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## Narrowing the Gap between Tax Law and Accounting

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**Narrowing the Gap between Tax Law and Accounting**

Humayun Chaudhary

A DISSERTATION SUBMITTED TO  
THE FACULTY OF GRADUATE STUDIES  
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS  
FOR THE DEGREE OF  
DOCTOR OF PHILOSOPHY

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YORK UNIVERSITY  
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## ABSTRACT

Accounting income and taxable income are both designed to capture the economic activities of an entity based on their own rules and assumptions. Despite all the differences in reporting objectives and measurement methods, accounting income forms the starting point for determining taxable income. This suggests that much of accountants' use of consistency and matching principles flows through to the legal measure of taxable income. This thesis argues that the principles in some select areas of financial reporting can be sanctioned more explicitly and enacted into the *Income Tax Act (ITA)* in determining the taxable income of corporations. It also recommends a new reporting schedule that requires taxpayers to disclose greater reconciliation between accounting and taxable incomes in a limited number of areas subject to any statutory or legal provisions to the contrary.

The book–tax income gap can be divided into two components: a conceptual gap in computing income or profit and a second gap arising from policy-based deductions and/or aggressive tax planning. The conceptual gap is mostly due to different rules for the calculation of income based on section 9 of the *ITA* and case law in contrast to the rules for calculating book income based on accounting principles, such as International Financial Reporting Standards (IFRS). The second type of gap arises due to policy-based deductions in the *ITA* that may allow for more or less generous deductions or write-offs compared to accounting rules. This gap can also be caused by aggressive tax planning.

This thesis contributes to the literature by exploring economic, accounting, and legal definitions of income in a setting with more recent business transactions. It estimates the gap between accounting income and taxable income based on the historical data of Canadian companies and the reasons why they may have diverged in recent years. It also argues why narrowing the gaps may be desirable – at least in some select areas. While this study was being conducted, the federal government introduced an elective mark-to-market regime for derivatives – an illustration of one of this dissertation's recommendations.

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# 1 Introduction

Income is calculated differently for accounting and tax compliance purposes. Accounting income is calculated based on accounting principles, such as generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS) or Accounting Standards for Private Enterprises (ASPE).<sup>1</sup> Revenues are recognized and expenses deducted therefrom according to accounting rules that ascertain income before taxes (hereafter referred to as income). This accounting or book income is reported to shareholders, investors, and the general public in the form of financial statements.

Taxable income for the purposes of determining statutory taxes payable is calculated using the statutory provisions legislated in the *Income Tax Act (ITA)* and the legal precedents developed by the courts. Taxable income for tax purposes is determined after deducting allowable expenses from gross revenues – as dictated by statutory provisions and case law.

The book–tax income gap represents a difference between financial accounting income and taxable income. This gap gives rise to a difference between tax expense or taxes payable as shown on the financial statements and the actual income tax paid to the tax authorities. The existence of this gap and the diverging trend in this gap over time suggests that businesses may be able to enjoy the best of both worlds: appear successful to their shareholders and creditors while appearing less successful to the tax authorities.

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<sup>1</sup> Companies listed on stock exchanges are required to have audited financial statements and make them publicly available. In Canada, these publicly traded firms need to report quarterly and annual financial statements using IFRS. Private companies in Canada need to report using ASPE. In the US, the corresponding standards are GAAP. This dissertation will use the generic GAAP to imply all forms of accounting standards.

There are two major types of gaps between taxable income for tax purposes and accounting income as calculated under GAAP. The first one is a conceptual gap in computing income or profit. Section 9 of the *ITA* and case law are often different from accounting principles used to calculate income. Examples of this gap include differences between accounting measurement principles and tax statutory provisions in areas such as hedging, mark-to-market, and percentage-of-completion. Principles for measuring accounting income rely more on accrual methods (to be explained later), whereas statutory tax provisions and case law rely more on the realization principle. The realization principle requires cash flows to be received before income taxes can be imposed on the underlying net income since cash is necessary to fulfill tax obligations. This realization principle is a foundational principle embedded in tax law, and judges often refer to it as a tax law principle.

Unlike tax law, accounting attempts to capture and reflect the time series of periodic reported incomes to stakeholders so that shareholders and creditors can assess the growth (or lack thereof) and performance trend over time using measurement principles that are consistently applied. In contrast, tax law has limited interest in consistent application of income or profit measurement methods over consecutive time periods. The fact that tax statutes and case law change all the time illustrates that tax authorities have limited interest in maintaining consistent income determination methods.

One measurement method that accountants rely on for the consistent reporting of accounting standards is the accrual principle. The accrual measurement method is based on the matching principle and attempts to match expenses to the revenues recognized (or “earned”) in a given period regardless of whether the cash flows were paid or received in that period. This makes the accrual principle diametrically different from the realization principle relied upon by

the tax statutes and case law and partly explains why the conceptual book–tax gap arises. Examples of applications of the matching principle or accrual accounting can be found in areas such as hedging, mark-to-market, and percentage-of-completion. Chapter 2 will elaborate on how this conceptual gap in computing profit may be narrowing over time as recent case law incorporates more accounting rules to determine income for tax purposes.

The second type of gap arises due to policy-based tax deductions that may allow more (or less) generous deductions or write-offs (e.g., capital cost allowances) due to tax policy reasons. This gap also arises as a result of aggressive tax planning as will be illustrated in the second half of Chapter 2. This type of gap seems to be diverging or growing over time and may be difficult to fix even if it is desirable to fix the gap.

Tax authorities would and should be reluctant to give up their key policy lever of offering capital cost allowances, for example, that are different from accounting depreciation rates under GAAP. Therefore, any gap resulting from these dual measurement methods may not necessarily be a concern, nor is it something that could, feasibly, be fixed. Chapter 2 offers evidence of this gap from the literature and from primary empirical evidence and analysis done for this dissertation.

After describing the two types of gaps, Chapter 3 presents reasons why the conceptual gap (the first type) should be narrowed, the problems in narrowing it, and the issues arising if it is not narrowed. The chapter starts with a discussion of the ideal notion of income and the ideal tax base envisioned by the Carter Commission. Carter considered economic income as being closer to reflecting a taxpayer's ability to pay income taxes. I argue that accounting income may better

reflect the notion of Carter's ideal taxable base or economic income than the current notion of income determined by the statutory provisions and case law.

Chapter 3 goes on to propose specific ways of narrowing the gap by outlining how recent statutory provisions, such as paragraph 12(1)(a) and 20(1)(m), better reflect accounting conventions and how these provisions may narrow the conceptual gap. Court cases are analyzed to illustrate how judges are recognizing the merit of the accountants' matching principle in a wide range of areas such as hedging, employee stock options, and the percentage-of-completion method.

Chapter 4 presents reasons why the book-tax gap (the second type of gap) should be narrowed, the problems encountered in narrowing it, and the issues arising if it is not narrowed. Since this book-tax gap is driven by tax deductions that are policy-based, I will argue that it is more difficult to legislatively eliminate this gap since policy makers cannot be expected to give up their tax policy tools in driving economic growth.

This book-tax gap is also driven by taxpayers' aggressive tax planning. I argue for some disclosure about the book-tax gap, which, if required to be reported on a consistent basis and enforced, may shed some light on taxpayers' aggressive tax-planning behavior that may be useful to stakeholders, such as tax authorities, policy makers, employee groups, and groups advocating for corporate sustainability reporting (CSR). If carefully evaluated, such disclosure may also shed light on the effective tax rates (ETR) imposed on corporate income, which could contribute to the societal debate on horizontal and vertical tax equity.

Currently, corporations may be able to truthfully claim that they pay the very last cent in taxes that they owe under tax legislation without shedding any light on how much tax they

actually pay. They do not disclose the amount of income taxes they pay on the grounds that such disclosure would impair their strategic or competitive advantages. However, such lack of disclosure may be holding back the societal debate on horizontal and vertical tax equity.

The counterargument is that there may not be any need for more universal accounting disclosure since the Canada Revenue Agency (CRA) can always ask for more disclosure from relevant taxpayers. However, seeking such additional disclosure on a case-by-case basis is costly and cumbersome given the CRA's limited audit resources and can lead to greater tax litigation brought about by both taxpayers and the tax authorities. While there is no large-scale empirical evidence in this area, greater disclosure required on a consistent basis and enforced can curb some tax-aggressive transactions and tax litigation.

Chapter 5 summarizes and offers concluding remarks on why the gap between tax law and accounting exists, the types of gaps, the evidence for these gaps, why they need to be narrowed, the problems encountered in narrowing the gaps, and the problems encountered if they are not narrowed. The focus on solutions to the book-tax gap is highlighted. The issue of using selective accounting rules as tax principles is very eloquently summarized by D'Ascenzo and England:

...the real reform issue ...is probably not whether accounting profit and loss should form the starting point for tax purposes. It already does in practice to some extent. The real issue might be how to best structure and draft income tax law so as to use accounting concepts where it is sensible to do so, and to clearly identify where there are differences from accounting outcomes.<sup>2</sup>

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<sup>2</sup> Michael D' Ascenzo & Andrew England, "The Tax and Accounting Interface" (2005) 1:1 J of the Australian Tax Teachers Assoc 24 at 37. Also mentioned by Judith Freedman, "Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges" (2004) 2:1 eJ of Tax Research 71 at 77 (AustLII) [Freedman].

## 2 Two Types of Gaps

There are two types of gaps giving rise to the difference between income for tax purposes and accounting income. The first is a conceptual gap in computing income and arises due to differences between *ITA* section 9 and case law, on the one hand, and accounting principles, on the other. For example, tax law and court cases are more reliant on the realization principle, since cash flows need to be realized in order to pay the income taxes. In contrast, accounting principles rely more on the accrual principle which may reflect realizable values rather than realized values. Examples of areas giving rise to this gap include hedging, mark-to-market, and the percentage-of-completion method for recognizing revenues.

This conceptual gap between income for tax purposes and accounting income is therefore due to different rules followed by tax law and accounting, or due to timing differences that arise as a result of recognizing income in different time periods. The accrual principle can create a significant difference between book income and tax income as a result of differences in the recognition of income earned versus income received. Tax law and accounting use accrual accounting differently, thereby creating timing differences in the recognition of income and expenses.

The second type of gap between taxable income and accounting income arises due to policy-based deductions that may allow more (less) generous deductions or write-offs (e.g., capital cost allowances) during periods of low (high) economic growth. This gap also arises as a result of aggressive tax planning as will be illustrated later. This type of gap seems to be diverging or growing over time and may be difficult to fix even if some of the gap may be desirable to fix.

Tax authorities would and should be reluctant to give up their key policy lever of offering capital cost allowances that are different from accounting depreciation rates under GAAP, and therefore, any gap resulting from these dual measurement methods may not necessarily be a concern, or is it something that could, feasibly, be fixed.

## 2.1 The Conceptual Gap in Computing Income

The early days of taxation established that the profit of any business or trade is a surplus of receipts over expenses that are necessary to earn those receipts.<sup>3</sup> No specific rules, such as those provided by GAAP, were invoked. In contrast, accounting income has been calculated based on GAAP, which is, in effect, an extensive code. Under GAAP, recognition of revenues and expenses used to calculate net income is based on the foundational principle of accrual accounting. In general, accounting income becomes the starting point to calculate income for tax purposes, because, unlike GAAP, the *ITA* does not provide an elaborate set of rules.

For income tax purposes, income is recognized based on the realization principle (with some exceptions such as imputed interest). Profit is calculated by using well-accepted business principles provided that the method is not inconsistent with the provisions of the *ITA* or established case-law principles. These well-accepted business principles include, but are not limited to, GAAP.

