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MAX-PLANCK-GESELLSCHAFT

Max Planck European Postdoctoral Conference on Tax Law

21 and 22 November 2011

Max Planck Institute for Tax Law
and Public Finance

Munich

Program

Monday, 21 November 2011

- 13.00 – 13.15 **Welcome Address**
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Matthias Valta, Heidelberg
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- 14.15 – 15.15 **The Era of Exchange of Information and Fiscal Transparency: The Use of Soft Law Instruments and the Enhancement of Good Governance in Tax Matters**
Alicja Brodzka, Wrocław, and *Sebastiano Garufi*, Milan
Discussant: *Alberto Vega Garcia*, Barcelona
- 15.15 – 15.45 Coffee Break
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Jennifer Farrell, London
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- 16.45 – 17.45 **Taxation and Development**
Maria Amparo Grau Ruiz, Madrid
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Nina Aguiar, Porto
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Basarab Gogoneata, Bucharest
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Aurora Ribes Ribes, Alicante
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Alberto Gil Soriano, Valencia
Discussant: *Cihat Öner*, Amsterdam
- 13.30 – 14.30 Lunch Break
- 14.30 **Concluding Remarks**

**DO COMMERCIAL ACCOUNTS AND THE TAX BASE HAVE TO BE
ALIGNED?**

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Key words

Taxable profit; annual accounts; formal linkage; IAS/IFRS; concepts of income; prudence; ability to pay; discretionary judgements; proof.

Abstract

A “formal linkage” between taxable income and commercial annual accounts forms a pillar of corporate tax. Its rationales are practicability; the annual accounts as a meaning of proof as to discretionary accounting judgments; and the notion that commercial income as a basis for taxation matches the ability to pay principle. These rationales assume that commercial income features suit the ability to pay requirements, an idea that has been contested recently on the basis that the IAS/IFRS normative system is conceived for purposes very different from those of taxation and therefore the “formal linkage” rule should be abandoned. In this paper the author sustains that the measurement of income under IAS/IFRS has all the necessary features to match ability to pay, including prudence. But even when the tax legislator considers that taxable profit must deviate widely from commercial profit, such deviation is technically compatible with a “formal linkage” between taxable income and commercial annual accounts, and such a “formal linkage” is totally justified by proof requirements concerning discretionary accounting judgements. This paper attempts to demonstrate this last point through the examples of Italy, Spain and Portugal current legislations.

I. Introduction

A number of recent studies confirm that a “formal linkage” between taxable income and commercial annual accounts exists and has existed for long not only in most continental European countries but also in the UK, the USA and Australia¹. In face of its generality

¹ SCHÖN (ed), *Steuerliche Massgeblichkeit in Deutschland und Europa*, Cologne, 2005; FREEDMAN, *Aligning Taxable Profits and Accounting Profits*, eJournal of Tax Research, 1, 2004, pp. 71-72; ENDRES et al. (eds), *The Determination of corporate taxable income in the EU member states*, Alphen an den Rijn, 2007, p. 25; AGUIAR, *Tributación y contabilidad. Una perspectiva histórica y de derecho comparado*, Granada, 2011.

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and its antiquity, we can say that a “formal linkage” between taxable income and commercial annual accounts forms a pillar of corporate tax law.

A “formal linkage” between taxable income and commercial annual accounts was first demanded by taxpayers and auditors at the beginning of corporate taxation, in the 19th century. For the past few decades, however, an academic and professional sector with great impact on the mainstream opinion has persistently claimed for the end of this “formal linkage” between taxable income and commercial accounts. This debate has been reawakened in recent times² subsequently to the introduction of IAS/IFRS’s in European commercial accounting law and the submission to the Parliament and the Council of a proposal for a directive on a CCCTB³. In this paper we offer a review of arguments for and against the “formal linkage” between taxable income and commercial annual accounts.

II. Aligning taxable income and accounting income under IAS/IFRS – is it feasible?

1. The foundations of the “formal linkage”

When we speak of a “formal linkage” between taxable income and commercial annual accounts we mean a tax legal norm, by which qualification and valuation judgments made in accounts approved for commercial law purposes are preclusive for tax purposes, unless ruled otherwise by an exceptional tax law provision (*exceptio*)⁴.

In the basis of this connection there have been historically a few different rationales.

² V.g. GAMMIE et al, *Achieving a common consolidated corporate tax base in the EU*, Brussels, 2005, p. 53; SLOT/GERRITS, *Can IFRS also become the standard for Netherlands tax purposes?*, *European Taxation*, 8, 2009, p. 409; BIELEN, *International Accounting Standards/International Financial Reporting Standards and corporate tax base design*, in LANG et al. (eds), *Tax compliance costs for companies in an enlarged European Community*, Alphen an den Rijn, 2008, p. 479.

³ European Commission, COM(2011) 121/4, Brussels, March 2011.

⁴ BURNS/KREVER, *Taxation of income from business and investment*, in Thuronyi (ed.), *Tax Law Design and Drafting*, vol. II, Washington D.C., 1998, p. 677.

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The first one was practicability⁵, since a “formal linkage” between commercial annual accounts and taxation spared managers from having to prepare a double series of financial accounts based on two different sets of rules for tax and commercial purposes⁶. At present, this rationale has lost some of its importance, since information technology now makes it quite easy (although not cheap) to overcome the difficulties resulting from having to prepare two sets of accounts based on two different sets of rules.

The second main rationale lies in the proof function attributed to commercial accounts. In this proof function, though, we must distinguish two different aspects that must be assessed separately, as we try to appreciate whether they can constitute a valid rationale for a “formal linkage” at the present:

a) The proof of objective facts:

If we consider a proof function related to *objective* economic facts (the existence of a contract, the terms of the contract, the date of the agreement, etc.⁷), a formal linkage between commercial accounts and taxation is not needed. To prove these facts, annual commercial accounts are not strictly necessary at all, because accounting support documents contain all that information. Yet, if in order to certificate the economic facts given in the tax return, the tax administration had to examine all the accounting support documents, this would turn into such a heavy task that it would make corporate taxation practically impossible. In this sense, the balance sheet, as it makes a synthesis of all the relevant economic facts that must be taken into account, is also a declaration from the auditors attesting the truth of those *objective* facts. Taking the balance sheet as a proof for those *objective* facts, thus, is necessary for taxation efficiency and is not something dispensable.

However, for the balance sheet to be used as a proof concerning just the *objective* facts, it would not be necessary that the valuation and qualification discretionary judgments

⁵ TIPKE, K. /LANG, J., *Steuerrecht*, 18^a ed., p. 651; PEZZER, *Bilanzierungsprinzipien als sachgerechte Massstäbe der Besteuerung*, in Werner Dolralt (ed.), *Probleme des Steuerbilanzrechts*, Cologne, 1991, p. 18.

