

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Key words: Taxable income; commercial accounts; formal conformity; legal accounting choices; reverse dependence.

Abstract

The different issues that can be identified in addressing the relationship between income taxation and accounting. Substantive and formal aspects of this relationship. The concept of a formal conformity relationship as meaning that sound legal choices made in commercial accounts are preclusive for tax purposes. The formal conformity relationship as a normative concept. How a formal conformity can be defined in a normative sense. The structural elements of the norm setting out a formal conformity. An application of the normative definition of formal conformity to the German, Spanish, Italian, French and Portuguese systems. Differences in the legal formulae used in these systems and an analysis of the meaning of these differences. The "reverse dependence" between tax accounting and commercial accounting. The recent development concerning "reverse dependence" in the studied five systems.

1. Introduction – delimiting the question to be treated

The long debated topic of "the relationship between taxation and accounting" (or, more accurately, between the determination of taxable profit and commercial accounting) encompasses many different questions, which are often confused. Two main issues can be distinguished, the first one (issue one) concerning *which rules* apply in determining the profit to be taxed and the second one (issue two) concerning the *preclusive value of the approved commercial annual accounts* for the determination of taxable profit[1]. The issue one concerns the assessment of the substantive norms to be applied in determining the tax base while issue two concerns a particular formal requisites to be met by assessing the tax base.

The two issues are not strictly interdependent, as can be easily shown through an example: supposing that, according to a certain legal provision (rule *Y*) defining the base of an

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[1] The distinction has been made by other authors. In German literature, the distinction was first made by ZITZLAFF, *Einkommensteuerfragen, Teil I,* Steuer und Wirtschat, (1938), p. 560; and PANKOW, Max, *Keine Bindung der Steuerbilanz an die Handelsbilanz im Falle von Sonderabschreibungen,* Der Betriebs-Berater, 3 (1967), p. 113; more recently, *pars pro toto*, KNOBBE-KEUK, B., *Bilanz- und Unternehmenssteurrecht*, 9th ed., Dr. Otto Schmidt, Köln, 1993, pp. 21 ss.; Outside Germany, McCOURT, P. y RADCLIFFE, G., «*Les relations fiscalité-comptabilité» in France: a model for Europe?,* British Tax Review, 5 (1995), pp. 461-463; HERRERA MOLINA, P., *Capacidad económica y sistema fiscal. Análisis del ordenamiento español a la luz del Derecho alemán,* Marcial Pons, Madrid-Barcelona, 1998, p. 409.

income tax, the taxable profit must be calculated according to commercial accounting rules, we'll have the first question (partially) solved: in order to determine the taxable profit, we must apply the commercial law accounting rules. As to where are these rules to be found, it is a second step of the same question. But once we have identified these rules, if we find that the applicable commercial provision sets up two alternative valuations or qualifications for the same fact *X* – valuations or qualifications *A* and *B* – we will still have to answer the following question: is the taxpayer allowed to apply *A* in his commercial accounts, for commercial law purposes, and *B* in calculating his taxable profit, for tax purposes? This is the second of the two main issues described above. Clearly, rule *Y* tells us nothing about the latter question.

From a theoretical point of view, these two questions concerning two intrinsically different aspects of the determination of taxable profit should be answered separately, even in the presence of a single legal provision regulating both of them[2]. But the two questions should also be separated from a *lege ferenda* point of view, because they have different axiomatic bases. In fact, if the tax legislator is to decide whether to establish a referral to commercial law, he must ask: "*Are commercial accounting rules suitable to compute profit for tax purposes?*". And this question should be answered being divided in two points: *i) "Are commercial rules suitable in their structure, to compute profit for tax purposes?" which is equivalent to asking if these rules, when used by tax law, agree with the legality and the equity principles;* and *point ii) "Is the commercial concept of profit suitable for tax purposes?", which is equivalent to asking if it does fit the ability-to-pay principle.*

On the other hand, if the legislator needs to decide whether commercial accounts are to be taken as preclusive to the calculation of taxable profit, he must ask: *"Is there any legal rationale demanding that taxable profit be strictly related to the commercial balance sheet[3]?*

Each of these two major issues (issues one and two) can be subdivided into more specific aspects. As to the first one – 1) *which rules apply in determining the profit to be taxed* – two further questions can be distinguished:

a) Which rules apply directly in determining the taxable profit?

b) Which rules apply in elaborating the commercial balance sheet?

The secondary issue 1.b) – *Which rules apply in elaborating the commercial balance sheet?* – becomes relevant to our subject whenever the legal provision that defines the taxable base either refers to commercial accounting rules (it's the case, in general, in European civil law systems, where the tax regulations require the application of commercial accounting rules in the calculation of taxable profit[4]) or makes the commercial balance sheet, when elaborated according to commercial rules, preclusive to the determination of taxable profit.

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2 The existence of a single provision regulating both aspects without distinguishing between the two, was the classical formulation shared by practically all civil law systems, and it was the source of many misunderstandings and difficulties in the application of the law. These difficulties gradually led in systems like the Spanish, the Italian and the German ones, to the individualization of a specific provision regulating the preclusive effect of the commercial balance sheet to the determination of the taxable profit.

3 TIPKE, K. /LANG, J., *Steuerrecht,* 17rth ed.,Otto Schmidt, Köln, 2002. p. 303: „Die Massgeblichkeitnorm ... ist daher Fiskalzwecknorm".