Arguably, accounting and taxation are considered two different systems serving different purposes. Some fundamental legal principles established in the *Thor Power* case are still being

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<sup>3</sup> Francis E LaBrie, *Introduction to Income Tax Law Canada* (Toronto: CCH Canadian Limited, 1955) at 85 [LaBrie].



used to differentiate between accounting and taxation computations of income.<sup>4</sup> Although this case was decided based on tax laws in the United States (US), it is arguably applicable to all Anglo-Saxon countries where the tax system is independent of the accounting system. A thorough analysis of this case helps us to understand the conceptual gap between accounting and taxation. *Thor* established that accounting and taxation are two different systems with different objectives. The purpose of taxation is to collect revenues for the government, and the purpose of accounting is to provide information to investors about the workings of a company.

A sound tax system cannot be based on uncertainty; therefore, tax laws require that all events or transactions should be ascertainable. The ability to pay is a foundational principle of taxation based on the realization principle, since it establishes that the taxpayer has the cash to pay the underlying taxes. This is important to tax authorities given their mandate to collect tax revenues. In contrast, accounting is open to estimates and probabilities. Unlike the tax law's insistence on realization, accounting recognizes revenues when the sale is completed regardless of whether the underlying cash flows have been received or paid. Accounting also recognizes a liability as soon as it can be reasonably established and estimated.

GAAP gives taxpayers a choice among alternative forms of reporting, whereas the tax system offers minimal choice to taxpayers to ensure consistent results across the board (but not necessarily across time periods). According to the finding in *Thor*, GAAP gives taxpayers choices, and if GAAP is used as a tax base, it can cede control to taxpayers to control the amount of taxes payable. This choice is not acceptable in taxation:

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<sup>4</sup> *Thor Power Tool v Commissioner* 439 US 522 (1979).

Accountants long have recognized that “generally accepted accounting principles” are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. “Generally accepted accounting principles,” rather, tolerate a range of “reasonable” treatments, leaving the choice among alternatives to management. Such, indeed, is precisely the case here. Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure, as far as possible, that similarly situated taxpayers pay the same tax. If management’s election among “acceptable” options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.<sup>5</sup>

Based on the above analysis, taxpayers are required to use income computation methods that portray the true picture of a company’s profit regardless of whether such a method is based on GAAP.

### **2.1.1 ITA Section 9 and Case Law Versus Accounting Principles**

Lord Clyde’s statement from 1883 that profit is surplus revenue over the expenditures necessary to earn these receipts is over 100 years old, but still constitutes the main argument for tax law’s independence from accounting rules.<sup>6</sup> According to this perspective:

In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business *during such year or accounting period* and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the *Income Tax Act*, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial

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<sup>5</sup> *Ibid* at 439, Footnotes omitted also quoted in Deborah A. Geier, “The Myth of the Matching Principle as a Tax Value” (1998) 15:17 *American J of Tax Policy* 17 at 36 [Geier].

<sup>6</sup> *Russell v Town and County Bank*, (1883), 13 App. Cas. 418 at 424 cited in (*PC*) *MNR v Anaconda American Brass Ltd*, 55 DTC 1220; [1955] CTC 311.

accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes.<sup>7</sup>

The calculation of business income is based on section 9 of the *ITA*. However, this section is general in nature and does not provide sufficiently detailed information to calculate taxable income objectively or uniformly. According to subsection 9(1) of the *ITA*, a taxpayer's income from business or property is his/her profit during the taxation year. However, profit is not defined in the *ITA*, and taxpayers are not required to use any one specific method to calculate their profit. This lack of precision and guidance on how to calculate profit has led the courts to develop their own principles to determine income.

According to Justice Iacobucci, the decision of not defining “profit” in the Act may be deliberate because one single definition of profit cannot be applied to millions of taxpayers who are bound by the Act. Every taxpayer is required to compute the true and accurate picture of his/her income without overriding any specific provision of the *ITA*.<sup>8</sup>

In practice, the courts have historically relied on accounting income as a starting point for the calculation of taxable income. In *Woodward Store*, the court decided that generally accepted accounting principles should apply unless a statutory rule to the contrary could be found.<sup>9</sup> *The Queen v Metropolitan Properties Co. Ltd.* ruled that GAAP could be applied for tax purposes if it gives the true picture of the company's profit or loss for a specified period and there is no

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<sup>7</sup> *Whimster & Co v The Commissioners of Inland Revenue* (1925), 12 TC 813 at 823 cited in *Anaconda*, *Ibid* [emphasis original].

<sup>8</sup> *Canderel Ltd v Canada*, 98 DTC 6100, [1998] 1 SCR 147 at 30 [*Canderel*].

<sup>9</sup> *Woodward Stores Ltd v The Queen*, 91 DTC 5090; [1991] 1 CTC 233.

violation of any section of the *ITA*.<sup>10</sup> In the *Royal Trust* case, the court ruled that to assess any item for tax purposes, the first step was to check the accounting treatment of that item.<sup>11</sup> In the *CDSL* case, the court ruled that “the use of GAAP is acceptable whenever the Act does not provide otherwise, and their use would not thwart the clear application of the provisions of the Act.”<sup>12</sup>

In the *Friesen* case, it was decided that determination of profit was a question of law. The profit would be calculated according to the “well-accepted principle of business (or accounting) practice” or “well-accepted principles of commercial trading” as long as they were not inconsistent with any of the specific provisions of the *ITA*. For example, gross profit was to be computed according to GAAP principles as confirmed by the Supreme Court of Canada SCC in the *Friesen* case:

In calculating profit under s. 9 of the Income Tax Act, a business calculates its gross profit and then subtracts allowable operating and non-operating expenses. Under well-accepted principles of business and accounting practice gross profit for a business involved in sale is calculated according to the following formula:

Gross profit = Proceeds from sale–Cost of sale.<sup>13</sup>

Interestingly, the Supreme Court of Canada confirmed in this case that the determination of business profit is based on commercial and business principles that are subject to established case-law principles.<sup>14</sup> There was no framework given by the court for the calculation of business profit. In arriving at its 1998 decision in *Canderel*, the Supreme Court outlined a principled

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<sup>10</sup>*Queen v Metropolitan Properties Co Ltd*, 85 DTC 5128 (FCTD).

<sup>11</sup>*Royal Trust Co v Minister of National Revenue*, 57 D.T.C. 1055 (Ex. Ct.) at 1059 cited in *Canderel*, *supra* note 8 at 31.

<sup>12</sup>*CDSL Canada Limited v The Queen*, 2008 TCC 106 at 21 [*CDSL*].

<sup>13</sup>*Friesen v Canada*, 95 DTC 5551, [1995] 3 SCR 103 at 42 [*Friesen*].

<sup>14</sup>Brian R. Carr, “Current Receipts and Expenses after *Canderel*, Toronto College Park, and Ikea” (1998) 46:5 Can Tax J 953 [Carr].

approach and gave a framework to compute income for tax purposes. Unlike *Friesen*, the Court in *Canderel* clearly stated that calculating taxable profit is a question of law and also explained the role of commercial and accounting principles in determining profit in more details, as follows:

The determination of profit is a question of law. The profit of a business for a taxation year is to be determined by setting against the revenues from the business for that year the expenses incurred in earning said income. In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year. In ascertaining profit, the taxpayer is free to adopt any method which is not inconsistent with: (a) the provisions of the *Income Tax Act*; (b) established case law principles or "rules of law"; and (c) well-accepted business principles.<sup>15</sup>

The court also decided that to calculate profit, a taxpayer is free to use any well-accepted business principle that can give a true profit of the business provided that the chosen method is not in conflict with any statutory or legal provisions. The court further explained the term "well-accepted business principle" and refused to prefer one accounting method over another:

Well-accepted business principles, which include but are not limited to the formal codification found in generally accepted accounting principles (GAAP), are not rules of law but interpretive aids. They are non-legal tools, external to the legal determination of profit, whereas the provisions of the Act and other established rules of law form its very foundation. To the extent that well-accepted business principles may influence the calculation of income, they will do so only on a case-by-case basis, depending on the facts of the taxpayer's financial situation, and only for the purpose of achieving an accurate picture of profit. It is not for the court to decide that one such principle is paramount, or applicable to the subordination of all others, by deeming it a rule of law. That is exclusively within the province of Parliament.<sup>16</sup>

The *Canderel* decision is a significant milestone in the journey of establishing taxable income by Canadian courts. In this ruling, the court concluded that beyond statutory and

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<sup>15</sup> *Canderel*, *supra* note 8 at 53.

<sup>16</sup> *Canderel*, *supra* note 8.

established legal provisions, any further tools of analysis are just “interpretive aids and no more,” including well-accepted principles of business (or accounting) practice. According to the court, accounting principles are nonlegal tools and as such are external to the legal determination of profit. At the same time, the court acknowledged the importance of accounting principles by stating that:

In the absence of a statutory definition of profit, it would be unwise for the law to eschew the valuable guidance offered by well-established business principles. Indeed, these principles will, more often than not, constitute the very basis of the determination of profit.<sup>17</sup>

In *Dominion Taxi Cab Associate v MNR*,<sup>18</sup> the Supreme Court of Canada decided that determination of profit should be based on ordinary commercial principles unless any provision of the Act requires a departure from such principles.<sup>19</sup> The same conclusion was reached in the *Associated Investors* case where the court decided that “profit from a business, subject to any special directions in the statute, must be determined in accordance with ordinary commercial principles.”<sup>20</sup>

In the case of *Metropolitan Properties*, the court ruled that “GAAP should normally be applied for taxation purposes also, as representing a true picture of a corporation’s profit or loss for a given year.”<sup>21</sup> The only exception is if a section or sections in the *ITA* justify or require a departure from accounting principles. The court seems to clearly state that if there is nothing specific in the *ITA* regarding any item, then the computation of net income for tax purposes must

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<sup>17</sup> *Canderel*, *supra* note 8 at 35.

<sup>18</sup> *Dominion Taxicab Association v Minister of National Revenue*, 54 DTC 1020, [1954] CTC 34, [1954] SCR 82.

<sup>19</sup> GAAP is allowed but not as an exclusive criterion. Taxpayers are free to choose any method that gives the true picture of the business. This method can be GAAP, but other methods are also allowed.

<sup>20</sup> *Associated Investors of Canada Limited v MNR*, 67 DTC 5096; [1967] CTC 138.

<sup>21</sup> *The Queen v Metropolitan Properties Co Ltd*, 85 DTC 5128, [1985] 1 CTC 169 at 5137.

be based on GAAP, although it is possible to use a method other than GAAP as long as that method can give an accurate picture of a company's profit.<sup>22</sup>

In *Symes v Canada*, the court expressed the opinion that calculating profit under section 9 is a matter of judicial determination and GAAP is not binding for legal purposes:

Any reference to G.A.A.P connotes a degree of control by professional accountants which is inconsistent with a legal test for 'profit' under s.9 (1). Further, where an accountant questioning the propriety of deduction may be motivated by a desire to present an appropriately conservative picture of current profitability, the *Income Tax Act* is motivated by a different purpose: the raising of public revenues. For these reasons, it is more appropriate in considering the s. 9(1) business test to speak of 'well accepted principles of business (or accounting) practice' or 'well accepted principles of commercial trading.'<sup>23</sup>

This judgment raises the question of the difference between profit computed in accordance with the ordinary principle of business practice and profit computed in accordance with the ordinary principle of accounting. According to Arnold et al., there is no distinction between ordinary commercial principles and ordinary accounting principles in Canadian income tax, and the courts—for the most part—appear to assume that there is no significant difference between the principle of commercial and business practices and accounting principles.<sup>24</sup>

The CRA gives significant weight to accounting principles for calculating taxable income. In the absence of any statutory and legal provision, the CRA considers profit calculated under GAAP to most accurately reflect income. According to the CRA, GAAP is an acceptable starting

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<sup>22</sup> In the case of *the British Yukon Railway Company*, the FCTD ruled that in the absence of any provision in the *Income Tax Act*, any method of accounting was acceptable if it truly showed the taxpayer's income (*The British Yukon Railway Company v The Queen*, 77 DTC 5176; [1977] CTC 256 at 51). The same conclusion was reached by the Exchequer Court in the case of *Meteor Homes* where the court accepted the accounting treatment of sales tax liability claiming it was not against any statutory provision (*Meteor Homes Ltd. v MNR*, 61 DTC 1001, [1960] CTC 419 (Ex. Ct.)).