⁶ PEZZER, *op. cit.*, p. 18; THIEL/LÜDTKE-HANDJERY, *Bilanzrecht*, 5^a ed., Heidelberg, 2005, p. 111.

⁷ In Italy, MAZZA, *L'autonomia economica e giuridica della 'dichiarazione annullae'*, *Rivista dei Dottori Commercialisti*, 1975, p. 210, designates this type of accounting values as "negotiated values" as opposed to "opinion values".

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were preclusive for taxation purposes. In other words, a “formal linkage” would not be necessary. If the legislator considers that the accounting discretionary judgments for tax purposes (tax options) should or might be allowed to diverge freely from those made for commercial purposes, the tax base *could be* determined on the basis of the balance sheet (for simplification reasons only), but could be totally transformed by different options made under commercial accounting rules. This transformation could be done in the tax return. This procedure, in which it is not to be seen any “formal connection”, would not affect the balance sheet proof function concerning *objective* facts. To demonstrate the accurateness of this assertion, we would ask the reader to consider for a moment the following example:

An accounting norm assigns the business manager and taxpayer the option of applying the fair value to a given asset. The taxpayer has chosen to use the fair value criterion in the valuation of the asset in his balance sheet. He is convinced that by doing so he has given a true and fair view of their financial situation for commercial purposes. But the same taxpayer thinks that historical cost is the most adequate criterion to evaluate the same asset for tax purposes. The judgment about which of the two criteria is the most adequate is a discretionary one to a great extent. Since the use of historical cost instead of fair value in taxation would originate a different figure, the taxpayer should make the correspondent adjustment in the tax return, without affecting the balance sheet. The profit or loss account, attached by the taxpayer to his tax return, would still accomplish the task of proving a range of facts: the existence of the asset or valued at fair value, its acquisition date and its historical cost. But the same effect could be achieved if the taxpayer simply would elaborate a completely new balance sheet for tax purposes, based on different criteria. This example aims to demonstrate that it is possible to use the commercial balance sheet as a meaning of proof concerning *objective* financial facts, without requiring a “formal linkage”, which concerns discretionary judgments only (tax options)⁸.

⁸ AGUIAR: *Tributación...*, cit., p. 455; *Income taxation and Accounting: Conceptual Tools for Comparing European Systems*, Rivista di Diritto e Pratica Tributaria, 3, 2009, p.1294; BORDEWIN, *Zur Massgeblichkeit der Handelsbilanz für die steuerliche Gewinnermittlung*, Deutsches Steuerrecht, 21, 1988, p. 668; SCHEFFLER, *Abweichungen zwischen Handels- und Steuerbilanz. Übersicht über die Reichweite des Massgeblichkeitsprinzip und die Ausnahmen von der Massgeblichkeit der Handelsbilanz für die Steuerbilanz*, BBK, Supl.1, 2004, p. 38.

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b) The proof of discretionary judgments

By discretionary judgments we mean any valuations or qualifications of an accounting nature that involve subjectivity. V.g. the judgment about the existence of a risk that justifies a provision, the effective depreciation on an immobilization, the loss on some assets fair value, the possibility of generating income from an investment on an intangible asset, etc.⁹. In these situations, the annual accounts approved by the shareholders certify not only the *objective* financial facts under these valuations/qualifications but also certify that the discretionary judgments made by the managers are the most effective in showing a true and fair view¹⁰. Based on this aspect, the tax legislator may want to extend the balance sheet proof function to reach those discretionary judgments. If the legislator wants this effect, he will make those discretionary judgments preclusive for tax purposes (“formal linkage”). In this case, the taxpayer will not be free to replace, for tax purposes only, the discretionary judgments made in the balance sheet, on the consideration that a different criterion is more suitable for tax purposes. The tax legislator dilemma between establishing and not establishing a “formal linkage” concerns exclusively this second proof issue, because only discretionary judgments are concerned by the “formal linkage”¹¹.

The third classical legal rationale for a “formal linkage” between commercial annual accounts and taxation lies in the taxation ability to pay principle: The commercial profit, i.e., the profit disclosed in financial statements approved for commercial law purposes, when it is accurate, is assumed by the tax legislator to be an adequate expression of ability to pay taxes¹².

⁹ WALTON/AERTS, *Global financial accounting and reporting: principles and analysis*, London, 2006, p. 11.

¹⁰ FALSITÀ, *Il bilancio di esercizio delle imprese*, Milan, 1985, p. 169; GALEOTTI-FLORI, *Aspetti fiscali della politica di bilancio*, Rivista dei Dottori Commercialisti, 6, 1974, p. 955.

¹¹ Supra nota 8.

¹² The idea was early expressed by QUARTA, *Commento alla legge sull'imposta di ricchezza mobile, II*, Milán, 1902, p. 222. In the present: ANDREANI, *Le modifiche nella disciplina della fiscalità*, in Musaiò (ed.), *La riforma del diritto societario. Profili economico-aziendali*, Milan, 2005, p. 100; SCHEFFLER, *Besteuerung von Unternehmen, II*, Müller, Heidelberg, 2010, p. 17; GREEN, *Accounting standards and tax law: complexity, dynamism and divergence*, British Tax Review, 5, 1995, p. 451.

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Since the first rationale can no longer be a foundation for a “formal linkage between commercial annual accounts and taxation, the current debate is confined to the second and third rationales. The second and third rationales, on their turn, are based on two assumptions: 1) that discretionary judgments of an accounting nature made in the commercial balance sheet are appropriate for tax purposes, and 2) that accounting income expresses ability to pay. These two assumptions form the current Gordian knot of the “formal linkage” issue.

3. The common teleological approach – a critic analysis

It is often affirmed by those who claim the end of the “formal linkage” between commercial annual accounts and taxation that the tax income determination has purposes different from those of commercial/financial accounting¹³.

The teleological approach – coming from the sociological school of Law Philosophy - seems to be generally accepted by everyone. But in order to lead to valid conclusions, it must be enunciated on a correct basis. In the first place, it is necessary to compare the proper terms. Recurrently the terms compared are the “taxation purposes” or the “corporation tax purposes” (first comparison term) and the “financial accounting purposes” (second comparison term)¹⁴. In comparing these two terms, it is often affirmed that the taxation main purpose consists in obtaining fiscal revenues¹⁵, while the purpose of financial accounting is to supply information to a range of entities interested in financial information (investors, market partners, workers, public entities, etc.¹⁶. This

¹³ In Italy FANTOZZI, *Le valutazioni dei beni delle società ai fini del bilancio e della dichiarazione dei redditi*, Diritto e Pratica Tributaria, I, 1970, p. 842; ALLEGRI, *Bilancio civilistico e imponibile fiscale*, Naples, 2005, p. 73; DODERO/ FERRANTI/ IZZO/ MIELE, *Imposta sul reddito delle società*, Milan, 2008, p. 479; BORIA, *Il sistema tributario*, Milan, 2008, p. 309; In anglo-american literature, v.g. WHITTINGTON, *Tax policy and accounting standards*, in JAMES (ed.), *Critical perspectives on the world economy*, London, 2002; PORCANO/ SHULL/TRAN, *Alignment of taxable income with accounting profit*, Australian tax Forum, 4, 1993, p. 478; ENDRES, *op. cit.*, pp. 6-7. In Spain, MORENO ROJAS, *Contabilidad y fiscalidad. Diferencias entre resultado contable y base imponible en el nuevo Impuesto sobre Sociedades*, Sevilla, 1997, p. 12.