4 About this referral to commercial accounting regulations in civil law systems vid., *pars pro toto*: (Italy) ZIZZO, G., *Il reddito d'impresa,* in Falsittà, *Manuale di diritto tributario. Parte speciale. Il sistema delle imposte in Italia,* Cedam,

Concerning the second major issue – (issue 2) *do commercial annual accounts have a preclusive effect on the determination of taxable profit* – it can also be displayed in two questions:

a) *Are commercial annual accounts preclusive for the taxpayer, in determining his taxable profit?*
b) *Are commercial annual accounts preclusive for the Inland Revenue, in determining the taxpayer's taxable profit?*

This paper focuses exclusively on the second of the two major issues mentioned above (issue two), regarding the preclusive or non preclusive effect of commercial annual accounts for the determination of taxable profit. To refer to this type of relationship between the determination of taxable profit and commercial accounting, where valuations and qualification choices and judgements made in commercial annual accounts are preclusive for the taxpayer in determining his taxable profit, we use in this paper the term *formal conformity*.

2. Tax and commercial accounting choices

In civil law systems, commercial law requests companies (and any other businesses in general) to disclose an annual balance sheet, which includes the duty of quantifying the net asset value and of measuring annual income, for private law purposes. Quantifying income becomes especially relevant for corporations, in order to allow a fair distribution of dividends. In this paper, when we refer to *commercial annual accounts* we do not mean the *regulations* of commercial accounting but the particular private law act by which annual accounts are approved to comply with specific commercial law provisions. In general, these annual accounts approved for civil legal purposes must follow, in civil law systems, *commercial* (not tax) accounting regulations[5].

Commercial accounting provisions – characterized in general by allowing wide discretionary powers regarding valuation/qualification judgements – often set out a range of possible solutions (*choices* and *subjective judgements*) for a given economic fact, leaving to the person who prepares the accounts a discretionary choice between them[6]. Whenever any valuation/qualification choices or judgements have to be made in *commercial annual accounts*, it becomes necessary to assert whether these options are to be followed in determining taxable profit or, on the contrary, the taxpayer remains free to adopt different valuations/qualifications, within the commercial accounting set of rules.

This view of the relationship between the determination of taxable profit and commercial accounting is not new. In Germany, this conception was completely developed by scholars[7],

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Padua, 2000, p. 170; (Germany) TIPKE, K. /LANG, J., *Steuerrecht,* 18th ed.,Otto Schmidt, Köln, 2005, p. 650; (Spain) GARCÍA MORENO, V. A., *La base imponible del Impuesto sobre Sociedades,* Tecnos, Madrid, 1999, pp. 84 ss.

[5] (Italy) ZIZZO, G., *L'imposta sul reddito delle persone giuridiche,* in FALSITTÀ, *op. cit.*, p. 343; (Spain) HERRERA MOLINA, P., *op. cit.*, p. 408; (Portugal) SALDANHA SANCHES, J. L., *A Quantificação da Obrigação Tributária,* Cadernos de Ciência e Técnica Fiscal n.173, Lisboa, 1995, p. 307.

[6] About in commercial accounting *legal choices* and *subjective judgments*, and the way the tax law deals with them, TIPKE, K. /LANG, J., *cited,* 18th ed., p. 662-663 and the bibliography cited there.

[7] One of the first German authors distinguishing and characterizing these two aspects of a relationship between commercial accounting and the determination of taxable profit was ZITZLAFF, *Einkommensteuerfragen, Teil I, Steuer und Wirtschat,* (1938), pp. 549-568.

long before it was set forth in the statute text of art. 5.1(2) of the *Einkommensteuergesetz* in 1990. And recent studies[8] show that in most legal systems, sound legal accounting choices made by the taxpayer are, in general, *preclusive* to the determination of taxable profit. This allows it to be stated that most legal systems are *formal conformity systems*. But this *formal conformity* is never absolute. There are, on the one hand, categories of valuations excluded from the *formal conformity* rule. And there are, on the other hand, categories of valuations where *formal conformity* is mitigated, allowing variations – between taxable profit and commercial profit – in predefined situations and within limits.

3. *Formal conformity* as a normative concept

Thus, a first statement about *formal conformity* must be a negative one: *formal conformity* cannot be defined as a *de facto* coincidence of commercial and taxable profit. On the other hand, saying that a *formal conformity* means a partial coincidence, between the determination of the taxable profit and commercial accounting, is a meaningless assertion in terms of law, since it does not express a proposition of a normative type, and *formal conformity* must be capable of being expressed in this way. On the limit, it is possible that in a given formal conformity system, there is such a large number of exceptions to the general rule that situations where *formal conformity* apply become rare, but the system as a whole will remain a *formal conformity* system, as far as a legal formal conformity principle can be identified.

For the same reason it is legally senseless to speak about a connection between the calculation of taxable profit and the balance sheet as a whole, instead of a connection with each valuation/qualification in particular. If there is not a connection between tax accounting – the calculation of taxable profit – and each particular valuation/qualification of the balance sheet[9], with the taxpayer being allowed to modify any valuations whenever a tax provision or principle allows a different treatment, there is no *formal conformity* at all.

In normative terms, a *formal conformity* means that any valuation or qualification choice and/or judgements made in commercial accounts, so far as it apply correctly the commercial accounting rules and is not contrary to any taxation legal rule, must be maintained in determining the taxable base[10], binding both the taxpayer and the tax administration[11].

Of this notion, two elements in particular are to be pointed out:

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[8] SCHÖN, W., *Steuerliche Massgeblichkeit in Deutschland und Europa,* Otto Schmidt, Colonia, 2005; AGUIAR, N., *La relación entre la determinación del beneficio imponible y la contabilidad mercantil, Estudio de derecho comparado* (PhD thesis), University of Salamanca, Salamanca, 2006.