<sup>23</sup> *Symes v Canada*, 94 DTC 6001, [1993] 4 SCR 695.

<sup>24</sup> B.J. Arnold et al, *Timing and Income Taxation: The Principle of Income Measurement for Tax Purposes*, 2nd ed (Toronto, Canadian Tax Foundation, 2015) at 48.

point for computing taxable income. If GAAP allows more than one method, the CRA will accept the method used by the taxpayer in his/her financial statements.<sup>25</sup> The CRA also expects taxpayers to apply GAAP on a consistent basis to all income tax filings and all years.<sup>26</sup> As per CRA interpretation bulletin:

As a general rule, taxpayers are required by section 9 to use the accrual method of accounting to calculate the income from a business or property. In calculating income for tax purposes, accounting for prepaid expenses and deferred charges should, in most cases, be in accordance with the matching principle, a generally accepted accounting principle, except where the *Income Tax Act* provides otherwise (for example, see paragraph 20(1)(e) and section 37). For prepaid expenses this would involve deducting the applicable expenditures in the years in which the relevant service is provided to the taxpayer. For deferred charges it may require that part or all of the expense be deferred to future years and amortized on a reasonable and systematic basis.<sup>27</sup>

In the *Canderel* case, Tax Court of Canada (TCC) ruled that there was no legal requirement that tax rules should follow accounting rules. They are two different systems, although GAAP is a beneficial tool for taxation. “In fact, if this Court was to follow GAAP without question, the Canadian Institute of Chartered Accountants would be *de facto* legislating the development of tax law through the *CICA Handbook*.”<sup>28</sup> The court further commented that given the subjective professional judgment required in applying GAAP, reliance on GAAP would lead to a state of confusion and uncertainty:

It is not surprising that courts have been reluctant to place reliance upon GAAP in the determination of income for income tax purposes. GAAP is not relevant in determining whether a receipt or expense is on [a] revenue

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<sup>25</sup> *Ibid* at 54.

<sup>26</sup> Canada Revenue Agency, “Impact of the IFRS on taxable income” (21 February 2017), online: <<http://www.cra-arc.gc.ca/tx/bsnss/tpcs/frs/mpct-eng.html>>.

<sup>27</sup> Canada Revenue Agency, Interpretation Bulletin IT-417R2, “Prepaid Expenses and Deferred Charges” (10 February 1997) at Section 4. CRA has now archived this page.

<sup>28</sup> *Canderel Ltd v The Queen*, 94 DTC 1133; [1994] 1 CTC 2336.



or capital account. It is not relevant in determining whether an item of revenue is to be recognized in the year of receipt or in a later year.<sup>29</sup>

The Federal Court of Appeal (FCA) disagreed with the TCC and claimed that if the GAAP is not against the provisions of the *ITA*, they should be followed. If two methods are allowed under GAAP, and both are appropriate for tax purposes, the court will prefer the method that results in a “truer picture” of the profit. Justice Stone went on to say that “in my view, the matching principle of accounting has, at least in this court, been elevated to the status of a legal principle.”<sup>30</sup>

The above analysis of court cases suggests a trend where courts are giving weight to accounting measurement principles in tax cases. Macdonald claims that the modern judicial approach to accounting practice starts from *Gallagher v Jones*, where Sir Thomas Bingham strongly advocated the use of accounting principles:

The object is to determine, as accurately as possible, the profits or losses of the taxpayers’ business for the accounting periods in question. Subject to any express or implied statutory rule, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which legislation requires to be answered.<sup>31</sup>

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<sup>29</sup> *Ibid.*

<sup>30</sup> *The Queen v Canderel Ltd.*, [1995] 2 FC 232; 95 DTC 5101; [1995] 2 CTC 22.

<sup>31</sup> *Gallagher v Jones*, [1993] STC 537 at 123B cited in, Graeme Macdonald, “The Taxation of Business Income: Aligning Taxable Income with Accounting Income” (2002) Tax Law Review Committee, The Institute for Fiscal Studies, TLRC Discussion Paper No. 2 at v [Macdonald].

The courts also recognize the problem of second-guessing accounting practice: “If we reject the statements of approved accountancy practice, then where are we to look for the criterion?”<sup>32</sup>

Can a judge-made rule override the application of GAAP? Sir Thomas Bingham in *Gallagher v Jones* reported the following:

I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question [,] (b) is not one of two or more rules applicable to the situation[,], and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits of losses of the business.<sup>33</sup>

There are many terms and expressions that are not defined in the Act. Without the help of accounting, there is no other way to get their meaning. In the case of *Royal Trust Co.*, the taxpayer argued that a GAAP interpretation should only prevail in the technical sense, such as “carrying value,” but not in the case of terms like “tangible property.” The court disagreed on this position and said that if any expression is not expressly defined in the Act and it has an accepted meaning in commercial or accounting principles, that meaning should prevail in applying the statute.<sup>34</sup>

A similar observation was offered by the Ontario Court of Appeal in the case of *Upper Lakes Shipping*:

There is no doubt that GAAP do not govern the result. . . . This does not detract from the fact that, in the absence of a statutory definition for

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<sup>32</sup> *Ibid* at 37.

<sup>33</sup> *Gallagher*, *supra* note 31 cited in Clinton Alley and Simon James, “The interface between financial accounting and tax accounting: a summary of current research” (2005), University of Waikato, NZ, Working Paper No 84 at 14.

<sup>34</sup> *Royal Trust Co v The Queen*, docket 97-3757-IT-G.

"earned, capital and any other surplus," resort must be had to ordinary commercial principles to attribute any meaning to the phrase.<sup>35</sup>

With very few exceptions, tax laws have moved from a cash-based system to an accrual-based system without any explicit provision in the *ITA*. In the case of *Banner Pharmacaps*, the company did not receive cash for declared dividends but instead received a demand promissory note. The company recorded this dividend in its accounting books, but not for tax purposes. The TCC decided that for determining the profit or loss of a business, the cash method of accounting is not permissible under the Act. According to the court:

There is an underlying assumption in the *Income Tax Act* that income from business or property will be determined by the accrual method of accounting. Many examples support that underlying assumption. When computing income:

- paragraph 12(1)(b) requires receivables to be included;
- paragraph 18(1)(a) permits the deduction of expenses incurred; and
- paragraph 20(1)(l) permits the deduction of a reserve for doubtful debts.<sup>36</sup>

Therefore, the court decided that there was no option for the company other than to adopt the accrual method of accounting and include the amount of the dividend receivable in its income for tax purposes. This decision was later affirmed by the FCA. According to the court, the resolution declaring the dividend was clearly saying that the dividend was paid on the date of the resolution and that the dividend was to be paid using delivery of a promissory note in that

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<sup>35</sup> *Upper Lakes Shipping Ltd v MF*, 98 DTC 6264; [1998] 3 CTC 281 at 4.

<sup>36</sup> *Banner Pharmacaps NRO Ltd v The Queen*, 2003 DTC 245, 2003 TCC 82, aff'd 2003 FCA 367, 2003 DTC 5642.

amount. As the promissory note was delivered as agreed, the dividend was paid and had to be included in the company's income in that year.<sup>37</sup>

In the case of *Johnston v Britannia Airways*, the court ruled in favor of the accounting method of anticipating the costs of major engine overhauls, claiming it presented a truer picture of annual profit.<sup>38</sup>

In the case of *Stearns Catalytic Ltd.*, the Federal Court Trial Division (FCTD) did not accept the Minister's request to treat the cost of spare parts as inventory. Instead, the court relied on accounting evidence to consider parts as capital property for income tax purposes.<sup>39</sup>

In the case of the *Urbandale Realty Corporation*, the issue was the deduction of prepaid development expenses. Both the majority and the dissenting decisions were based on the true picture approach. The dissenting judge found no evidence that an accurate picture of income for the year could be derived by expensing prepaid development expenses rather than capitalizing them.<sup>40</sup> This is in contrast to the *Canderel* case where Justice Iacobucci ruled that if the taxpayer claims to have shown the true picture of the company's profit, then "the onus shifts to the Minister to show either that the figure provided does not represent an accurate picture, or that another method of computation would provide a more accurate picture."<sup>41</sup>

In the case of *Toronto College Part*, FCA Justice Robertson J.A. considered that the matching principle should be given priority over the truer picture criterion. He wrote:

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<sup>37</sup> *Ibid.*

<sup>38</sup> *Johnston v Britannia Airways Ltd.*, [1994] BTC 298 (Ch. D.) at 316.

<sup>39</sup> *Stearns Catalytic Ltd et al v The Queen*, 90 DTC 6286; [1990] 1 CTC 398.

<sup>40</sup> *Urbandale Realty Corporation Ltd v The Queen*, 2000 DTC 6118; [2000] 2 CTC 250.

<sup>41</sup> *Canderel*, *supra* note 8 at 53.

According to the analysis provided in *Canderel*, the issue is not which of the three GAAP options gives the truer picture of the taxpayer's profit or net income. Rather the question is whether an expense in question can be matched with a specific source of revenue. If it can, then it must be amortized. In *Canderel* this Court was unanimous in holding that tenant inducement payments could be so matched and therefore the “amortization method is the only method acceptable for income tax purposes” (per Desjardins, J.A. at 270).<sup>42</sup>

Later in the appeal, the SCC disagreed with this interpretation, emphasizing that it was important to find an accurate picture of the taxpayer’s profit. Justice Iacobucci commented that:

In light of the decision of this Court in *Canderel*, I obviously cannot agree with the Court of Appeal’s holding that the matching principle is to be applied irrespective of accounting evidence or of the search for an accurate picture of the taxpayer’s income. With respect, the accuracy of the income picture is the only issue to be considered, once it has been established that the method used by the taxpayer to arrive at this picture is consistent with the provisions of the Act, with the judicial interpretation thereof, and with the well-accepted business principles, including but not limited to GAAP, which are found to be applicable in the particular case. While accounting evidence is not determinative of the legal question of profit, it is certainly relevant and may in many cases be highly persuasive. The approach taken by the Court of Appeal is, in my view, unsupported by any previous authority other than its own decision in *Canderel*, which has now been set aside.<sup>43</sup>

In the case of *Bernick*, Justice Sharlow favored the Minister’s decision to disallow the partnership losses on the basis that accounting method used by the taxpayer was not providing an accurate picture of the profit. According to Justice Sharlow, “an accounting method is not acceptable for income tax purposes unless it results in an accurate determination of income.” She further commented that “[i]n this context, ‘accuracy’ means reasonable accuracy, bearing in mind that any computation of profit may involve estimates and judgment calls relating to timing,

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<sup>42</sup> *The Queen v Toronto College Park Ltd.*, [1996] 3 FC 858; 96 DTC 6407; [1996] 3 CTC 94.