¹⁴ JAMES (ed.), *Taxation: critical perspectives on the world economy*, London, 2002, p. 399.

¹⁵ HORNGREN/GARY/ELLIOTT, *Introducción a la contabilidad financiera*, 7ª ed., Pearson Educación, México, p. 331; MORENO ROJAS, *op. cit.*, p. 12.

¹⁶ V.g. DODERO/FERRANTI/IZZO/MIELE, *op. cit.*, p. 479; JULIÁ/SERVER, *Contabilidad financiera*, Valencia, 2006, p. 61; HORNGREN/GARY/ELLIOTT, *op. cit.*, p. 331.

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approach may be seen as a replication possibly not too rigorous of the *Thor Power doctrine*¹⁷, produced in a US Supreme Court sentence that reached a wide echo.

Clearly, the ultimate purpose of taxation in general is to obtain revenue to provide financial resources to pay public entities' activities. Nevertheless, if we look at tax law instead of at the taxation activity, the same assumption is not at least so clear, since the purpose of tax law is not to collect revenues, but to collect revenues according to the ability to pay taxes¹⁸. Therefore, referring to the tax norms that define the tax base, their purpose is to define a tax base that matches the ability to pay taxes¹⁹.

Concerning the second comparison term – financial accounting – we start by noting that usually no reference is made to the fact that in the basis of financial accounting there is an *ex lege* obligation, set down in commercial law. In fact, the term “financial accounting” somehow hides – not intentionally – the legal root, founded in commercial law, of the most important part of business accounting. Certainly there is at present time a financial accounting oriented to stock markets²⁰, which purpose is to supply information to investors in order to help their decisions (EC Regulation 2002/1606 concerning the adoption of IFRS's is about this accounting). This accounting demands legal protection, too. But it must be recognized that only a very small number of enterprises are admitted to an official stock market. The majority of enterprises prepare annual accounts and submit them to the shareholders' approval to comply with a legal obligation set down in commercial law²¹ which has nothing to do with stock markets protection. On the basis of this assumption, the annual accounts approved in the context of commercial law must have a *legal purpose*²². This *legal purpose* is necessarily the

¹⁷ *Thor Power Tool Company v. Commissioner* (1979) US 439. For a detailed analysis of this US Federal Court, GRAETZ/ GRISWOLD, *Federal income taxation: principles and policies*, Foundation Press, Nueva Iorque, 1985, pp. 873 *et seq.*; on the point, SCHÖN, *International accounting standards – a “starting point” for the Common European Tax Base?*, *European Taxation*, 10, 2004, p. 431.

¹⁸ TIPKE/LANG, *Steuerrrecht*, 13^a ed., Otto Schmidt, Colonia, p. 20.

¹⁹ ANDREANI, *op. cit.*, p. 100.

²⁰ INTERNATIONAL CHAMBER OF COMMERCE, COMMISSION ON TAXATION, *Important differences between taxation and accounting rules, Policy statement*, 2003.

²¹ INTERNATIONAL CHAMBER OF COMMERCE, COMMISSION ON TAXATION, *op. cit.*

²² HENNRICH, *Bilanz- und Steuerrechtliche Aspekte der sogenannte Scheinauslandsgesellschaften*, in BERGER, K P., *Zivil und Wirtschaftsrechts im Europäischen und Globalen Kontext*, Berlin, 2006, p. 391; COLOMBO, *Il Bilancio...*, *cit.*, 1994, p. 27.

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one that has motivated the legislator to set such an obligation in the first place²³, and that legal purpose of financial accounting is what we should try to find, if we wish to compare in proper terms commercial/financial accounting purposes with tax accounting purposes.

Before trying to define the *legal* commercial accounting purposes, we'll say a word about the commercial accounts legal nature, which we see as a double legal nature, empirical and contractual. In the one hand, the annual accounts have an empirical aspect²⁴, as accounts declare facts. In this sense, we can agree with Libonati²⁵, in that commercial accounts are “a declaration of science” to which certain legal effects are attributed by law. This empirical aspect of accounting has limits posed by the intrinsic variability of the concepts of income and capital, and by an immovable subjectivity degree in financial valuation²⁶. This variability and subjectivity can be used in favour or against certain social interests connected with financial information²⁷. For this reason, commercial law, aside from setting down rules for the preparation of accounts, sets a range of mechanisms for setting those accounts – submission to the shareholders assembly and subsequent approval, auditing, public register, publication and the possibility of judicial challenge²⁸ - aimed at achieving a fair arrangement of all social

²³ In Italy, GREGORIO, *Corso di diritto commerciale*, 6^a ed., Milan, 1960, p. 43; In Germany, LANG, *Grundsätze ordnungsmässiger Buchführung*, in LEFFSON/RÜCKLE/GROSSFELD (eds.), *Handwörterbuch unbestimmter Rechtsbegriffe im Bilanzrecht des HGB*, Cologne, 1986, p. 236; In Spain GARRIGUES, *Tratado de Derecho mercantil*, Madrid., 1947, p. 300.

²⁴ On the distinction between empirical and normative sciences RADBRUCH, *Introdução à Ciência do Direito*, trad. BARKOW, São Paulo, 1999, p. 221.

²⁵ LIBONATI, *Bilancio delle società. Estratto dall'appendice del Novissimo Digesto italiano*, Turín, 1979, p. 8.

²⁶ GIOVANNINI, *Bilancio civile e variazioni fiscali*, Rivista de Diritto Finanziario e Scienza delle Finanze, Vol. LII, I, 1993, p. 595; FANTOZZI, *Le valutazioni...*, cit., p. 839; GHINI, *Le valutazioni per il bilancio di esercizio*, Milan, 1972, p. 79; THIEL/ LUDTKE-HANJERY, *op. cit.*, p. 198.

²⁷ THIEL/LÜDTKE-HANDJERY, *op. cit.*, p. 198; MACDONALD, *Matching accounting and taxable profits: reflections on Gallagher v. Jones*, British Tax Review, núm. 5, 1995, p. 484; SIMONETTO, *I bilanci. Appuni dalle lezioni di diritto commerciale tenute nell'anno accademico 1966-67 nella Facoltà di Economia e commercio dell' Università di Padova sede distaccata di Verona, , Padua, 1972, pp. 51 et seq.*

²⁸ COLOMBO, *Il Bilancio...*, cit., 1994, p. 182.