[9] As it is the understood in German law (SCHEFFLER, W., *Besteuerung von Unternehmen,* II, 5th ed., C.F. Müller, Heidelberg, 2007, p. 21).

[10] THIEL, J. & LÜDTKE-HANDJERY, A., *Bilanzrecht,* C.F. Müller, Heidelberg, 2005, p. 118; SCHEFFLER, W., *op. cit.,* p. 21; SCHREIBER, *§ 5 EStG*, in BLÜMICH, EStG, *KStG, GewStG Kommentar*, Franz Vahlen, Munique, 2003, p. 38; THIEL, J., *Zur formellen Massgeblichkeit der Handelsbilanz – Ein Vorschlag de lege ferende,* Der Betrieb, Vol. 42, Núm. 11 (1989), p. 539.

[11] In recent debates, the question has been analysed mainly in the perspective of the taxpayer freedom to disregard his own choices or judgments made in his commercial accounts. But the question of whether and in what extent the Inland Revenue is limited by the taxpayer's commercial choices and judgements has been quite prominent in a recent past in a substantive number of countries and even at present it still keeps a good part of its relevance. It concerns the conditions in which the Inland Revenue can impose modifications to the business income statement submitted by the taxpayer, based on an inaccuracy of commercial valuations or qualifications. About this issue in Italian tax law of 1956, BERLIRI, A., *Il testo unico delle imposte dirette (esposizione istituzionale dei primi otto titoli),* Giuffrè, Milán, 1960, pp. 69 ss.

i) A *formal conformity* does not mean a complete coincidence between commercial accounts and tax accounts, but affects only a part of the financial valuations. Its field of application is limited by the presence of the following three conditions:

a. A *formal conformity* rule only applies when there are multiple possibilities of treatment for the same fact, *according to tax law;*

b. These multiple possibilities of treatment are, at least partially, coincident in tax law and commercial law, in the sense that at least one of the commercial law possibilities is accepted by tax law.

c. The taxpayer has applied in his commercial balance sheet a treatment that is accepted by tax law.

ii) When the taxpayer has adopted in his commercial balance sheet a treatment not accepted by tax law, he is not bounded, in general, by any *formal conformity rule* and he can adopt a different treatment for tax purposes, by means of an *adjustment, or an extra accounts modification*[12].

A *formal conformity*, characterized as above, exists in most civil law tax systems. Next, we'll try to demonstrate that it exists not only in Germany, but also in France, Italy, Portugal and Spain in very similar terms, despite important differences in the legislative *formulae* used. Because the common conception of a formal conformity is so attached to the German system, we will take this system as a paradigm to compare with other systems.

4. Selected systems compared

Germany

In Germany, until January 2009, article 5.1(2) of the Income Tax Act[13] provided that *legal tax choice rights* shlould be employed consistently with whatever had been applied in commercial accounts. A majority of German scholars saw this provision, introduced in 1990, as having either set out or confirmed (declared) a *formelle Massgeblichkeit principle*[14]. Before that, the existence of such a principle in German law had divided scholar's opinions for a long time[15].

According to this general rule, when the tax law admits two solutions *A* and *B*, for the same financial fact, the taxpayer would not be allowed, in principle, to adopt choice *A* in commercial accounts and *B* in determining taxable profit, for he should exercise "taxation choice rights" consistently with commercial accounts, while determining taxable profit.

No problem arose, by applying this rule, when commercial and tax law both allowed choices *A* and *B (GoB-konform Wahlrechte)*, and allowed no other choices than those. In that case, by applying the general rule, if the taxpayer has correctly adopted the solution *A* in his commercial accounts; and being the solution *A* also admitted by tax law, then the taxpayer will

[12] THIEL, J. & LÜDTKE-HANDJERY, A., *op. cit.,* p. 118.
[13] *Einkommensteuergesetz.*
[14] *Pars pro toto* KNOBBE-KEUK, B. *op. cit.,* p. 22.
[15] As already mentioned, ZITZLAFF, *op. cit.,* has sustained in 1938, against the main stream, that the German income statute of the time did not set out any *formal conformity* rule.

not be allowed to adopt the solution *B* in calculating his taxable profit, but he must adopt the solution *A* also for tax purposes.

But difficulties arise when the above described condition does not occur. In a first possible situation, the tax legislation allows a choice *C*, which is not admitted by commercial law *GoB-inkonform Wahlrecht*). Applying the general rule to this case - supposing that there is no statute tax provision expressly derogating the general rule – if the taxpayer has correctly adopted the solution *A* in his commercial accounts; and if the solution *A* is admitted also by tax law, then the taxpayer will not be allowed to adopt the solution *C* in calculating his taxable profit, but he must adopt the solution *A* also for tax purposes, because he must maintain the treatment correctly adopted in his commercial balance sheet[16]. This understanding of the rule, though, is not widely held among German scholars, since some authors hold, in this case, that the taxpayer should be allowed to adopt the treatment *C* in his tax accounting, in divergence with his commercial balance sheet[17]. To overcome the difficulties coming out of these situations, in particular for tax incentives, commercial statute sometimes operates, through "opening clauses" (*Öffnungsklauseln*), an incorporation of *tax legal choices.* In these cases, though, there are correspondent *legal choices* in commercial and tax law[18].