<sup>43</sup> *Toronto College Park Ltd v Canada*, [1998] 1 SCR 183 at 24.

allocation, estimates of value, and other such matters that accountants are often called upon to make.”<sup>44</sup>

In many instances, courts have rejected accounting measurement practices even when there was no overriding statutory provision. According to Arnold et al., such rejection of accounting practices may have been justified on the basis of how accounting rules aligned with principles of taxation. However, in many instances, the rejection was hard to justify, and the courts failed to substantiate their rejection of reliance on accounting standards.<sup>45</sup>

In the case of *Cummings*, the FCA ruled that “the fact of the acceptability in accounting practice of dealing with a particular item in a particular manner cannot, by itself, make that practice a proper deduction for income tax purposes.”<sup>46</sup> According to the court, the lease pickup was a contingent liability prohibited by paragraph 12(1)(e) of the Act, and it did not make any difference for tax purposes whether this item was classified as a liability instead of a contingent liability on the balance sheet for accounting purposes.

In the case of *J.L. Guay Limitée*, the Court admitted that the *ITA* does not offer a solution to every problem. However, the court went on to say that we cannot only use accounting rules for tax calculations because the calculation of taxpayer’s tax liability is not the primary purpose of the accounting. The Court went on to say:

The *Income Tax Act* does not always give a complete answer to the question as to what the total amount of profits and earnings in the year assessed is. In determining the taxable profits of a taxpayer, we can take as a starting point the profit and loss statement prepared according to the rules of accounting practice. However, the profit shown on this statement

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<sup>44</sup> *Bernick v Canada*, 2004 DTC 6409, 2004 FCA 191 at 24.

<sup>45</sup> Arnold et al, *supra* note 24 at 48.

<sup>46</sup> *Cummings v The Queen*, 81 DTC 5207, [1981] CTC 285 at 294.

has always to be adjusted according to the statutory rules used in determining taxable profits. This is because a number of facts taken into consideration by accountants are excluded by certain provisions of the *Income Tax Act* in the determining of taxpayers' profits.<sup>47</sup>

In the case of *Bernick*, the FCA refused to accept the taxpayer's accounting method even though the method was not inconsistent with the *ITA* or with an established legal principle. According to the court, "an accounting method that cannot possibly produce an accurate result can never meet the *Canderel* standard."<sup>48</sup>

In the case of *Kenneth Robertson*, it was decided that any sound accounting practice is permissible for income tax purposes provided that it will not conflict with a clearly stated intent of the Act. In case of conflict, the Act will govern. The court further said that:

I find [it] difficult to reconcile the decision with the authorities that apply the general rule that profits are to be taxed in the year in which they are received, and the losses borne in the year in which they are sustained.<sup>49</sup>

In the case of *Edmonton Plaza Hotel*, the FCTD decided that the treatment of expenditures for income tax purposes should not depart from GAAP unless required by the *ITA*. Accordingly, the court found that the cost of a development permit payment was part of the capital cost as per the taxpayer's financial statements.<sup>50</sup>

Accounting is often the first reference in assessing the deductibility of any particular expense. According to the court in *Daley v M.N.R.*, the first enquiry about the disbursement or deductibility of any particular expense is whether it is permissible by the ordinary principles of

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<sup>47</sup> *J L Guay Ltée v MNR*, [1971] FC 237; 71 DTC 5423; [1971] CTC 686, also cited in *Northwood Pulp et al v The Queen*, 96 DTC 1104; [1996] 2 CTC 2123.

<sup>48</sup> *Supra* note 44 at 25-26.

<sup>49</sup> *Kenneth B S Robertson Ltd v MNR*, 2 DTC 655; [1944] CTC 75.

<sup>50</sup> *Edmonton Plaza Hotel Ltd v The Queen*, 87 DTC 5371; [1987] 2 CTC 153.

commercial trading or accepted business and accounting practices. The court found that “an expenditure properly deducted according to accounting standards would be deductible for tax purposes *unless* prohibited by some provision of the Act.”<sup>51</sup>

In the *Neonex International* case, the court disallowed the deduction of costs incurred during a year for incomplete signs. The company was required to include such costs in its work-in-progress inventory. The Minister favoured the company’s use of GAAP for tax purposes. According to the court, obtaining an accurate picture of a taxpayer’s taxable income is not necessarily based on GAAP. Whether GAAP will be used or not is a question of law determined by the Court. The Court questioned the GAAP method used by the company. “The expenses incurred in connection with the partially completed signs were laid out to bring in income in the next or some other taxation year, not in the year in which they were claimed.”<sup>52</sup>

In the case of *Canadian General Electric*, the SCC accepted the company’s use of accrual accounting for income tax purposes on the grounds that this method offered the true picture of the company’s position, thereby reversing the Exchequer Court’s decision in favour of the Minister.<sup>53</sup>

In the case of *Terra Mining & Exploration*, the issue was about the different treatment of the same item for income tax and accounting purposes. The company used interest expenses on a cash basis for tax purposes while simultaneously using accrual accounting for financial reporting. The Tax Review Board allowed the company to use a cash basis for interest expenses,

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<sup>51</sup> *Daley v MNR*, [1950] C.T.C. 254 (Ex. Ct.), at 260, cited in *Friesen*, *supra* note 13 at XXXI.

<sup>52</sup> *Neonex International Ltd v The Queen*, 78 DTC 6339; [1978] CTC 485.

<sup>53</sup> *Canadian General Electric Co Ltd v MNR*, 61 DTC 1300, [1961] CTC 512, [1962] SCR 3.

Same reasoning is offered in the case of *Stearns Catalytic Ltd.*, the FCTD did not accept the Minister’s request to treat the cost of spare parts as inventory. Instead, the court relied on accounting evidence to consider parts as being capital property for income tax purposes (*Supra* note 39).



whereas the FCTD favoured the Minister. The court emphasized that both subsection 20(1)(c) and 12(1)(c) require conformity with accounting principles. It also ruled that:

A distinction must be made between a requirement that income for tax purposes be accounted for generally in conformity with accounting principles and a requirement that the taxpayer's treatment of his financial statements and his tax returns be identical.<sup>54</sup>

Interestingly, the court suggested that a taxpayer may use the “hybrid system” where some interest income can be calculated using the cash method and some using the accrual method.

In the case of *Maritime Telegraph*, Reed J. held that unbilled but earned revenues are not receivables under paragraph 12(1) (b) of the Act. Instead, they are considered income under subsection 9(1), and this method gives a truer picture of income for the year compared with the alternative method.<sup>55</sup> The purpose of paragraph 12(1) (b) is to ensure that income from a business is computed on the accrual basis, not a cash basis, with certain specified exceptions. The court agreed that earned but unbilled revenues gave a true picture of the taxpayer’s income.

Similarly, the *West Kootenay* case concluded that the *ITA* does not allow revenue recognition on the billed basis, even though the taxpayer used earned or accrued method (including estimates for unbilled revenue) for financial statement purposes. The court insisted on the same treatment of revenue recognition for both tax and accounting purposes. The court says that “it would be undesirable to establish an absolute requirement that there must always be conformity between financial statements and tax returns,” but any method that presents the true picture of a taxpayer’s revenue should be followed.<sup>56</sup> The selected method should more fairly and

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<sup>54</sup> *The Queen v Terra Mining & Exploration Ltd.*, 83 DTC 497; [1983] 1 CTC 2537 at 6188.

<sup>55</sup> *Maritime Telegraph and Telephone Company Limited v The Queen*, 91 DTC 5038.

<sup>56</sup> *West Kootenay Power and Light Company Ltd v The Queen*, [1992] 1 FC 732; 92 DTC 6023; [1992] 1 CTC 15.

accurately portray income, and it should match revenue and expenditures. According to the court, “*Canadian Income Tax* requires that profits be taken into account or assessed in the year in which the amount is ascertained.”<sup>57</sup>

Justice Brandeis, delivering the opinion of the Supreme Court of the US in the case of *Brown v Helvering*, commented on an insurance agent’s commission income, saying that, “when received, the general agent’s right to it was absolute. It was under no restriction, contractual, or otherwise, as to its disposition, use, or enjoyment.”<sup>58</sup>

In the case of *Queen v Marchand*, the court clearly ruled that a taxpayer can deduct an amount from income under only two conditions: first, if the deduction is made according to GAAP, and second, if any provision of the Act does not prevent such a deduction.<sup>59</sup>

According to tax law, running or current expenses should be deducted in the year of outlay. In the case of *Toronto College Park*, the FCTD decided that if benefits of running expenses were extended beyond the year of the expenses, a taxpayer could either deduct the full expenses in the year of the expense or “defer the deduction if deferral accords with GAAP and creates a truer income picture.”<sup>60</sup> The CRA describes running expenses as “an exception to the above rule” and adds that they:

[M]ay be deducted in the year they are incurred unless the rules in subsection 18(9) apply. The determination of whether a particular expense can be classified as a “running expense” is a question of fact. The courts have described “running expenses” as expenses that are not referable or related to any particular item of revenue and would include

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<sup>57</sup> *Ibid.*

<sup>58</sup> *Brown v Helvering*, 291 US 193 at 199.

<sup>59</sup> *The Queen v Marchand*, [1979] 1 FC 32; 78 DTC 6507; [1978] CTC 763.

<sup>60</sup> *Supra* note 42.

any expenses that are necessarily incurred on a continuing and recurring basis for the general purpose of producing income.<sup>61</sup>

Subsection 9(1) is a general provision of the Act. Courts look to specific provisions over general provisions in making their decisions in favour of the taxpayer or the Minister. The Supreme Court in *Schwartz v Canada* decided that giving precedence to general provisions over the detailed provisions of the Act is inconsistent with the basic principle of interpretation.<sup>62</sup> In this case, the Supreme Court concluded that the damages relating to the lost salary and employee stock options were not taxable under section 3(a) of the Act as income from employment. The Supreme Court also confirmed the tax court's finding that the damages were not "income from employment" under section 3(a) because a source of income had been taken away or destroyed.<sup>63</sup>

In the case of *Anaconda American Brass Ltd.*, a majority of the SCC allowed the taxpayer to use the last-in, first-out (LIFO) method of inventory accounting for tax purposes even though the tax authorities only allow the first-in, first-out (FIFO) method under the *ITA*. This case was heard in 1947 under the *Income War Tax Act* and the *Excess Profit Tax Act*. According to these statutes, the valuation of inventories was to be done based on recognized or accepted accounting methods. The Exchequer Court and a majority of SCC judges concluded that in this particular type of business operation, the LIFO method of inventory accounting better determined the true income of the business with greater accuracy. This decision was reversed by the Privy Council

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<sup>61</sup> *Supra* note 27 at 4.

<sup>62</sup> *Schwartz v Canada*, 96 DTC 6103, [1996] 1 SCR 254

In this case, the appellant accepted an offer of employment from a company in May 1988. A few months later (before joining), the company informed the appellant that his services would not be required and offered him some money in exchange for a full and final release. The appellant refused the offer and, following negotiations, reached a settlement with the employer, who agreed to pay him \$360,000 in damages plus \$40,000 for costs.