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interests connected with financial information²⁹. In this sense, the annual commercial accounts encompass also an agreement concerning the business financial evaluation for external and internal purposes³⁰. If the above statements are right, then we must conclude that it is not correct to reduce the legal purposes of commercial accounts to the supplying of information³¹.

When it comes to define commercial accounts legal purposes, we find no uniformity³². Nevertheless, there is a firmly supported opinion stream according to which those purposes are basically: i) supplying information to a range of entities interested in that information, in which the business selling price is included³³; ii) determining the annual payable dividends³⁴.

If we accept that the commercial annual statements have among their main legal aims measuring the annual net income or profit³⁵, and if annual net income is what is supposed to be taxed, we must conclude then that the above described approach, consisting in that the tax base measurement and the annual financial statements have different purposes and therefore cannot coincide, leads to a circular reasoning and thus to a falsification. The tax law wants the tax base to equal the ability to pay taxes; The

²⁹ GREGORIO, *op. cit.*, p. 43.

³⁰ EDEY, *Income and the valuation of stock in trade*, British Tax Review, 1962, p. 165; GREGORIO, *op. cit.*, p. 347.

³¹ Financial scholars in general do not agree with this view: NEEDLES/ POWERS/ CROSSON, *Principles of Accounting*, 10th ed., London, 2007, p. 186; ELLIOTT/ELLIOTT, *Financial accounting and reporting*, 12th ed., Harlow, 2008, p. 3.

³² MOXTER, *Bilanzlehre, Band I, Einführung in die Bilanztheorie*, 3^a ed., Wiesbaden, 1984, p. 26.

³³ CREZELIUS, § 5, in Kirchhof, *EStG Kompaktcommentar*, 2nd ed. Heidelberg, 2002, p. 324.

³⁴ HENRICHS, *Bilanz- und Steuerrechtliche Aspekte der sogenannte Scheinauslandsgesellschaften*, in Berger, *Zivil und Wirtschaftsrechts im Europäischen und Globalen Kontext*, Berlin, 2006, p. 392; CREZELIUS, *op. cit.*, p. 324; LANG, *op. cit.*, p. 237; REUTER, *op. cit.*, p. 28; D'IPPOLITO, *I principi contabili razionali ed i principi contabili de comune accettazione*, Riv. Dot. Com., año XXVI, 1975, p. 869; ONIDA, *Il bilancio d'esercizio nelle imprese e la sua "standardizzazione" e "certificazione"*, Rivista dei Dottori Commercialisti, 2, 1974, p. 233; COLOMBO, *Il bilancio d'esercizio*, in COLOMBO/PORTALE (dir.), *Tratato delle Società per azioni*, Vol. 7, Turin, 1994, pp. 38-39; FERRARA/CORSI, *Gli imprenditori e le società*, Milan, 1978, p. 564; SALDANHA SANCHES, *A quantificação...*, *cit.*, p. 242; PITA, *Direito aos lucros*, Coimbra, 1989, pp. 50 et seq.

³⁵ Stickney et al, *Financial Accounting: An Introduction to Concepts, Methods and Uses*, Mason, 2010, p. 145.

commercial accounts aim to determine the net assets value and the changes in that value (net income) over an accounting period, which matches the notion of ability to pay in a tax on capital income. In order to judge about the fittingness of commercial accounts as a tax base, we suggest that instead of comparing purposes, it is necessary to compare the features that the tax base and the commercial financial measurement must possess in order to serve adequately their respective purposes.

4. The required features of tax and commercial/financial accounting income

It has been observed that the most important variable features of financial measurement for commercial and tax purposes concern time issues³⁶, meaning that it is always possible to choose different moments to place financial facts, involving a probability judgement³⁷. We would dare add that these timing differences lead to different degrees of liquidity (“realization”) in income. So basically, different forms of financial measurement lead to concepts of profit that differ from each other on its liquidity or realization. If a conservative concept, based on prudence, is adopted, the result will be a low risk, highly liquid net income³⁸. Such income measurement will assign the business creditors a high level of protection³⁹, while incurring the risk of undervaluing the net assets, originating hidden profits⁴⁰. Hidden profits can be highly harmful to some interests connected with financial accounting, namely by showing a business selling price lower than the fair value⁴¹. On the other hand, when a less conservative concept of profit is adopted, the result will be a low liquidity, high risk profit for the uncertainty associated to some of the disclosed values. Such income measurement is more favourable in terms of stewardship evaluation and anticipates the possibility of dividend payment, which may be convenient for some interest groups. On the other hand, a risk is incurred of transmitting to the public an overestimated business selling price and of

³⁶ SCHÖN, *International...*, cit, p. 437; WEINMAN, *Conformity of tax and financial accounting*, Taxes, 7, 1981, p. 420; ONIDA, *op. cit.*, p. 207.

³⁷ GIOVANNINI, *op. cit.*, p. 595; THIEL/LÜDTKE-HANDJERY, *op. cit.*, p. 198.

³⁸ MAYR, *CCCTB: Der Steuerpflichtige Unternehmensgewinn- gemeinsame Strukturelemente*, in SCHÖN/SCHREIBER/SPENGLER (eds.), *A Common consolidated tax base for Europe*, Berlin, 2008, p. 88; HENO, *Jahresabschluss nach Handelsrecht, Steuerrecht und internationalen Standards*, 5th ed., Heidelberg, 2006, p. 69; THIEL/LÜDTKE-HANDJERY, *op. cit.*, p. 132.

³⁹ WEBER-GRELLET, *Bilanzsteuerrecht... cit*, p. 24.

⁴⁰ COLOMBO, *op. cit.*, pp. 195 et seq.; HENO, *op. cit.*, pp. 188-189.

⁴¹ COLOMBO, *op. cit.*, p. 195.

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weakening the creditors' guaranty. In addition, it may be observed that a conservative way of measuring income favours internal and banking business financing over capital markets, whereas a less conservative income measurement favours capital markets. In fact, a conservative accounting will end up by creating hidden reserves that are in fact undistributed profits that will eventually be reinvested internally. On the other hand, these hidden reserves are easily perceptible by credit institutions who will give credit on that basis. On the contrary, hidden reserves have no effect at all on stock markets, as common investors cannot perceive their existence.