If, on the contrary, commercial law admits a solution *D,* not permitted by tax law, and the taxpayer adopts *D* in his commercial accounts, he will be allowed, in principle, to maintain that treatment in his balance sheet, while adopting a different treatment for tax purposes[19].

Another problem pointed out by the German scholars to the Income Tax Act norm now abolished[20], was the notion of "choice rights". Restrictively interpreted, the expression would mean those methods or criteria of accountancy expressly set out by the norm as alternative (an example of this would be the different alternative methods in which amortization of immobilizations can be calculated. This interpretation would leave outside the concept those cases where the norm, setting out but one single criterion, leaves room for a subjective judgement (for instance the norm about provisions based on an appreciation of the risk). In these cases, it is mainly understood that there is no *choice right* in a strict sense, but a mere margin of appreciation[21]. But taking into consideration the different purposes of commercial and tax accounting, the criterion could allow two different qualifications or valuations, and in this case, article 5.1(2) of the German Income Tax Act would not apply. This understanding hasn't been accepted by judges.

In January 2009, the second phrase of article 5.1 of the income tax act was abolished. According to the legislator, the intention was to affect only the cases where the tax law allowed treatments not accepted in commercial law, i.e, for commercial accounting purposes (*GoB-*

[16] SCHEFFLER, W., *op. cit.,* p. 27.
[17] About this discussion BORDEWIN, A., *Umgekehrte Massgeblichkeit bei ausschliesslich steurlichem Bilanzierungswahlrecht?,* Der Betrieb, 6, 1992, p. 291.
[18] WEBER-GRELLET, H., Bilanzsteuerrecht, 8th ed., Alpmann und Schmidt/O. Schmidt, Münschen/Köln, 2004, p. 38.
[19] SCHEFFLER, W., *op. cit.,* p. 27.
[20] By the act called *Bilanzrechtsmodernisierungsgesetz (BilMoG).*
[21] German literature distinguishes between *choice rights* (*Wahlrechte*) and norms which admit subjective judgements (*Spielräume*) (*vg.* GLASCHKE, M., *Unabhängigkeit von Bilanzpolitik im IFRS-Einzelabschluss und in der Steuerbilanz,* Schriftenreihe Steuerinstitut Nürnberg Nr. 2006-04). The authors are not unanimous about whether the formelle Massgeblichkeit rule set out in §5.1 (2) apply to the latter (*vg.*SCHNEELOCH, D., *Die Grundsätze der Massgeblichkeit,* Deutsches Steuerrecht, Vol. 28, 3 (1990), pp. 51).

inkonform Wahlrechte). This means that a *formelle Massgeblichkeit* continue to exist, in exactly the same terms, for choice rights compatible with both commercial and tax law *Gob-konform Wahlrechte.* This *formelle Massgeblishkeit* would have its base, now, on article 5.1, as it was previous to 1990 reform.

Spain

In Spain, *article 10.3* of Corporation Tax Act[22] says that taxable profit is to be determined on the basis of "accounting profit", which can be *adjusted* according to special tax provisions. *Article 19.3* establishes a more precise *accounting conformity rule*, while fixing its exact limits. According to this provision, no cost will be accepted for tax purposes unless it has been admitted in the commercial balance sheet of the same or of a previous year; and any income recognized in the commercial balance sheet of any year cannot be excluded from the taxable income of the same year[23]. Exceptions to this general rule are established in a number of special provisions[24].

Thus, for instance, if commercial law allows a choice between capitalizing an R&D expense or deducting it as an annual cost, and if the taxpayer capitalizes it in his commercial balance sheet, he won't be allowed to deduct it as an annual cost for tax purposes; if the taxpayer chooses not to make a provision in his balance sheet, when he could have done it according to commercial and tax statutes, he will not be allowed to make it for tax purposes either; etc. As to earnings, if the taxpayer, exercising a commercial *legal choice*, has recognized income from a contract before receiving the amount, he won't be allowed to postpone it's recognition for tax purposes, even if this would be a correct treatment according to tax statutes. In any of these situations, the choices made in commercial accounts, as far as they are admitted by tax law, are to be kept for tax purposes.

Special provisions establishing limits to cost deductions fit this general rule. For instance, if a 25 per cent amortization is allowed by commercial law and a tax provision sets out a maximum limit of 20 per cent for the same amortization, we can say that in a five per cent portion, the valuation made in commercial accounts is not admitted by tax law. In this case, the taxpayer is allowed to make an *adjustment*, which means that he will not be required to modify his commercial accounts and, as a result of the *adjustment*, the profit submitted to tax will be different from the profit showed in the commercial balance sheet.

Real exceptions to the general rule, where income recognized in commercial accounts can be excluded from tax profit and costs not recognized in commercial accounts can be deducted from tax profit, mainly concern tax incentives[25].

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[22] Ley del Impuesto sobre Sociedades, 43/1995, of 27th december.

[23] About this specific provision GARCÍA MORENO, V. A., *Breve análisis de la exigencia de la contabilización de los gastos como requisito de deducibilidad,* REDF, núm. 94, (1997), pp. 199-213.

[24] Examples of this kind of special provisions can be found in articles 19.3 *in fine,* and article 20 *quater,* 1, Corporation Tax Act 1995.

[25] As it is the case of articles 19.3 *in fine* ("free amortizations"), and article 20 *quarter* 1 ("allowances for investments abroad"), Corporation Tax Act 1995. About the qualification of these provisions as tax incentives, SOLER ROCH, M.T., *Incentivos a la Inversión y Justicia Tributaria*, Civitas, Madrid, 1983, p. 64.