<sup>63</sup> *Ibid* at 12.

based on the Minister's argument that the LIFO method did not produce a better or true income compared with the FIFO method, even for the specific taxpayer in this case.<sup>64</sup>

The Act fails to give a precise definition of income. Therefore, the courts developed their own test to determine whether or not a receipt should be considered as income. In the early days of taxation, the courts established, to constitute income, receipts had to have certain properties, such as an inflow, convertibility into cash, periodicity or recurrence, realization, separation from source, and profit-making intentions. This definition of taxable income is done on an *ad hoc* basis as cases come before the courts.<sup>65</sup> According to Holmes, "the judicial notion of income is not as well conceptualized, and therefore, not as theoretically robust, as the economic and accounting approaches."<sup>66</sup>

#### **2.1.1.1 Accounting Standards and IFRS**

Accounting income is computed based on GAAP, and Canada has now adopted the IFRS for public companies.<sup>67</sup> Accounting standards are set by various expert groups (consisting of investors, creditors, employee groups, and governments) established by the International Accounting Standards Board (IASB).<sup>68</sup> Each country has its own Accounting Standards Board whose task is to define the accounting rules and regulations (GAAP) by which financial statements are produced and reported.

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<sup>64</sup> *Supra* note 6.

<sup>65</sup> Kevin Holmes, *The Concept of Income A Multidisciplinary Analysis* (Amsterdam, IBFD, 2000) at 320 [Holmes].

<sup>66</sup> *Ibid* at 320.

<sup>67</sup> CPA Canada, *CPA Canada Handbook-Accounting*, Part 1-IFRS Standards (2017) (Knotia)[CPA].

<sup>68</sup> Holmes, *supra* note 65.

Accounting standards may be categorized as rule based or principle based. In rule-based standards, extensive sets of rules are prescribed or dictated and need to fit their situation to these rules and report accordingly. Rule-based standards often tend to be very detailed and elaborate, dealing with all possible scenarios. In contrast, principle-based standards offer only broad guidance to users, who are required to use their professional judgment to decide how to report certain transactions. Arguably, IFRS (now the Canadian GAAP for public companies) is more principle based compared with the US GAAP. Whereas there are more jurisdictions following principle-based standards, reporting entities remain limited in their choices for the accounting treatment of various transactions. The complex business world often requires some flexibility by which to report various complicated business situations.

Accounting standards are based on certain concepts that are not required for deriving taxable income. The major accounting concepts determining income are as follows:

The going concern concept: an assumption that the business will continue in operational existence for the foreseeable future so that the implications of liquidation can be ignored;

The accruals concept (or matching principle): revenues and costs are to be recognized in the period in which they are earned or incurred, and not when money is received or paid; costs or expenses are matched to revenues recognized in the period;

The consistency concept: an assumption that reporting entities need to be consistent in their accounting treatment over time or over reporting periods;

The concept of prudence or conservatism: the requirement that revenue and profit are delayed until realized in cash or reasonably certain of being

so realized, while losses and liabilities are provided for as soon as foreseen.<sup>69</sup>

Accounting standards try to satisfy the requirements of various users of the financial statements, such as managers, investors, and governments, with all such users exercising their influence on the development of an accounting standard. According to Ali and Wang, if accounting rules are influenced by the government, they tend to satisfy the government needs, such as reporting for tax compliance or reporting numbers that can help formulate government policies.

On the other hand, if the accounting rules are set by independent bodies, they are more likely to address the needs of investors and capital providers. Whitaker suggests that in contrast to tax accounting, these financial reporting standards are often more principled than rules oriented and often have fewer controlling authorities.<sup>70</sup>

The IASB is an independent body that issues IFRS standards. Since it was formally constituted as a board in 2001, it has issued a number of IFRS standards and has adopted all of the International Accounting Standards (IAS) issued by its predecessor body, the International Accounting Standard Committee (IASC). Most of the IAS originally produced by the IASC have subsequently been amended or superseded, but to promote continuity, the amended IAS have generally retained their initial designation as IAS standards. In general, only “new” standards have been designated as IFRS standards, but all of the standards have the same authority.<sup>71</sup> IFRS

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<sup>69</sup> Macdonald, *supra* note 31 at 13.

<sup>70</sup> Celia Whitaker, “Bridging the Book-Tax Accounting Gap” (2005) 115:680 *The Yale L J* 681 at 724 [Whitaker].

<sup>71</sup> This information is taken from the IFRS foundation website (2 October 2017), online: IFRS < <http://www.ifrs.org/about-us/> >.

has been a success on the global stage, and to date, more than 140 countries have adopted these standards.

The objectives of IFRS standard setters are to develop “a single set of high-quality, understandable, enforceable, and globally accepted financial accounting standards based on clearly articulated principles. These standards should require high-quality, transparent, and comparable information in financial statements and other financial reporting.”<sup>72</sup> The mission of IFRS is “to develop IFRS standards that bring transparency, accountability, and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth, and long-term financial stability in the global economy.”<sup>73</sup> IFRS is focused on accounting standards, but its scope does not extend to legal, regulatory, or tax.

Norberg claims that there is a shift in accounting from a transaction-based approach in standard setting to a value-based approach, and the latter approach is bringing accounting income closer to the Schanz–Haig–Simons (SHS) definition of income, which is often considered a superior or a more principled measure of income.<sup>74</sup> Norberg outlines the distinctions between transaction-based and value-based approaches to standard setting:

A transaction-based approach starts with the historical cost of assets, measurement of those costs over time, demands that income should be realized by disposal of assets and emphasizes matching of income and costs. Focus is on the income statement. A value-based theory focuses on the balance sheet, what is an asset or a liability and how they should be valued. The latter approach allows assets to be valued at fair value and no principal distinction is made between realized and unrealized income. The value-based theory defines income as the increase in equity adjusted

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<sup>72</sup> Deloitte, “IFRS Foundation” online: <<https://www.iasplus.com/en/resources/ifrsf/governance/ifrsf>>.

<sup>73</sup> *Supra* note 71.

<sup>74</sup> Claes Norberg, “Accounting and Taxation” (2007) Kari Tikka memorial lecture, EATLP, Helsinki at 4-5.

for payments to and from owners of the company, often called “comprehensive income.”<sup>75</sup>

Revenue should be measured at the fair value of the consideration received or receivable.<sup>76</sup>

An exchange for goods or services of a similar nature and value is not regarded as a transaction that generates revenue. However, exchanges for dissimilar items are regarded as generating revenue.<sup>77</sup>

According to IFRS,<sup>78</sup> profits are realized if and when the entity has transferred to the buyer the significant risks and rewards of ownership of the good, the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, and the amount of revenue and cost can be measured reliably.

IFRS has also introduced the concept of comprehensive income that includes unrealized gains and losses. The component of other comprehensive income includes changes in revaluation surplus, remeasurements of defined benefit plans, gains and losses from foreign-currency translation, gains and losses from the measurement of financial assets and equity instruments at fair value, and gains and losses from hedging transactions.<sup>79</sup>

According to Lev and Gu, while adopting IFRS saves information generation and processing costs for the multinational companies, it also has unintended adverse consequences. “In particular, uniformity deprives accounting of a major force for innovation and rejuvenation—the vital experimentation and evolution that comes with diversity.”<sup>80</sup> They further say that regulatory

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<sup>75</sup> *Ibid* at 4-5.

<sup>76</sup> CPA, *supra* note 67 at IAS 18.9.

<sup>77</sup> CPA, *supra* note 67 at IAS 18.12.

<sup>78</sup> CPA, *supra* note 67 at IAS 18.

<sup>79</sup> CPA, *supra* note 67 at IAS 1.7.

<sup>80</sup> Feng Gu & Baruch Lev, *The End of Accounting and The Path Forward for Investors and Managers*



development is generally a trial-and-error process, and in the absence of an experimental and dynamic process, regulations keep piling up, and ineffective ones are rarely removed because “no trial, no error—just more of the same.”<sup>81</sup> Many accounting standards have legal elements that require adjudication by the courts.<sup>82</sup> Accounting standards need to be closely linked to tax principles. Talking about fair value accounting and tax rules, Freedman says:

It seems more likely that legislation will be used to counter the more extreme effects of fair value accounting but, if fair value accounting is introduced without legislative variations, it is not impossible that the courts will revive the notion of the importance of realization for tax purposes and endeavour to examine for themselves whether an accounting treatment amounts to anticipation of profits, especially if the accounting profession finally removes all references to realization as we have known it previously from its standards. This will truly raise the question of whether any tax principles remain which can override accounting standards.<sup>83</sup>

### **2.1.2 Nature and Examples of the Conceptual Gap**

In the early days of the development of taxation, accounting and taxation relied on reasonably uniform rules, but “when the difficulties of using uniform rules for tax and other accounting system[s] became apparent, tax authorities developed tax-specific accounting rules to accomplish the income tax’s goals.”<sup>84</sup>

Many items are treated differently in accounting and taxation. These items contribute to the difference between income for tax purposes and accounting income. In the following section, I explain some of the items that create differences between income for tax purposes and book income.

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(Toronto: Wiley Finance Series, 2016) at xviii.

<sup>81</sup> *Ibid.*

<sup>82</sup> Freedman, *supra* note 2.

<sup>83</sup> Freedman, *supra* note 2 at 96.

<sup>84</sup> Adam Chodorow, “Is it time to abandon accrual accounting for tax purposes?” in Anthony C. Infanti, ed, *Controversies in Tax Law A Matter of Perspective* (New York: Routledge, 2015) 111 at 118.

### 2.1.2.1 Leases

Leasing is an essential part of a firm's capital structure, yet many lease contracts do not appear in an entity's balance sheet, resulting in debt being kept "off the books."

US and Canadian GAAP categorize leases into two types: finance leases (or capital leases under Canadian GAAP) and operating leases. Only the assets and liabilities arising from finance leases are recognized in the statement of financial position (or balance sheet). For an operating lease, the lessee simply recognizes lease payments as an expense over the lease term.<sup>85</sup>

The criteria for classifying a "sale" or "lease" transaction include whether the benefit and burden of ownership have passed to the user of the asset. If the lessee is required to purchase the asset, or if the lessee has the option to acquire the asset on very reasonable terms at the end of the lease, then the lease is considered as a sale for tax purposes, and the lessee as a user of the asset can claim or deduct capital cost allowance (CCA), but not the lease payments.

A lease is an example of a business transaction where the accounting and tax treatments may not be parallel. Different classifications of the lease under tax and accounting rules give rise to the book-tax income gap. Leases have potential financial and tax reporting advantages. While providing a form of financing, certain types of leases are not shown as debt on the balance sheet. The assets leased under these types of leases also do not appear as assets on the balance sheet. Therefore, no corresponding interest expense or depreciation expense is included in the income statement.

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<sup>85</sup> Both FASB and IFRS issued new standards for leasing in 2016.

Since financial reporting rules may differ from tax regulations, a company may end up owning an asset for tax purposes (and thus obtain deductions for a depreciation expense for tax purposes) while not reflecting the ownership in its financial statements. A lease that is structured to provide a company with the tax benefits of ownership while not requiring the asset to be reflected on the company's financial statements is known as a synthetic lease. Synthetic leases are not hard to engineer.

### 2.1.2.2 Interest Expense and Interest Income

The *ITA* requires that corporations, partnerships, and certain trusts use only the accrual method for reporting interest income and interest expenses. These entities are required to include any interest on a debt obligation that accrues to the end of the year, or becomes receivable, or is received before the end of the year.<sup>86</sup>

In accounting, any interest payable or receivable must be recognized on an accrual basis at year-end regardless of whether the actual payment is paid or received.

There is no definition of interest income or interest expense in the Act. The term "interest" has been defined by the Supreme Court of Canada to be "the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to, another."<sup>87</sup>

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<sup>86</sup> *Income Tax Act* (RSC, 1985, c 1 (5th Supp.)) at subsection 12(3) [*ITA*].

Whereas individual taxpayers can report *via* the cash or receivable methods (with interest earned by individuals reported on each anniversary date of the investment contract as income), corporations are required to use accrual method, see *ITA* subsection 12(1).

<sup>87</sup> Arnold et al, *supra* note 24 at 296.