It is well known that the classical commercial law has achieved a synthesis between these two vectors – the conservative and the optimistic⁴² ones – by means of the prudence principle, understood as a criterion to determine the income that can be distributed⁴³ and the net assets value, while minimizing the risk transferred to third parties⁴⁴, as most transactions take place on the basis of those conservative values. It may be worth note that the prudence principle is an instrument for the capital maintenance principle⁴⁵, which does not mean that the company capital must be maintained, but that dividends can only be paid when, as a consequence of dividends payments, the business capital will not follow under equity capital⁴⁶, since this would mean that equity would have been distributed in a covered way, instead of net income.

If it is so, we may say that prudence is required by the concept of income itself, since the economic concept of income is based on the idea of preservation of the source generating income⁴⁷ and since there is an uncertainty ratio surrounding income determination that cannot be eradicated. The prudence principle could only be removed if income measurement, by some scientific advance in finance, would become possible

⁴² BORDEWIN, *op. cit.*, p. 669.

⁴³ HENNRICHS, *op. cit.*, p. 392.

⁴⁴ THIEL/LÜDTKE-HANDJERY, *op. cit.*, p. 132.

⁴⁵ WILHELM, *Kapitalgesellschaftsrecht*, 2nd. ed., Berlin, 2005, p. 103; HENNRICHS, *op. cit.*, p. 392; VEIL, *Das System der Kapitalrichtlinie versus Situative Ausschüttungssperre*, in Lutter (ed.), *Das Kapital der Aktiengesellschaft in Europa*, Berlin, 2006, p. 92.; GIOVANNI, *La Distribuzione degli utili agli azionisti ordinari nell'esperienza anglo-americana (profili comparatistici)*, *Rivista delle Società.*, Vol. XIX, 1974, p. 166.

⁴⁶ On the point, SCHÖN, *The future of legal capital*, *European Business Organization Law Review*, 5, 2004, pp. 429 *et seq.*

⁴⁷ HOLMES, *op. cit.*, p. 86.

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to measure with absolute certainty, which it is not yet. It seems to be no doubt that this same principle must be incorporated in the tax income concept, because a tax that produced a depletion of the income source would be unsustainable and confiscatory.

The principles described above have formed the basic features of income measurement both for commercial⁴⁸ and tax purposes⁴⁹. Sometimes tax law was viewed as less conservative than commercial accounting, in the sense that the prudence principle had a weaker weight in tax law than it had in commercial law. In fact, tax law has always set limits to prudence, but did this in order to avoid evasion, so in order to prevent tax income from departing from real income. So this cannot be interpreted as a less conservative concept of income. In other aspects, at least in recent times, tax law was more conservative than commercial law, as in the field of fixed assets revaluation at fair value.

5. The alleged weakening of the prudence principle in the IAS/IFRS system

But the European context of commercial accounting law has markedly changed recently, following the incorporation of IAS/IFRS in the European commercial law, making it pertinent to question whether the prudence principle remains a core feature of the current European commercial accounting law and, consequently, of national law. A part of the legal academy has affirmed an essential incompatibility of IAS/IFRS with the prudence principle⁵⁰. Concerning this point, it must be observed that, first of all, the prudence principle cannot be considered excluded at all from IAS/IFRS⁵¹, although it

⁴⁸ COLOMBO, *Il Bilancio...*, cit., 1994, p. 181; GREGORIO, *op. cit.*, p. 54; LUTTER, *Europäisches Unternehmensrecht*, 4^a ed., Walter de Gruyter, Berlin, 1996, p. 50.

⁴⁹ SPENGLER, *International...*, (I), cit., p. 30.

⁵⁰ WENDT, C., *A Common tax base for multinational enterprises in the European Union*, Manheim, 2009, p. 115; BIELEN, *op. cit.*, p. 479; BAUMGÄRTEL, *Taxation, accounting and transparency: The interaction of taxation and financial accounting*, in SCHÖN (ed.), *Tax and corporate governance*, Heidelberg, 2008, p. 95.

⁵¹ EUROPEAN COMMISSION, DIRECTORATE-GENERAL MARKET, *Examination of the conformity between IAS 1 to IAS 41 and the European Accounting Directives*, Brussels, 2001, p. 9: “the application of prudence remains one of the main principles for ensuring the achievement of fair presentation under the Directives”.

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might be mitigated in some specific situations⁵². It can be found, concretely, in the so called “imparity principle”⁵³. The “fair value” criterion itself cannot be seen as radically opposed to prudence, as the application of the fair value criterion requires strict requisites aimed at guaranteeing certainty in the valuation at fair value.

On the other side, concerning the definition of income, there can be no doubt that by adopting the possibility of valuating some assets at fair value, the IAS/IFRS normative system gives room to a more prospective conception of income⁵⁴ making it possible to come to a more unrealized income⁵⁵. It is necessary though to understand that a “more prospective income” means just a least liquid income, in the sense that assets not sold yet are being valued by its market (exit) value. Fair value is not a measurement criterion that consents a higher margin of error in income measurement, it is a measurement criterion that consents the recognition of a least liquid income. In this sense, it is valid to conclude that a distribution of business assets, in the form of dividends or other any other form, which are not covered by a real accretion in net assets, are prohibited within the IAS/IFRS normative system⁵⁶.

Table 1
The impact of the first time IFRS adoption in Portugal in Euronext Lisbon indexed corporations

Negative impacts		Positive impacts	
Benefits to employees (IAS 19)	– 1, 954 M€	Deferred taxes	1 061 M€
Tangible assets (IAS 16)	– 1,037 M€	Provisions	787 M€
Intangible assets (IAS 38)	– 426 M€	Consolidation differences	551 M€
Postponed costs (new timing rules)	– 358 M€	Good will	238 M€
Financial instruments (IAS 39)	– 274 M€		
Labour costs (new timing rules)	– 127 M€		
Equity	– 10,29%		
Comprehensive income	– 5,82%		

Source: PricewaterhouseCoopers, Lisbon, 2009.

⁵² HOLE, *Revenue recognition*, British Tax Review, 2, 2003, p. 79; GURTNER, *Nueve Rechnungslegung- Prinzipielle Massgeblichkeit oder eigenständige Steuerbilanz?*, ASA/Archives, 1/2 2000, p. 74.

⁵³ PEZZER, *op. cit.*, pp. 23-25; TIPKE/LANG, *Steuerrrecht...*, 18^a ed., *cit.*, pp. 658-659.

⁵⁴ BIELEN, *op. cit.*, p. 477.

⁵⁵ TABELLINI, *op. cit.*, p. 354; BIELEN, *op. cit.*, p. 482.

⁵⁶ OESTREICHER/SPENGEL, *op. cit.*, p. 594.