The formula used in the Spanish tax statute has the advantage over the formula used in the German statute of avoiding a somehow vague notion of "legal choice rights", surmounting the difficult question of whether valuation and qualification norms demanding a subjective judgement are to be included in that concept. The Spanish tax statute surmounts also the problem of whether subventional special tax norms are to be included in the *formal conformity* rule, by expressly excluding each and all of them. These can be seen as real exception rules, formally stated, as by the general rule all subventional valuations and qualifications would fall under the general rule. The Spanish statute avoids also the problem of determing whether situations of non corresponding legal choices (in tax law and in commercial law) are affected by the *formal conformity rule.*

Italy

In Italy, the *article 83* of the 1986 Income Tax Act[26]*,* following a tradition coming from 1973, says that taxable profit is to be determined on the basis of the profit and loss account. Current Italian academic doctrine[27] interprets this provision as referring to the *commercial profit and loss account*, and not to a tax *specific* profit *and loss account*. The similarity between this provision and *article 10.3* of the Spanish statute is very clear.

At its hand, *article 109.4* of the Italian tax statute sets out that costs and other negative income components are not deductible if and to the extent that they are not recognized in the profit and loss account of the same year, or of a previous year if, in the latter case, the deferral for tax purposes has been made in accordance with special tax provisions concerning the timing of costs recognition. So far, similarity between the Italian norm and *article 19.3* of the Spanish statute is total. As to positive income components, the Italian statute contains no similar provision to the Spanish *article 19.3*, but it just says that income recognition follows a rigid accrual basis, as a general rule, and that it must be included in taxable profit regardless of its recognition in the commercial balance sheet. As the *accrual* criterion is not free of subjective judgement, the question remains of whether, once an income has been disclosed in commercial accounts, it follows that this income must be recognized for tax purposes in the same period, if the tax accounting criterion somehow diverges from the commercial criterion. Based on the general provision of article 83, it is generally understood that recognition of income can not be deferred for tax purposes, when it has already been recognized for commercial purposes[28].

In conclusion, concerning costs, if the taxpayer can choose between two timing options for tax purposes (*tax legal choice rights*), and, in his balance sheet, he applies a timing solution admitted by tax law, he must adopt the same solution for tax purposes, unless a different solution, admitted by tax law, leads to postponing the cost for tax purposes. As for earnings, if commercial regulation allows two timing options, and the taxpayer applies in his balance sheet

[26] *Testo unico delle imposte sui redditi,* D.P.R. 22.12.1986 n. 917.
[27] Pars pro toto, ZIZZO, G., *op. cit.,* p. 165.
[28] *Vg.* about the special case of change in stock, DEZZANI, F., *La Valutazione delle Rimanenze di Magazzino nelle Imprese con Produzione di Serie, in* UCKMAR, MAGNANI & MARONGIU (ed.), *Il Reddito di Impresa nel Nuovo Testo Unico,* p. 426. An exception to this general rule appears to have been set out for capital gains recognized in the commercial profit and loss account before a transaction based realization.

an option admitted by tax law, it is article 83 that prevents him from adopting a different solution in calculating taxable profit. Until 2007, exceptions could be allowed for valuations connected with tax incentives. It was the case for *anticipated and accelerated amortizations*[29], which have though been abolished in tax law since 2007[30].

France

The French system has many particularities that make it somehow different from the other civil systems. In the French tax legislation we can't find a provision similar to any of those mentioned above. The article 38 of the French Tax Code[31] states that *net profit* must be taken as a starting point to calculate *taxable profit*, so the *taxable profit* will be the result of a modification of the *net profit.* But nothing in the Tax Code clarifies whether this *net profit* shall be taken from commercial accounts or whether a *net profit* can be calculated specifically for tax purposes[32], although applying, according to *article 38 quarter* of Annex III of the tax code, the *definitions* of the accounting regulations[33] (the same is to say whether a *net profit* can be calculated specifically for tax purposes, in divergence with commercial accounts, when this specific tax net profit would comply with commercial accounting regulations). There are specific formal conformity clauses, as is the case for amortizations (*article* 39.1.2nd of the CGI)[34] and provisions (article 39.5 of the CGI)[35]. As to amortizations, article 39.1.2nd says that amortizations are deductible when "made in reality", and judges have interpreted this provision as meaning that for an amortization to be accepted as "made in reality" it must have been previously disclosed in commercial accounts of the same year[36]. As to provisions[37], article 39.5 expressly requires their disclosure in commercial accounts. But there is not a general formal conformity rule applicable to other situations.

However, judges and scholars have traditionally seen commercial accounting law and tax accounting provisions as not having two different fields of application. In 1911 a court stated in its sentence that "commercial accounts were to be prepared in accordance with tax regulations"[38]. And in 1952, Escarra affirmed that "tax law is a direct source of commercial law, in the sense that it provides solutions for commercial law problems"[39]. This allows us to conclude that traditionally, courts and scholars have conceived the system as a *single balance sheet system*[40]. This traditional conception has persisted until today and has consequences at

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[29] On this point PICINELLI, G. Il Bilancio di Esercizio nella Normativa Tributaria, CEDAM, 2000, Milan, p. 80.
30 Legge 244/2007, finanziaria 2008.