According to paragraph 20 (1) (c) of the *ITA*, interest expense is deductible only if the amount paid or payable is based on a legal obligation to pay interest on borrowed money used for the purpose of earning or producing income from a business or property.

*ITA* paragraph 12(1) (c) uses the words “received” or “receivable.” It shows that the taxpayer has a choice between a cash method and receivable method. Under the cash method, interest is recognized as income only when actually received. Under the receivable method, interest is recognized as income when the amount has become legally due, and payment is enforceable. The case law concerning the availability of choice between the cash and payable methods for deducting interest has been inconsistent.<sup>88</sup>

### **2.1.2.3 Inventory and Cost of Goods Sold**

Taxable income cannot be calculated without determining the value of the cost of goods sold. According to accounting, inventories are assets that are:

- a) held for sale in the ordinary course of business;
- b) in the process of production for such sale; or
- c) in the form of material or supplies to be consumed in the production process or in the rendering of services.<sup>89</sup>

Accounting allows three distinct methods for the valuation of inventories: specific identification, weighted average cost, and FIFO.<sup>90</sup> Accounting standards do not permit the use of

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<sup>88</sup> Arnold et al, *supra* note 24 at 458.

<sup>89</sup> CPA, *supra* note 67 at IAS 2.6.

<sup>90</sup> CPA, *supra* note 67 at IAS 2.23 & 2.25.

the LIFO formula to measure the cost of inventories.<sup>91</sup> Instead, inventories are required to be measured at the lower of cost and net realizable value if prices are declining.<sup>92</sup>

Gross profit is calculated by subtracting the value of the cost of goods sold from the revenues. The cost of goods sold refers to the total cost of selling the inventory and is calculated as the beginning inventory plus all purchases less the ending inventory. The critical task in this formula is finding the appropriate cost of the ending inventory. This ending inventory appears as an asset on the balance sheet and becomes the beginning inventory in the following period. The objective of using the cost of goods sold is to match the inventory cost to the revenues in that particular period.

Subsection 10(1) of the *ITA* requires inventory to be accounted as follows:

For the purpose of computing a taxpayer's income for a taxation year from a business that is not an adventure or concern in the nature of trade, property described in an inventory shall be valued at the end of the year at the cost at which the taxpayer acquired the property or its fair market value at the end of the year, whichever is lower, or in a prescribed manner.

In the case of a business that is an adventure or concern in the nature of trade, inventory is required to be valued at acquisition cost.<sup>93</sup> In *CDSL*, the court decided that “[o]nly when the fair market value of the property is lower than its cost does section 10 indirectly authorize the taking of a loss before the actual disposition of the inventoried property.”<sup>94</sup>

This provision requiring inventory to be written down in value to reflect market conditions is clearly not in accordance with the tax principle of realization. However, the concept of lower

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<sup>91</sup> CPA, *supra* note 67 at IAS 2.

<sup>92</sup> CPA, *supra* note 67 at IAS 2. 9.

<sup>93</sup> *ITA*, *supra* note 86 at subsection 10(1.01).

<sup>94</sup> *CDSL*, *supra* note 12 at 21.

of cost or fair market value represents good conservative accounting, and on this issue, taxation supports conservatism. Comparing this rule with the accounting principle of historic cost, Lord Reid, in *Ostime v Duple Motor Bodies, Ltd.*, stated that “this lack of symmetry is not entirely logical, but it represents good conservative accountancy and therefore has always been recognized as legitimate for taxation purposes.”<sup>95</sup>

In the *Bernick* case, the court further says that section 10(1) is an exception to the *ITA* and based on the well-accepted accounting principle of lower of cost or market.<sup>96</sup>

Under IFRS, the fair market value of inventory is replaced with the net realization value of inventory. This reduces the alternatives available under “fair market value” (FMV) since FMV could include replacement cost, net realization value (estimated selling price less the cost to complete the sale), or net realization value less a normal profit margin. We need to keep in mind that when the FMV was added to the *ITA*, accounting standards were also using the same method—i.e., lower of cost or FMV.

Inventories are defined in the subsection 248(1) as follows:

[I]nventory means a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year or would have been so relevant if the income from the business had not been computed in accordance with the cash method and includes (a) with respect to a farming business, all of the livestock held in the course of carrying on the business, and (b) an emissions allowance[.]<sup>97</sup>

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<sup>95</sup> *Ostime v Duple Motor Bodies Ltd*, [1961] 2 All ER 167, at 172 (HL) cited in *Friesen*, *supra* note 13 at 47.

<sup>96</sup> *Supra* note 44.

<sup>97</sup> *ITA*, *supra* note 86 at subsection 248(1).

This is a broad definition and includes all different types of inventory. It may be difficult to differentiate between inventory and capital assets based on this definition since capital assets are also used in computing the business income. Arnold et al. stated:

Given the importance of determining whether property is inventory under the Act, it is surprising that inventory is defined so ambiguously in subsection 248(1). The definition is excessively broad and appears to include almost all property that could conceivably be held by a taxpayer as part of a business. The definition could include depreciable property and eligible capital property, since the cost of such property is relevant in computing income from a business. These types of property are considered by tax practitioners, the CRA, and accountants not to be inventory, and despite the statutory definition of inventory, a court would not likely treat them as such. Another difficulty with the statutory definition of inventory is that it does not contain any criteria to distinguish inventory from other property.<sup>98</sup>

According to Arnold et al., the inventory provisions of the *ITA* are brief and do not provide specific guidance as to their application in various situations. Most of the case law on section 10 and other inventory provisions relates to the interpretation of subsection 10(1). The authors further claim that in the recent years, the CRA has generally begun to accept accounting principles for the treatment of inventory.<sup>99</sup>

The result of this vague definition of inventory is that it is now left to the courts to decide whether an asset is inventory in the regular course of business or whether it is a capital asset that needs to be depreciated or amortized. The difference between these two treatments is important since income generated from selling inventory is business income and fully taxable, whereas income generated from selling capital assets is considered capital gains, only half of which is taxable.

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<sup>98</sup> Arnold et al, *supra* note 24 at 597.

<sup>99</sup> Arnold et al, *supra* note 24 at 595.

In *CDSL*,<sup>100</sup> appellants argued that they met all the conditions of subsection 10(1), and therefore, their work in progress was inventory within the meaning of paragraph 10(5) (a) of the Act. The taxpayers proceeded to record their work in progress at FMV in their financial statements and at cost for income tax purposes. The Minister was of the opinion that taxpayers should also value their work in progress at FMV for tax purposes since FMV provided a more accurate picture of profit in accordance with subsection 9(1) of the Act. The Minister did agree that the taxpayers met the criteria for inventory in section 10, which allowed for the lower of cost or market value.

The TCC observed that it was not necessary to raise the issue that subsection 10(1) was a specific provision overriding a general provision. In other words, the TCC ruled that section 9 and the other provisions must be read together. According to the Court, the main decision criteria were based on the *Canderel* criterion for providing an “accurate picture” of the financial situation of the taxpayer’s business. Section 10 requires inventory to be valued at the lower of its FMV and cost, but section 1801 of the Income Tax Regulations allows the use of FMV at all times. The court concluded that the method of computing income used in the taxpayer’s financial statements provided a more accurate picture of the profit in that year.

In the FCA, the Court found that there was a conflict between section 9 and subsection 10(1) and that subsection 10(1) was a mandatory provision that ruled out the general application of section 9 regarding the valuation of inventory.<sup>101</sup> In the case of *MNR v Shofar Investment Corp.*, the court also reached the same conclusion.<sup>102</sup>

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<sup>100</sup> *CDSL*, *supra* note 12.

<sup>101</sup> *CDSL Canada Limited v Canada*, 2008 FCA 400 at 32 & 33.

<sup>102</sup> *MNR v Shofar Investment Corp.*, 79 DTC 5347; [1979] CTC 433.



In the *Friesen* case, the taxpayer wanted to deduct the loss in FMV of inventory as part of a business loss based on subsection 10(1). The Minister disallowed these losses because the property was not “inventory in a business” under the meaning of ss.10 (1) and 248(1). In a 3-2 split decision, the SCC ruled in favour of the taxpayer, thereby offering a relatively clearer definition of inventory as follows:

Under that definition [s. 248(1)], an item of property is not required to contribute directly to income in each taxation year in order to qualify as inventory. Provided that the cost or value of an item of property is relevant in computing business income in a year, that property will qualify as inventory. As a general principle, items of property sold by a business venture will always be relevant to the computation of income in the year of sale. The property at issue is therefore correctly categorized as “inventory” for the purposes of the *Income Tax Act*, both in the taxation year of disposition and in preceding years, because its cost or value is relevant to the computation of business income in a taxation year.<sup>103</sup>

The court argued that subsection 10(1) recognized the well-accepted commercial and accounting principle of requiring a business to value its inventory at the lower of cost or market value. This definition was consistent with the Canadian GAAP prevailing at that time. The court also confirmed the principle that the plain meaning of the relevant sections of the *ITA* was to prevail unless the transaction was a sham. According to the court, the plain meaning of section 10 required the taxpayer’s venture to be a “business” and a business for which property must be “inventory.” If a taxpayer satisfied these two conditions, he could use section 10.<sup>104</sup> The court concluded that section 10(1) represented not only an exception to the realization when there was a loss but also an exception to the principle of symmetry because gains were not recognized until they were realized. The court stated:

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<sup>103</sup> *Friesen*, *supra* note 13.

<sup>104</sup> *Friesen*, *supra* note 13 at 12.

Section 10(1) is specifically designed as an exception to the principles of realization and matching in order to reflect the well-accepted principle of accounting conservatism. In addition to recognizing accounting conservatism, the section is designed to stop a business from accumulating pregnant losses from declines in the value of inventory. The object and purpose of the section is to prevent businesses from artificially inflating the value of inventory by continuing to hold it at cost when the market value of that inventory has already fallen below cost.<sup>105</sup>

Further, the court ruled that clear language of the Act takes precedence over the view of the court about the provision. More specifically, the Court ruled that:

[I]t is not the role of the court to restrict the interpretation of the clear statutory language because the exception created by the language has been the subject of academic criticism. Many sections of the *Income Tax Act* have been the subject of academic criticism.<sup>106</sup>

In the dissenting note, Justice Iacobucci says that “the appellant’s interpretation would also undermine the matching principle underpinning section 9 of the Act,” and this method would significantly distort the profit from some transactions.<sup>107</sup> He further commented that “I have serious doubts that this was the intent of the drafters of the exception to the realization principle contained in s. 10(1) and Regulation 1801.”<sup>108</sup>

In the case of *Cyprus Anvil Mining Corporation*, the FCTD decided that there should be no requirement of consistency in ss. 10(1) and that this section neither contained a provision against changing the method of inventory valuation from time to time nor did it permit the method selected at will.<sup>109</sup> The FCA disagreed with this conclusion and commented as follows:

To permit the taxpayer to change its usual accounting practices solely to maximize its profits during the exempt periods distorts not only the

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<sup>105</sup> *Friesen*, *supra* note 13 at 60.

<sup>106</sup> *Friesen*, *supra* note 13 at 58 [emphasis original].

<sup>107</sup> *Friesen*, *supra* note 13 at XLVI.

<sup>108</sup> *Friesen*, *supra* note 13 at XLV.