6. The issue of what is income under the IAS/IFRS system

But the problem of comparing tax and commercial/financial income has become now more complex under the IAS/IFRS system, than simply comparing the basic measurement features. Since “Schanz-Haig-Simons” comprehensive definition of income, it has been accepted that income is the net assets accretion over a period⁵⁷. Most tax laws have fully incorporated this concept of income, as opposed to source-income⁵⁸. The fact that non realized gains were not taxed as a general rule, does not invalidate this assertion. The exclusion/inclusion of unrealized gains in income does not connect directly to the amplitude of the concept of income – source-income *v.* accrual-income – but rather to the timing element of income – “when is income considered to be accrued?”. The accruals concept of income means that any net assets accretion is income, whenever they occur⁵⁹. Realization is a criterion to define when an accretion is to be taken into account for some legal effects, namely dividends payment and taxation. In accordance with the accretion concept of income and the “balance theory” it was assumed for more than a century that any net assets accretion is income regardless of whether it is recognized through profit or loss or directly in equity.

This concept of income remains valid under IAS/IFRS, since all net assets accretions, either recognized in profits or loss or in equity, are to be included in the “comprehensive income for the period” (IAS 1). Accretions that have been imputed directly to equity are identified (IAS 1, 106), although this identification may not be very perceptible by non-experts external users of the information contained in the statements.

As to fair value accretions⁶⁰, according to the IAS/IFRS regulations, some of them are recognized through profit or loss, while some other are to be reflected directly in equity. The separation of the two situations – recognition through profit or loss and recognition through equity – seems to be based on a liquidity criterion. Only for liquid or quasi-liquid assets, fair value accretions must be recognized through profit or loss. It is the case of investment immovable property (IAS 40), which can only be valued at fair value

⁵⁷ HOLMES, *op. cit.*, p. 147.

⁵⁸ BURNS/KREVER, *op. cit.*, p. 599.

⁵⁹ ALEXANDER, *Systemic bank restructuring and macroeconomic policy*, Washington D.C., 1997, p. 147.

⁶⁰ Fair value decreases or losses are more often recognized in profit or loss by virtue of the imparity principle.

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when there is certainty about the market price, what supposes that it would be easy for the entity to sell the assets, held for investment, at the recognized value. It is also the case for biological assets and financial instruments held for trading, amongst very few others⁶¹. So fair value accretions, either recognized through profit or loss or in equity, are always part of “the comprehensive income of the period”.

Before the introduction of IAS/IFRS in European commercial accounting law, Art. 15(1) (a) of the Second Directive provided that “[...] no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes”. At that time, and for this effect, the “net assets” value was measured in a conservative manner, based on realization (according to Art. 31(1) (c) (aa) of the Fourth Directive, revenues may only be shown when they are “made” or “realized”). By the combination of these two provisions, only realized income could be distributed. Presently, the first provision is still in force. But as many accretions are recognized at fair value and directly in equity, the “net assets value” referred to in article 15(1) (a) of the Second Directive – which is central to the limiting of value available to distribution - is measured largely at fair value. So the distribution of assets valued at fair value is possible without compromising Article 15(1) (a) of the Second Directive. And there is not any provision in the European commercial accounting law banning the distribution of accretions not realized or recognized through profit or loss. So under the IAS/IFRS system it is possible and actually very easy to distribute not realized income, i.e. accretions measured at fair value.

Domestic commercial law can impose some restrictions on the distribution of income directly recognized in equity. For instance, in Italy, a statute provision enacted in 2005 (Decreto Legislativo n. 38/2005, Art. 6) prohibited the payment of dividends out of reserves resulting from “fair value” revaluations. The Portuguese commercial legislation prohibits the distribution of dividends out of assets accretions recognized at fair value. In Spain, the “statement of income for the period” remains a “profit or loss account” in the sense of article 2 of the 4th Directive, from which accretions not reflected through

⁶¹Cfr. the study from Báez Moreno, “El ‘valor razonable’ y la imposición societaria”, Nueva fiscalidad, 10, 2006, pp. 89-188.

profit or loss are excluded⁶². So net assets accretions directly imputed to equity cannot be distributed.

The aspects described above should be decisive when we approach the relationship between accounting and taxation, and somehow make the above discussion around different measurement features meaningless. Because notwithstanding the differences between several income concepts, the classical assertion that income good enough to be distributed is also good to be taxed remains unrebutted⁶³. So if there is no restriction on the distribution of income recognized directly in equity – unrealized income – it is legitimate for the tax legislator to submit to tax all distributable income, at least.

III. Does a formal linkage system require aligning taxable income and accounting income under IAS/IFRS?

1. Allowing different concepts of income within a “formal linkage” rule

Until this point, we tried to demonstrate that the commercial/financial accounts concept of income is still largely based on prudence and therefore is adequate to be used as a tax base. Income measured under IAS/IFRS is real income although it may be partly unrealized income. But even when this is not accepted, there is a second rationale for tax law to set down a “formal linkage” rule, which is the role played by the annual accounts in proving the truth of subjective judgments made for tax purposes. If we want the tax law to rely on this proof – which is a *conditio* for keeping real income as the base of corporate taxation - a “formal linkage” must be maintained. We will try to demonstrate now that a “formal linkage” can be maintained even if a marked divergence between commercial income and taxable income would be judged necessary.

⁶² GADEA, *La reforma del impuesto sobre sociedades de 1995 y su proyección en el tiempo*, in “*La reforma del Impuesto sobre sociedades de 1995 y su proyección en el tiempo*”, in ONDARZA/LOUSA/RUIZ (eds.), *El Impuesto sobre sociedades*, 2nd. ed, Madrid, 2010, p. 18. Commercial Code, Art. 35, 2.

⁶³ QUARTA, *Commento alla legge sull'imposta di ricchezza mobile*, II, Milán, 1902, p. 222; BECKER, *Zur Frage, ob die vom Kaufmann für die Besteuerung des Einkommens eingereichte Bilanz berichtigt oder geändert werden kann*, *Steuer und Wirtschaft*, 1929, p. 24; more recently, NABAIS, *Direito fiscal*, 2nd. ed., Coimbra, 2003, p. 173.

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It is well known that the tax law does not take commercial profit at its face value, but submits it to a series of adjustments, according to its own *special* valuation and qualification rules. It is also well known that these special rules are usually applied through an extra-balance sheet mechanism, which means that some valuations are changed, without these changes having any effect on the balance sheet.

These adjustments sometimes are applied within the “formal linkage” rule and some other times they break the “formal linkage”⁶⁴. To understand what is on the basis of these two situations it is helpful to make a distinction concerning the special tax norms, dividing them in two categories: i) tax norms that aim to measure the real income; ii) and tax norms that aim to exclude certain portions of real income from the tax base.

Norms of the first category are aimed at determining a real economic income, but setting up limits with anti-avoidance purposes, reducing uncertainty and discretion that are typical of commercial accounting norms (although these norms are often seen as causing distortions of true and fair view of commercial accounts, in fact it is entirely the opposite, because, if it was not for these limits, in the presence of a “formal linkage”, distortion of commercial accounting true and fair view aimed to achieve a better tax position would tend to be much higher). By reducing discretion and indetermination, these rules cannot be considered as totally compatible with commercial law, since there are at least a number of solutions possible according to the commercial norm that are not possible according to the tax norm. Being so, the legislator must allow some room for an extra-balance sheet adjustment.