[31] *Code Général des Impôts.*
[32] OSTERLOH-KONRAD, C., *Frankreich, in* SCHÖN, W., *Steuerliche Massgeblichkeit in Deutschland und Europa,* Otto Schmidt, Colonia, 2005, p. 378.
[33] After article 38 *quater* of the Annex III of the *Code Général des Impôts*, enterprises must comply with the definitions set out in the *Plan Général de Comptabilité*.
[34] OUDENOT, P., *Fiscalité Approfondie des Sociétés,* 2ª ed., Litec, Paris, 2001, p. 377.
[35] OUDENOT, P, *op. cit.,* pgs. 324-325.
[36] For instance, the sentences of the Conseil d'État: C.E. 27.7.1979, *req*. nr. 4186, Revue de Droit Fiscal nr. 42, 1979; C.E. 5.10.1977, *req*. nr. 2667, Revue de Droit Fiscal nr. 15-16, 1978. About this point, and cooroborating this understanding, OUDENOT, P, *op. cit.,* p. 378.
[37] The term "provisions" is employed in the text in the sense of article 9 B of Council Directive 78/ 660/EEC.
[38] Aix, July 5, Journal des Sociétés 1912, p. 431, *in* HAMEL & LAGARDE, *Traité de Droit Commercial,* I, Dalloz, Paris, 1954, p. 327.
[39] ESCARRA, J., *Cours de Droit commercial,* Sirey, Paris, 1952, p. 41.
[40] This understanding is corroborated by OSTERLOH-KONRAD, C., *op. cit.,* p. 377.

two levels: i) the relationship between the determination of the taxable profit and the commercial balance sheet; and ii) the fields of application of commercial and tax law sources, with no real separation between the two.

At the first level, this traditional thinking has supported the understanding that the *net profit* mentioned in *article 38* of the *Code Général des Impôts* is the net profit extracted from commercial accounts. As a consequence, choices made in the commercial balance sheet have to be maintained for tax purposes to the extent that they are not contrary to any tax provision.

At present, however, a definite basis to stand for the existence of a *formal conformity* general rule in French tax law, regarding the determination of taxable profit, can be found in case law. Since 1958, the French *Conseil d'État* has developed the "administration decisions theory"[41]. According to it, a taxpayer who follows a given accounting method or norm in his commercial accounts can only modify it for tax purposes after having proved that the treatment adopted is an *involuntary mistake*. However, a treatment cannot be considered to be a mistake if it is a treatment admitted according to tax law, which corresponds to the condition *c)* of our definition of a *formal conformity rule*. This means that if the taxpayer, being given multiple choices of tax treatment (legal *tax choices*) for a given economic fact, adopts one of those choices in his commercial balance sheet – adopts a treatment admitted by tax law among a range of possible solutions - he will not be allowed to modify it for tax purposes.

Interpreting this norm *a contrario* we should conclude that the *formal conformity* rule will not apply, in principle, when a correct treatment adopted in the commercial accounts is not, though, among tax sound solutions. So far, however, the hypothesis may be merely theoretical, given the very deep entanglement between the commercial and the tax accounting rules. Since there is only one balance sheet, and being accepted that tax regulations normally apply to this balance sheet, an antinomy between commercial and tax regulations can not persist in formal terms, meaning that one of the norms will be obsolete[42].

If the tax statute grants a treatment not admitted by commercial accounting rules, then the taxpayer will be entitled, in principle, to adopt that treatment in his commercial balance sheet and to modify it for tax purposes in the income tax return. This is the case for some kinds of tax incentives, like special amortizations[43].

Portugal

[41] "*Théorie des décisions de gestion et des erreurs comptables".* This theory was firstly set out in the sentence *C. E.*, Mars 19 1958, nr. 35368, and confirmed in many others after, like C.E. January 23 1961, nr. 47 543; or *C. E.*, November 4 1970, nr. 75564. About the theory, PASSERON, *La Théorie des Décisions de Gestion et des Erreurs,* Revue de Jurisprudence Française, 1, 1976; PICARD, *Erreurs et décisions de gestion,* Revue de Jurisprudence Française, 2, 1979.

[42] Two specific situations can be mentioned to help clarify this point. Concerning the timing of income recognition in long term construction contracts, commercial regulations prescribe the "percentage-of-completion" method while the tax regulations prescribe the "completed contract method". In practice, taxpayers use the same method for commercial and tax purposes (cfr. OUDENOT, P, *op. cit.,* p. 151). Since the tax prescribed method is more favourable to the taxpayer, the tax law would not prevent the taxpayer from using the commercial method, and so the later can be seen as a tax legal choice. Being so, the formal conformity rule prevents the taxpayer from using different methods for commercial and tax purposes. Concerning stock depreciation, tax and commercial legal preovisions prescribe different qualifications, but a tax infra legal regulation (Anex III of the CGI) allows the taxapyer to use the commercial provision (cfr. OUDENOT, P, *op. cit.,* p. 407) which can only be understood in view of the the single balance sheet conception and the deep entanglement between commercial and tax law sources.

[43] Divergences allowed are indicated in an administrative instruction, Notice nr. 2032.

In the Portuguese corporate tax act[44], *article 17* sets out that the taxable profit is to be computed upon the "accounting net profit", adding that this "accounting net profit" is to be "corrected" according to any special provisions in the corporate tax code. The provision is quite similar to *article 10.3* of the Spanish statute and to article 83 of the Italian statute.