<sup>109</sup> *Cyprus Anvil Mining Corporation v The Queen*, 85 DTC 5306; [1985] 2 CTC 74.

income during that period but also that in the periods before and after it. This is neither logical, authorized by statute nor consistent with good business or accounting practice.<sup>110</sup>

In contrast to the FCA's position, the TCC argued in the *CDSL* case that according to subsection 10(2.1), a taxpayer had to use the same method from year to year unless the Minister approved the change.<sup>111</sup>

In the *Rudolph Furniture Ltd.*, the FCTD favoured using the accounting method for inventory valuation. According to the Court:

The income of a taxpayer from a business for a taxation year is his profit therefrom for the year. The Act does not define profit and it is to be determined by accepted accounting principles unless the provisions of the Act require a departure from those principles. The Act does not require such a departure in respect of the issues here beyond the limitations imposed by subsection 10(1).<sup>112</sup>

The court also mentioned that the taxpayer should use the same method of inventory valuation for opening and closing inventory balances to determine the most accurate profit for the period. Such a requirement for consistency is a basic foundational element of accounting, but not always required for tax purposes.<sup>113</sup>

Based on the preceding discussion, it is clear that in many cases, the courts are already accepting some elements of the accounting definition of inventory. The disagreement arises when some judges do not prefer the use of accounting based on the true picture test. However, accountants will acknowledge that there is no such thing as a "true picture" of the company's income.

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<sup>110</sup> *The Queen v Cyprus Anvil Mining Corporation*, 90 DTC 6063; [1990] 1 CTC 153.

<sup>111</sup> *CDSL*, *supra* note 12 at 17.

<sup>112</sup> *Rudolph Furniture Ltd v The Queen*, 82 DTC 6196; [1982] CTC 211.

<sup>113</sup> As cited in *Canderel*, *supra* note 8 at 36.

#### 2.1.2.4 Allowance for Doubtful and Bad Debts

When companies sell on credit, there is a chance that some of the customers will not pay their debts. The matching principle requires recording of bad debt expenses in the same accounting period in which the related sales are made. No mechanism can accurately predict bad debts. Accounting standards measure bad debt expenses using an estimated allowance method. The allowance method is based on estimates of the expected amount of bad debts and creating an account called allowance for doubtful accounts.

The timing of the expense recognition for bad debt and the actual receivable write-off do not usually coincide. Each year, a company makes a provision for bad debt expense reflecting its estimate of aggregate default by its credit customers. During the year, when it is determined that a customer will not pay a debt due to any reason, this amount is charged to the allowance without impacting any income statement account (and therefore without impacting income).

A reserve calculated for accounting purposes is not necessarily the same amount that is deductible for tax purposes. Subparagraph 20(1) (p) (i) allows taxpayers to deduct the total of “all debt owing to the taxpayer that is established by the taxpayer to have become bad debts in the year and that has been included in computing the taxpayer’s income for the year or a preceding taxation year.” Subsection 20(1) (p) (ii) provides a comparable deduction for uncollectible loans made by insurers, moneylenders, or financial institutions.

If any debt becomes bad or doubtful during the year, the Act allows the amount of the debt to be deducted from the current year’s income. In contrast, accountants set up an allowance for bad and doubtful debts based on total receivables, whereas taxation calculates it on an individual basis. For accounting purposes, the bad debt allowance is adjusted every year, whereas the *ITA*

requires any reserve deducted in 1 year to be included in income in the subsequent year, with a new reserve claimed for the subsequent year.<sup>114</sup> This method ensures that old debts do not become statute barred.

The “reasonable” amount of reserve calculation is based on various factors, such as the age of the overdue account, past experience with the debtor, and general business conditions. A reserve computed as a simple percentage of the taxpayer’s total accounts receivable is not acceptable for tax purposes.

When a debt is declared uncollectible or bad, the amount of that debt can be written off as an expense. The amount of bad debt written off in this way ensures that it is not included in the income in the following year. However, if this bad debt is recovered in future years, the amount of recovery is added to the income in the year of receipt. The different treatment of bad debt for accounting and tax purposes reflects the fundamentally different purposes of income measurement for accounting and tax purposes.<sup>115</sup>

In the case of *Groscki v Canada*, the FCA gave the following rationale for adding back the doubtful reserve in the following year’s income:

The combined effect of paragraphs 20(1)(l) and 12(1)(d) of the Act allows a taxpayer to deduct a reserve for doubtful debts for a given taxation year subject to this reserve being included in income in the following year and a new reserve being claimed as a deduction in that year, if justified. The result is that the payment of taxes on receivables, the collection of which can be shown to be doubtful, is deferred until such time as they cease to be doubtful. In contrast, when a debt can be

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<sup>114</sup> *ITA*, *supra* note 86 at paragraph 12(1) (d).

<sup>115</sup> Arnold et al, *supra* note 24 at 490.

shown to be unrecoverable, paragraph 20(1)(p) allows for a final one-time deduction with no corresponding inclusion.<sup>116</sup>

In *The Queen v Coppley Noyes & Randall Limited*, the Court established factors to be considered in determining whether a debt is doubtful or uncollectible. These factors include the time element, a history of the account, the financial position of the customer and the general business conditions in the area of debtor's business, and overall economic conditions.<sup>117</sup>

#### **2.1.2.5 Contingent Liabilities**

A contingent liability is a potential liability based on a historical event whose outcome depends on the occurrence of a potential future event. The treatments of contingencies for both financial accounting and taxation are significantly different. Provisions and contingent liabilities are discussed in IAS 37.<sup>118</sup> Potential liabilities are defined as contingent liabilities when there is uncertainty about timing or amount but where there is no uncertainty about the fact that liability will eventually exist. Accounting rules require reporting entities to record these liabilities based on the probability of occurrence and the ability of such entities to reasonably estimate the dollar amount. These estimates can be based on past experience and future expectations.

Contingent liabilities for accounting purposes are those liabilities that a company has to pay in the future if a specified event occurs and where the event has not yet occurred. It is “a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the

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<sup>116</sup> *Groscki v Canada*, 2011 DTC 5097 [at 5886], 2011 FCA 174 at 3.

<sup>117</sup> *The Queen v Coppley Noyes & Randall Limited*, 93 DTC 5508.

<sup>118</sup> In May 2017, the IASB issued IFRS 17 Insurance Contracts which amended IAS 37. This new standard will be applicable on or after January 01, 2021.

control of the entity.”<sup>119</sup> One example is a loan guarantee issued by the parent company for the loan taken by the subsidiary. The parent company is only liable when the subsidiary fails to pay the loan. If it is not possible to estimate the amount of liability, the amount is disclosed only in the notes to the financial statements. If the possibility of occurrence is probable (more likely than not) and the amount of liability can be estimated, then it is recorded in the body of the financial statements.<sup>120</sup>

For taxation purposes, contingent liabilities are confusing because they are not consistently treated. According to Arnold et al., “[o]wing to a hodgepodge of statutory provisions and case law that lacks any consistent theoretical basis, the tax treatment of contingent liabilities is extremely confusing.”<sup>121</sup>

A liability is deductible for tax purposes only when it is definite and absolute, whether paid or not. If the liability is contingent upon an event happening, it is not deductible until the liability becomes absolute. Contingent liabilities are different from future liabilities—e.g., deduction of a bonus payable to an executive. Companies can deduct this expense without the actual payment, but actual payment should be made within 179 days of the end of the employer’s taxation year. Otherwise, the deduction will be reversed.

Arnold et al. describe the different treatments of contingencies in accounting and taxation as follows:

Financial accounting is more accommodating of estimates (uncertain or contingent amounts) than is income tax, reflecting the different purposes

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<sup>119</sup> CPA, *supra* note 67 at IAS 37.10.

<sup>120</sup> Paul D Kimmel et al, *Financial Accounting Tools for Business Decision Making*, 6<sup>th</sup> Canadian Ed, (Toronto: Wiley, 2016).

<sup>121</sup> Arnold et al, *supra* note 24 at 420.

of financial accounting and income tax. In addition, accounting takes a practical substance-over-form approach to the determination of whether contingent liabilities should be recognized or disclosed in notes to the financial statements, whereas contingent, conditional, or uncertain amounts are generally not taken into account for tax purposes. The courts have held that an absolute obligation to pay does not become a contingent obligation only because of uncertainty as to the payment of the liability, the reduction of the amount, or the postponement of the payment. Therefore, for income tax purposes, when a taxpayer has a legal, though not necessarily an immediate, obligation to pay a sum of money, the taxpayer is considered to have incurred an expense. For financial accounting, however, events, amounts, and liabilities that are probable and can be reasonably estimated are commonly taken into account.<sup>122</sup>

Several complex issues on contingent liabilities have been resolved by the courts. In *Industries Perron Inc. v Canada*, the taxpayer was required to post security to cover potential liabilities for countervailing and anti-dumping duties for goods exported to the US. The company entered into a complex arrangement to provide this guarantee. It arranged a guarantee from the insurance company, which in return asked for irrevocable letters of credit from the bank, and the bank asked for a term deposit that was hypothecated in favour of the bank as security for obligations undertaken by the bank in favour of the insurance company. In the year of the guarantee, the taxpayer deducted the amount of a term deposit as an expense. In the following year, the taxpayer recognized the amount as income since the guarantee had expired and the taxpayer received his/her collateral back from the bank. According to FCA's decision, the amounts paid to the bank were not deductible because they were like a reserve, or a fund set up to cover a contingent liability. The taxpayer had no liability until a final determination was made, and therefore, the amounts were in respect of a contingent liability.<sup>123</sup>

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<sup>122</sup> Arnold et al, *supra* note 24 at 417 [footnotes omitted].

<sup>123</sup> *Industries Perron Inc v Canada*, 2013 FCA 176.



In *Canada v McLarty*, the SCC dealt with the issue of absolute versus contingent liabilities. In a split decision, the court decided that the liability regarding a promissory note is absolute. According to the court, the test for a contingent liability is “whether a legal obligation comes into existence at a point in time or whether it will not come into existence until the occurrence of an event which may never occur.” The terms of the promissory note demonstrated that the liability was absolute and not contingent.<sup>124</sup> The majority adopted the definition of a contingent liability in *Wawang Forest* and rejected it in the *Samuel F Investments* decision.<sup>125</sup>

In *Samuel F Investments Ltd. v MNR*, the court came up with the following three conditions for liability to be contingent: (1) whether the payment will be made; (2) the amount payable; and (3) the time by which the payment shall be made. According to the courts, “[i]f there is certainty regarding these three matters just enumerated and time of payment is deferred it will still be a real liability, but like a future obligation.”<sup>126</sup>

In *Wawang Forest Products Ltd. et al. v The Queen*, the FCA held that the “three uncertainties” referred to in the *Samuel F. Investments Ltd.* case may be characteristic of contingent liabilities in some circumstances, but cannot by themselves determine whether a liability is a contingent. The Court further said that the characterization of liabilities as absolute or contingent depended on the interpretation of the terms of the contract.<sup>127</sup>

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<sup>124</sup> *Canada v McLarty*, 2008 DTC 6354, 2008 SCC 26, [2008] 2 SCR 79.

<sup>125</sup> Arnold et al, *supra* note 24 at 424.

<sup>126</sup> *Samuel F Investments Ltd v MNR*, 88 DTC 1106; [1988] 1 CTC 2181.

<sup>127</sup> *Wawang Forest Products Ltd. et al v The Queen*, 2001 FCA 80; 2001 DTC 5212; [2001] 2 CTC 233.

### **2.1.2.6 Financial Derivatives and Mark-to-Market Method**

Derivatives are complex financial instruments that include forward contracts, options, warrants, swaps, and futures. IAS 32 and 39 and IFRS 2 deal with rules for reporting financial instruments. The value of derivatives comes from an underlying primary instrument, index, or nonfinancial asset, such as a commodity. Derivatives are used to manage risks as well as allow investors to take on more risk. Risks are managed by using derivatives, such as hedges to offset various risks faced by the business. Under IFRS, hedge accounting divides hedges into two basic groups: fair value hedge and cash flow hedge. Sophisticated financial models, such as Black-Scholes and binomial tree option pricing models, are available to value options, hedges, and derivatives.