The second category concerns tax incentives⁶⁵. These norms do not aim to determine a real economic income but to withdraw a part of real income from the tax base, in order to achieve extra-fiscal purposes.

⁶⁴ Exceptions to the “formal linkage” can be of different types: i) The tax norm can limit the application of the formal linkage to cases in which qualification and valuation options made in commercial accounts are in conformity with commercial accounting regulations; ii) The tax norm can limit the application of the formal linkage to cases in which qualification and valuation options made in commercial accounts fit the range of options set in the tax law itself; iii) The tax norm can exclude particular situations from the “formal linkage”, v.g. tax incentives (AGUIAR, *Tributación...*, *cit.*, pp. 415 et seq.)

⁶⁵ BORDEWIN, *op. cit.*, p. 668; LEUCHT, *Die umgekehrte Massgeblichkeit und ihre geplante gesetzliche Neufassung*, *Der Betrieb*, 45, 1989, p. 2237; SCHMITZ, *Massgeblichkeitsprinzip und*

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These two types of special tax norms must be coordinated with the “formal linkage” differently from each other. As to the second category, these norms require a break with the “formal linkage” rule, since doing otherwise would involve an interference of tax norms on the balance sheet and none of the “formal linkage” rationales described apply in this case. However, requiring the formation of a committed reserve for these cases should not be seen as misrepresenting the truth of commercial accounts and sometimes the legislator may have reasons to make that requirement. Mandatory reserves can never be a misrepresentation of true and fair view; they just restrict shareholders freedom regarding the employment of the business assets. As to the first category of special tax norms, they can be applied without any break of the formal linkage rule and without distorting commercial accounts either, even when the tax legislator accepts to tax an income different from the financial accounting “comprehensive income”. The only condition to achieve this is that the tax accounting system and the commercial accounting system adopt the same basic concepts and classification structure.

An example of how this can be achieved is the Spanish law. According to article 19.3 of the Corporate Tax Code, no cost will be allowed to be deducted against the tax base if it has not been deducted in commercial accounts of that or of a previous year (“formal linkage”); and any income disclosed in commercial accounts must be included in the tax base of the same or of a previous year. With these two rules, income can be anticipated unlimitedly for tax purposes but never deferred, regarding the moment when costs and income have been disclosed in commercial statements.

Examples:

1)

The tax rule allows a maximum amortization of 100; in the balance sheet the amortization is of 50; By virtue of the “formal linkage” rule, the tax amortization cannot exceed 50. The tax cost will equal the accounting cost; the balance sheet will not be affected by the “formal linkage”. Commercial and tax income will coincide.

2)

The tax rule imposes a maximum amortization of 100; in the balance sheet the amortization is of 150; by virtue of the “formal linkage” rule, the tax amortization cannot exceed 100; the balance sheet will not be affected by the “formal linkage”, since tax income is being anticipated in relation to commercial accounts. Commercial and tax income will not coincide.

Steuervergünstigungen, Der Betrieb, 1, 1986, p. 14; FALSITTÀ, *op. cit.* p. 6; ROCH, *Incentivos a la inversión y Justicia Tributaria*, Madrid, 1983, p. 64.

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3)

The tax rule, concerning a given economic fact, imposes recognizing a minimum income of 100. In the balance sheet the income is of 50; by virtue of the “formal linkage” rule, the tax income will be of 100. The balance sheet will not be affected by the “formal linkage”, since income is being anticipated in relation to commercial accounts. Commercial and tax income will not coincide.

4)

The tax rule, concerning a given economic fact, imposes recognizing a minimum income of 100. In the balance sheet the income is of 150; by virtue of the “formal linkage” rule, the tax income will be of 150. The tax income will equal the accounting income; the balance sheet will not be affected by the “formal linkage”. Commercial and tax income will coincide.

The previous examples intend to show that a wide latitude for divergence between commercial annual accounts and taxation is possible, while maintaining the “formal linkage” intact at the same time. Although the example was chosen from the Spanish system, the situation is quite similar in many other European tax systems. Allowing wide latitude for divergence between commercial annual accounts and taxation while maintaining the “formal linkage” intact at the same time may be justified by the proof function that commercial accounting accomplishes for corporate tax, regarding accounting discretionary judgments.

2. Dealing with fair value within a “formal linkage” rule: the examples of Italy, Portugal and Spain

Italy, Portugal and Spain have well established “formal linkage” systems. In Italy and Spain the legal formulae used by the legislator are very much alike. In Portugal, jurisprudence has played a more prominent role defining the rule. Following the entry into force of the Regulation (EC) 1606/2002, reforms occurred in the commercial accounting regulations in the three countries, by which either domestic accounting regulations have been largely adapted to the IAS/IFRS, or the IAS/IFRS system was made applicable to situations beyond those of mandatory application after the Regulation (EC) 1606/2002. The result, in any case, is that now a number of corporations and other types of business entities in all the three countries can apply either IAS/IFRS directly or IAS/IFRS-based domestic rules to prepare their individual annual accounts⁶⁶. In this section, we propose to look in particular at how these systems

⁶⁶ Vd. for Italy Zizzo, *La questione fiscale delle società che adottano i principi contabili internazionali*, in Beghin (ed.), *Saggi sulla riforma dell'IREES. Dalla relazione Biasco alla finanziaria 2008*, Milan, 2008, p.

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deal with coordination the IAS/IFRS fair value criterion with the “formal linkage” rule, and show at the same time that technically it is possible and relatively easy to conciliate wide divergences between two different ways of measuring income with the maintenance of a “formal linkage” in tax law.

In Spain, fair value changes are sometimes recognized through profit or loss and other times directly in equity (Commercial Code, Art. 38. bis., 3). By other side, the IAS 1, on “Presentation of Financial Statements” was only partially incorporated in the Spanish accounting law, as well. One of the most important differences concern the “statement of income for the period” which in Spain remains a “profit or loss account”, from which accretions not reflected through profit or loss are excluded⁶⁷.

At the tax level, value changes measured at fair value are not included in the tax base unless recognized through profit or loss (art. 15.1 of Corporate Tax Code). In synthesis, in the Spanish law:

- Commercial accounting law admits measurement at fair value in a few cases;
- In these cases value changes are recognized sometimes through profit or loss and other times in equity;
- Business entities include in their annual accounts a “profit or loss account” in conformity with the 4th Directive, which means that value changes imputed directly in equity are not included in the profit or loss statement, so annual accounts show only a realized profit;
- The corporate tax base is calculated on the basis of this profit;
- Fair value-related value changes directly imputed in equity do not affect the tax base.