The Portuguese corporate tax code does not contain, though, any provision similar to article 19.3 of the Spanish statute, or to article 109.4 of the Italian statute, expressly preventing the taxpayer from deducting in his tax base any costs he has not showed in his commercial balance sheet; or from eliminating from his tax base any income that he has included in his "accounting net profit". So, if a cost of 100 (correctly calculated according to commercial rules) is shown in the commercial balance sheet and the tax provision (*lex specialis*) allows a cost of 120, there is no specific provision preventing the taxpayer from using this higher cost in computing his taxable base, by means of a *correction* to the "accounting net profit". However, this possibility is not actually allowed by the higher Portuguese courts. In a few cases concerning risk credit provisions, the courts have refused the possibility of a different treatment in commercial accounts and in tax accounts[45], based on the general taxation rule that financial events must be recognized in the balance sheet of the year in which they occur and not in any other[46]. And the fact that a cost has not been shown in the balance sheet of a certain year is taken by courts as evidence that the cost has not occurred in that year.

In practice, however, the tax administration has defined the meaning and extent of article 17 of the corporate tax act, by fixing on a casuistic basis the cases and the manner in which the taxpayer is allowed to introduce "*extra accounts*" modifications ("*extra accounts*" meaning that these modifications are not meant to affect the financial accounts to be submitted to shareholders) in calculating his taxable profit. This has been done through the income tax return form issued by the tax administration[47]. Currently this income tax return form shows a wide range of available "*extra accounts*" modifications, mostly related to: i) costs not accepted by the tax statute, like amortizations over the legal tax limits; ii) income determined by the application of specific tax provisions not included in the accounting net profit; iii) technical modifications, like those related to tax transparency mechanisms; iv) tax relief; and v) some exceptional cases of accounting valuation methods not accepted by tax law, like the equity method of valuation.

5. "Reverse dependence"

In order to compare the relationship between taxable profit determination and the commercial accounts in different systems, it is important to distinguish a *formal conformity*

[44] Código do Imposto sobre o rendimento das Pessoas Colectivas, Decreto-Lei nº 442-B/88, 30.11.
[45] On this point, AGUIAR, N., Lucro *tributável e contabilidade na jurisprudência dos tribunais tributários superiores*, Jornal Fiscal, nº 2, 2008, pp. 7-17.
[46] In Portuguese, «princípio da especialização dos exercícios". Although this rule is usually translated to English as the "accruals principle", it corresponds more accurately the *Stichtagsprinzip* of German law. About this correspondence, SCHLAAK, W., *Das Stichtagsprinzip im Jahresabschluss nach HGB, IFRS, UK GAAP und US GAAP*, Vuvilleir, Göttingen, 2005.
[47] Declaração Modelo 22, Despacho SEAF nr. 9/2007-XVII, of January 4.

principle from the phenomenon known in Italian jurisprudence as *reverse dependence* (or with that known as "*heterointegrazione"* of commercial law by tax law), which means *the application of special tax provisions to commercial accounts*[48]. *Reverse dependence* can occur in association with *formal conformity*, and in some cases can imply *formal conformity* but it is not a necessary effect of it. It has been completely eliminated from the Spanish system, for instance[49]. Reverse dependence is thus to been seen as an extra element in relation to the *formal conformity* rule.

To determine whether *reverse dependence* occurs in a given legal system, we must take as a starting point the given general notion of *formal conformity* – the rule according to which valuation and qualification choices and/or judgements made in commercial accounts, so far as they apply correctly the commercial accounting rules and are not contrary to any taxation legal rule, must be maintained in determining the taxable base[50], binding both the taxpayer and the tax administration - and ask the following questions:

- What happens if the valuation/qualification choice or judgement made in the commercial accounts is not in accordance with commercial accounting rules?
- What happens if the valuation/qualification choice made in the commercial accounts is not admitted by tax law?
- What happens when tax law sets out or allows a treatment not allowed by commercial law?

Beginning with the first question, if a valuation or a qualification disclosed in commercial accounts is inaccurate - from the point of view of commercial accounting regulations - *formal conformity* could be disregarded, either by the taxpayer himself or by the administration. In practical terms, tax law has to deal with the question of whether it is equitable, considering tax principles that lead the tax legislator to set out a *formal conformity rule*, to leave the taxpayer free to modify the profit miscalculated in his commercial accounts, for tax purposes. In this case, an illegal behaviour on behalf of the taxpayer concerning his commercial legal obligations would be rewarded by liberating him from the formal *conformity* tax rule, which is a legal limit to his discretion powers in calculating his taxable profit. In the Spanish legislation, the *formal conformity rule* set out in article 19.3 extends to the situations where the taxpayer incurred in an inaccuracy in his balance sheet, so he cannot be benefited by it. When this occurs, we cannot say there is a *reverse dependence* rule or situation, because it does not imply that any tax valuation rules apply to commercial accounts, but only that the formal conformity rule is designed in a particularly rigorous way, in order to prevent the taxpayer from distributing to shareholders profits which are not taxable yet according to the accruals principle.

But in the past, in many legal systems, the fact that the taxpayer's commercial accounts were considered to be *inaccurate*, would entitle the tax administration to ignore the taxpayer's commercial accounts and to assert tax on a *deemed* profit. In addition, it could often be difficult

[48] In this sense SCHEFFLER, W., *op. cit.,* p. 24, about the *umgekehrte Massgeblichkeit.*
[49] MORENO, V. G., *La Base Imponible del Impuesto sobre Sociedades,* Tecnos, Madrid, 1999, p. 80.
[50] SCHREIBER, *§ 5 EStG*, in BLÜMICH, EstG, *KStG, GewStG Kommentar*, Franz Vahlen, Munique, 2003, p. 38; THIEL, J., *Zur formellen Massgeblichkeit der Handelsbilanz – Ein Vorschlag de lege ferende,* Der Betrieb, Vol. 42, Núm. 11 (1989), p. 539.

for the taxpayer to say when commercial accounts could be deemed *inaccurate* because tax legislation often failed to say clearly how to calculate a *correct* profit for tax purposes. More specifically, tax legislation often left unclear whether commercial accounts should conform to special tax provisions. In this situation, taxpayers often chose to prepare their commercial accounts in conformity with tax regulations. In this case, very common in the past, there was a *de facto reverse dependence* phenomenon.

As to the second question – what happens if the valuation disclosed in the commercial balance sheet is not admitted by tax law? – it shouldn't raise any particular problems in the application of a *formal conformity* rule. If commercial regulations allow a treatment *X,* which is not admitted by tax regulations, having used that treatment in his accounts, the taxpayer should be allowed to modify this particular valuation for tax purposes. In practice, however, the same problem as described above can arise: can the taxpayer be sure that the treatment *X* adopted in his balance sheet will be deemed *correct* by the administration, it being considered not acceptable by tax law? And if not, how will this affect the taxpayer's legal rights concerning the legal procedure of assessing the tax base? An accurate answer to these questions supposes having previously answered a first question, of whether, in a particular legal system, the set of tax regulations is applicable to commercial accounting. But in many legal systems, as is the case for the systems studied, statutes fail to set down clearly which rules that apply to calculate the taxable profit are to be taken in preparing commercial accounts as well[51]. We can say that tax law, in many legal systems, persist in maintain a grey zone of uncertainty as to whether tax provisions are to be applied in commercial accounts.

As to the third question – *What happens when a special tax provision sets out or grants a treatment not allowed by commercial law?* – two situations can be clearly distinguished:

a) If the special tax provision, although in divergence with commercial regulations, aims at ascertaining the *true profit*, the *formal conformity* must be applied, and the treatment allowed by the tax provision cannot be used. It can be seen as a *failed act* of the tax legislator, who granted a treatment to ascertain profit which is inadequate from the commercial point of view, while establishing a rule of *formal conformity* between commercial accounts and taxable profit. A reverse dependence effect will occur only if the taxpayer, in order to make use of the special tax valuation, adopts it in the commercial balance sheet as well, which would be an incorrect procedure.

b) If the special tax provision *does not aim to ascertain true profit* but is intended to set out a *tax incentive* (like the temporary exclusion from the base of gains from selling capital assets), there is no reason to apply any rule of *formal conformity*. The taxpayer should be allowed to modify his profit just for tax purposes (this is what happens in the Spanish system, in every case of tax incentives consisting in base deductions). This does not necessarily imply that a requirement of special reserves

[51] AGUIAR, N., *La relación.., cit.,* pp. 31 et seq.

cannot be established by the tax provision, nor would this mean a *reverse dependence effect*.

6. Conclusion

A *formal conformity* principle, according to which the financial valuations and qualifications made in the commercial balance sheet, in so far as they are correctly made according to commercial accounting regulations, and they are not contrary to any tax legal provision or principle, must be maintained for tax purposes – exists not only in the German legal system, but also in France, Italy, Portugal and Spain. The principle can be laid down with varying degrees of intensity, as the admissible divergence between taxable profit and the profit shown in commercial balance accounts varies. At the present time, legal systems consent in general to a certain divergence between the two, but the magnitude of that divergence is variable.

In most systems, when a qualification or valuation disclosed in commercial accounts is not compatible with a tax provision a divergence is admitted. In some systems, like the Spanish, formal conformity never applies where a special tax provision sets out a tax incentive, a divergence being admitted in these cases. The Portuguese system follows this model closely.

Lastly, it is possible to conceive the formal conformity principle in such a way that divergences between commercial accounts and the tax base are possible whenever such divergences do not lead to postponing tax profit recognition in relation to profit recognition in commercial accounts. This is the case in the Spanish system and to a certain extent, in the Italian system also.

Only when a tax provision, be it optional or obligatory, imposes or allows a treatment not granted by commercial law – except for the case of "opening clauses" like those existing in the German commercial law previous to the 2009 reform – not allowing for a divergence between the taxable profit and the profit showed in the commercial balance sheet, we'll be in the presence of the phenomenon known as "reverse dependence", in which the application of the tax norm requires its application also in commercial accounts.

Conclusion

The principle according to which discretionary valuations and qualifications made in commercial accounts are preclusive to the determination of the taxable income of an enterprise is a well established principle in civil law systems in general. There are several rationales for the principle. One of them lays in the practicability in assessing taxable income. If the principle did not apply, the taxpayer would have to prepare to balance sheets, for commercial and tax purposes. A second one is related to the need of proof of the valuations made by the trade administrators. Under a formal conformity principle (*dipendenza-prejudicizialità*) the commercial balance sheet is taken as *prima facie* evidence of the veracity of the valuations made. This presumption of veracity, on its hand, is based on the fact that the approval of the commercial balance sheet has to pass a series of control mechanism set down by commercial law, and

these control mechanisms are in principle made effective by the different and opposite private interests involved in the civil obligation of accounting. And a final rationale lays on the tax legislator purpose of not allowing the distribution of dividends that have not yet been submitted to tax. Nevertheless, the formal conformity principle has been put to stress, particularly in the past three decades, because most frequently it was accompanied by the phenomenon called reverse dependence. In the context of this tension, many voices have announced or defended the end of the principle. In the last years, however, tax law has developed formulas to make compatible the formal conformity principle with the respect for the commercial accounting rules. The systems analyzed in this paper demonstrate this adaptation.