In Italy, the IAS/IFRS system was adopted in commercial law with broader amplitude than in Spain, meaning that a wider use of fair value in individual accounts is available. Any corporation other than those who are legally allowed to submit an abridged balance sheet can prepare their individual annual accounts under IAS/IFRS (Decreto legislativo

135; for Spain, PEDREÑO, *Guía práctica del Plan General Contable*, 2^a ed., Valladolid, 2008, p. 23; AMAT, *El nuevo Plan General de Contabilidad*, Harvard Deusto Finanzas y Contabilidad, 76, 2007, pp. 12-23.

⁶⁷ GADEA, *op. cit.*, p. 18. Commercial Code, Art. 36.2, § 2.

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n. 38/2005, Art. 1). Being so, IAS/IFRS adopters must organize their statements according to IAS 1, which means that they do not disclose a “profit or loss account” (in the sense of the 4th Directive), but a “statement of comprehensive income for the period” which includes accretions directly imputed in equity. But income directly imputed in equity corresponding to accretions resulting from fair value changes cannot be distributed to shareholders and must be taken to a “committed reserve” (“riserva indisponibile”) (Decreto legislativo n. 38/2005, Art. 6).

On the tax level, article 83 of the Tuir⁶⁸ (Income Tax Act) provides that the profit or loss account is what is determinant to calculate the tax base. The same provision says that for an IAS/IFRS taxpayer, the profit computed in conformity with IAS/IFRS is determinant to calculate the tax base as well. So no distinction is made, concerning the “formal linkage”, between IAS/IFRS adopting and non-adopting taxpayers. A governmental regulation (decreto n. 48. 1.4 2009, art. 2.2(2)) says also that the gains and losses imputed directly in equity are computed to form the tax base. So in Italy, as a general rule, IAS-based commercial income and IAS-adopters tax income match each other, notwithstanding possible extra-accounts adjustments.

Portuguese accounting law was deeply reformed two years ago. By this reform, a full incorporation of IAS/IFRS in the domestic accounting regulations was accomplished, except for small and medium enterprises. Consequently, corporations do not apply IAS/IFRS directly in individual accounts but, except for small and medium enterprises, they do apply the same principles and rules through IAS/IFRS-based domestic regulations. Measurement at fair value is accepted in quite the same terms as in IAS/IFRS.

The commercial accounting income of the period as a general rule is preclusive for the calculation of the tax base (formal connection) (Art. 17 of Corporate Tax Act, CIRC). As a general rule (art. 18.9 CIRC), fair value-related value changes are not considered for tax purposes. There are the following exceptions:

- Value changes in financial assets recognized through profit or loss according to IAS 39;

⁶⁸ Testo unico delle imposte sui redditi.

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- Agricultural products, according to IAS 41.

On these exceptions, we can say that the taxable income is mostly a realized income, and in any case it is a highly liquid income. So there are obviously important differences between the commercial accounting income, which is a “comprehensive income of the period” computed according to IAS 1, and the taxable income. According to article 17.3 (b), commercial accounts must be organized in a way that make these differences “easily perceptible”. This later provision is formulated in unclear and improper terms, regarding the autonomy of commercial accounting law towards the tax law. But it expresses, although in improper terms, a legitimate legislative intention, which is demanding the taxpayer to offer the administration information that allow distinguishing any income elements that must be object of extra-accounting adjustments.

Finally, according to commercial law (art. 32.2 Commercial Code), fair value-related accretions recognized directly in equity cannot be distributed. Hence, there is a divergence not only between accounting income and taxable income but also between accounting income and distributable income.

Conclusion

The relationship between commercial/“financial” accounts and taxation is an issue of social relevance. The great flexibility of commercial accounting regulations, assigning large discretionary powers to accounts maker (business administrator) regarding valuation of financial facts, allows the accounts maker to show an income highly illiquid or even fictitious. The immediate consequence of this is the possibility of paying dividends on illiquid or fictitious income. This procedure will provoke enterprises’ decapitalization. Following a silent and unnoticed decapitalization process, the most likely result is that one day workers and creditors will wake in the morning to know that the enterprise they rely on to get daily salary and which has just distributed high dividends is now on bankruptcy, as capital pertaining to the enterprise and which was necessary to maintain the business going on, flew to shareholders.

Commercial law has at least since early 19th century prevented this possibility by means of the realization principle, stating that income can only be distributed in the form of dividends upon realization. This was just a legislative decision concerning distribution

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of business assets, not so much related with a fundamental assumption regarding how to measure income. This legal solution helped preserving the source of income. The tax law adhered to this “distributable income” formula, so tax income was linked to commercial income. This “formal link” to commercial annual accounts procured tax law an accurate measure of ability to pay taxes and a means of proof regarding the discretionary accounting judgements made in accounts submitted to tax administration.

In the meanwhile, pressure from accounting-related professional sectors has persistently risen claiming for a way of measuring income that showed the business assets fair value, i.e. their market value. This may be important to business owners because it makes it easier to obtain funds in stock markets in some cases. But it may be even more important to business managers because it allows showing the net business net assets accretion achieved in any period and connect this achievement with management decisions. Anyway, this view is not much concerned with capital maintenance. It has though progressively convinced the public opinion, partly because the economic-social context is favourable to it. In a time when stock markets are so popular and making money seems so easy, people feel easily attracted to any speech about economic efficiency, investment, growth, etc.

IAS/IFRS reflect the above referred view; IAS/IFRS normative system is intended to show income in real time, embracing radically the S-H-S comprehensive concept of income. The problem of this system does not concern how income is measured but when income is allowed to be distributed. Commercial law, in some countries at least, is overcoming this problem by prohibiting the distribution of unrealized income, in conservative reaction. This gives rise to a sort of schizophrenia in commercial law, as it allows showing a “comprehensive income” including unrealized income but do not allow this comprehensive income to be distributed (this is the Portuguese case). But there is a problem with taxation apparently more difficult to overcome, since showing an income unrealized to a great extent entails taxation on unrealized income. So the same who have persistently claimed for an accounting normative system allowing showing and distributing unrealized income are now claiming for the end of tax “formal linkage” and they are being convincing as usual. To justify the claim, it is argued that commercial/financial accounting and taxation purposes do not match. This argument has no valid foundations and is a falsification. The basic assumption that income good enough to be distributed is also good to be taxed was never falsified, thus remaining

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true. Besides this argument, which concerns ability to pay taxes, there is a second crucial reason for tax law to maintain the “formal linkage” rule, which lies on the proof function that annual accounts have regarding the truth of discretionary judgments. Thus the end of the “formal linkage” would most certainly mean the end of corporate taxation. Aware of this, tax legislators have developed formulae that consent the tax income to widely diverge from commercial income, while maintaining the “formal linkage” intact.