Many companies do business with foreign companies and incur foreign currency gains and losses in the course of their business. Some multinational companies mitigate their foreign-currency risk by hedging their foreign-currency exposure with swaps or futures.

*ITA* section 39 outlines the taxation of gains and losses on foreign currency. The first step is to determine whether the foreign exchange gain or loss originates from income or capital receipts. Income receipts are fully taxable, whereas capital receipts are half taxable. Subsection 10(15) allows taxpayers to exclude swaps, forwards, futures, options, or other similar agreements from their inventory.

According to Clearwater, derivatives transactions are difficult to tax because they render elements of the present tax system unworkable in certain practical contexts. Commenting on the FCA decision in *The Queen v Shell Canada Limited*, Clearwater raised the question of whether it

was properly equipped to address how derivatives ought to be taxed and concluded that complex matters of derivatives taxation should be left to Parliament.<sup>128</sup> According to Clearwater,

Absent an objective or predetermined classification scheme, derivatives create possibly unmanageable characterization problems, for they are hybrid entities lying somewhere on a continuum only the poles of which can be defined as recognizable traditional instruments.<sup>129</sup>

The mark-to-market method of accounting is an accrual method of accounting. In this method, financial instruments are measured at fair value at the end of each accounting period. This method provides a realistic value of the assets. Mark-to-market is a clear deviation from the realization principle.

According to Reed, there are many social and compliance costs due to the inability of the current tax system to properly tax financial instruments.<sup>130</sup> Inconsistent rules distort the taxpayers' behaviors and lead to an inefficient allocation of resources.<sup>131</sup> Reed says, "Most, if not all, of these problems could be solved by abandoning our current realization system and adopting mark-to-market accounting for financial instruments."<sup>132</sup>

In the *Kruger* case, the FCA said that the CRA has recognized that mark-to-market is an appropriate method for computing income for tax purposes in derivative financial instruments, including foreign exchange option contracts.<sup>133</sup> All parties agree that derivative financial instruments are not "mark-to-market" property as defined by section 142.2. The CRA has

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<sup>128</sup> Tom Clearwater, "The Judicial Role in Derivative Taxation: The Queen v Shell Canada Limited and Financial Contract Economics" (1998) 46:6, CTJ 1212.

<sup>129</sup> *Ibid* at 1224.

<sup>130</sup> Reed Shuldiner, "A General Approach to the Taxation of Financial Instruments" (1992) 71:2 Tex L Rev 243[Reed].

<sup>131</sup> *Ibid*

<sup>132</sup> Reed *supra* note 130 at 246.

<sup>133</sup> *Kruger Incorporated v Canada*, 2016 FCA 186 [*Kruger*].

accommodated banks and others, allowing them to value such contracts mark-to-market. In the case of *Friedberg*, the Minister proposed the use of the mark-to-market method over realization.<sup>134</sup>

In the case of *Bank One Corp. v Commissioner*, the tax court acknowledged that following traditional realization principles can distort the measurement of taxable income for derivative instruments. The only practical way to eliminate unpredictable timing distortions is to adopt a mark-to-market method of tax accounting.<sup>135</sup> The Court said:

Mark-to-market accounting has for decades been considered by academia and other commentators to be the most theoretically desirable of all the various systems of taxing income in that mark-to-market accounting consistently measures and levies tax on a taxpayer's economic (or Haig-Simons) income.<sup>136</sup>

Schizer favours the mark-to-market regime. According to him, this method “could eliminate planning by treating all equivalent transactions consistently and accurately.”<sup>137</sup>

In 1999, the Australian government conducted a thorough review of business taxation. The report clearly recommended the use of mark-to-market election. According to the recommendation of the report:

[A] taxpayer be able to elect to use market value for tax purposes for financial assets and liabilities that are marked to market for the purpose of the taxpayer's audited profit and loss statement in its financial accounts.<sup>138</sup>

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<sup>134</sup> *Friedberg v Canada*, [1993] 4 SCR 285 [Friedberg].

<sup>135</sup> *Bank One Corp v Commissioner*, 120 TC 174 (2003).

<sup>136</sup> *Ibid* at 292.

<sup>137</sup> David Schizer, “Frictions as a constraint on Tax Planning” (2001) Columbia University School of Law, Working Paper No 187 at 8.

<sup>138</sup> Austl, *A Tax System Redesigned, More Certain, Equitable and Durable: Report/Review of Business Taxation* (Canberra: Australian Government Publishing Service, 1999) at 9.1. Also known as Ralph report.

In the 2017 Federal Budget, the Canadian government introduced an elective mark-to-market regime for derivatives held on income account. Such an election allows taxpayers to mark-to-market all of their eligible derivatives, and this budget provision was enacted in the legislation.

### **2.1.2.7 Revenue Recognition and Long-Term Contracts**

Some items of revenue are recognized in different time periods for accounting and taxation, and this timing difference creates a gap between accounting and taxable incomes. IFRS recently introduced a new standard, IFRS 15, Revenue from contracts with customers. In contrast to the previous earnings approach, this new standard uses an asset–liability approach as the basis for revenue recognition: companies are required to analyze the contracts with customers and use a five-step process to ensure that revenue is measured properly. The use of this new approach will be mandatory after January 01, 2020.<sup>139</sup>

IFRS uses the percentage-of-completion method for long contracts. In this method, revenue and gross profit are recognized each period based on the progress made during the period in earning the proportion of total revenues and gross profits. This method requires that at least one of the following criteria is met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs.
- b. The entity’s performance creates or enhances an asset (e.g., work in progress) that the customer controls as the asset is created or enhanced.

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<sup>139</sup> CPA, *supra* note 67 at IFRS 15.

- c. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.<sup>140</sup>

The tax system also allows both the percentage-of-completion and the completed-contract methods. In the completed-contract method, the criteria are more general, and revenues and profit are recognized only when the contract is complete. The contractor is required to use the same method consistently from year to year.<sup>141</sup> This offers an interesting setting to illustrate how the accounting principle of consistency is creeping into the tax system.

To the extent that tax rules may be not entirely parallel to accounting rules when revenues are received in different periods, the courts have developed their own rules on a case-by-case basis. In the cases of *Bombardier Inc.*, both the TCC and FCA accepted the company's use of percentage-of-completion method.<sup>142</sup> In the case of *Wilson and Wilson Ltd.*, the Exchequer Court rejected the taxpayer's use of the completed-contract method. Although the taxpayer pleaded that the completed-contract method is more suitable due to the nature of his/her business and risk involved, the court rejected the taxpayer's plea and said:

This method of accounting, however useful it may be for the purpose of the company itself as showing accurately the profit or loss on any one or more contracts, is, in my view, completely wrong when it is used for the purpose of computing the income of a taxpayer for a taxation year.<sup>143</sup>

In the case of *Huang and Danczkay*, the company used the completed-contract method, but the Minister rejected this method. The Court favoured the taxpayer's method because the

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<sup>140</sup> CPA, *supra* note 67 at IFRS 15.35.

<sup>141</sup> Canada Revenue Agency, Interpretation Bulletin IT-92R2, "Income of contractors" (29 December 1983). <<http://www.cra-arc.gc.ca/E/pub/tp/it92r2/it92r2-e.html>>. CRA has now archived this page.

<sup>142</sup> *Bombardier Inc v The Queen*, 2011 TCC 48; *The Queen v Bombardier Inc*, 2012 FCA 46; 2012 DTC 5088.

<sup>143</sup> *Wilson and Wilson Ltd v MNR*, 60 DTC 1018; [1960] CTC 1.

Minister failed to convince the court that his proposed method could offer a more accurate picture of the company's profit.<sup>144</sup>

In the case of *Trom Electric*, the company used the percentage-of-completion method for the financial statements and the completed-contract method for tax purposes. The Minister did not object to the taxpayer's use of the completed-contract method for income tax purposes.<sup>145</sup>

In *CDSL Canada Limited, R & J Engineering Corporation, and PCL Construction Management*,<sup>146</sup> the Courts have accepted the percentage-of-completion method because it gives a more accurate picture of the company's profit. By accepting a percentage-of-completion method, the courts have moved away from the realization principle to recognize more accounting principles.

### **2.1.3 Explanations for the Existence of the Gaps**

Accounting income and taxable income try to capture the economic activities of an entity for different purposes. There are two types of relationship structures between accounting income and tax income: "independence" and "dependence."<sup>147</sup> In the independence structure, income determination for accounting purposes is independent of income determination for tax purposes. There is some overlap, but the main characteristic is the freedom to use different policies for accounting and taxation. In the dependence structure, either the commercial accounts follow the tax rule or income for tax purposes is based on the commercial accounts. The relationship between accounting and taxation keeps changing. Most countries, including Canada, the US, and

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<sup>144</sup> *The Queen v Huang and Danczkay Ltd*, 98 DTC 6393; [1998] 3 CTC 337.

<sup>145</sup> *Trom Electric Co Ltd v The Queen*, 2004 TCC 727.

<sup>146</sup> *CDSL, supra* note 12; *R & J Engineering Corporation v MNR*, 92 DTC 1844; *PCL Construction Management Inc. et al v The Queen*, 2000 DTC 2624; [2001] 1 CTC 2132.

<sup>147</sup> Paraphrased from Martin N. Hoogendoorn, "Accounting and taxation in Europe-A comparative overview" (1996) 5: Supplement *The European Accounting Review* 783.

the United Kingdom (UK), follow the independence structure with some overlap. Due to different accounting and tax rules, the independence structure almost always leads to a book–tax income gap. In the dependence structure, there is a possibility of complete alignment between book income and tax income.

Schön discusses how some tax rules differ from accounting rules, which “not only deviate from the financial accounting treatment, they also infringe [on] the ability-to-pay principle.”<sup>148</sup>

According to him:

It is a common feature of tax laws all over the world that many differences between book and tax income arise in situations where tax law addresses nontax policy issues, giving preferential or disadvantageous treatment to a specific investment or other economic behaviour of the taxpayer. Here we find tax incentives (for example, accelerated depreciation), pure fiscally motivated rules (for example, bad debts) or provisions that are meant to pursue distributive aims (for example, specific rules for small and medium-sized business).<sup>149</sup>

He argues against these exceptions because they distort the tax base and violate the principle of equity in general.

### 2.1.3.1 Timing Differences

One of the main reasons for the book–tax income gap is timing differences. Timing differences arise when revenues are recognized for tax purposes and expenses are deducted, thereby determining how much tax is paid. According to Arnold et al:

Timing potentially affects all revenue and expense items irrespective of their source or character—indeed, the importance of the source and

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<sup>148</sup> Wolfgang Schön, “The David R. Tillinghast Lecture: The Odd Couple: A Common Future for Financial and Tax Accounting?” (2005) 58 Tax L Rev 111 at 131 [Schön].

<sup>149</sup> *Ibid* at 131.



character of revenue and expense items often relates to the timing of the recognition of these items. For example, income from a business or property is generally taxable on an accrual basis, whereas capital gains and losses are taxable only on a realization basis when property is disposed of.<sup>150</sup>

Due to the time value of money and the potential for the progressive nature of tax rates, it may be to the taxpayer's advantage to delay paying taxes by postponing the inclusion of a particular amount of income. The timing of taxes makes a major difference since if the taxpayer can defer the realization of gain, there is no immediate tax to pay. Postponing the taxes to the future is advantageous "because a future tax is only a possible tax whereas a current tax is an actuality. Congress, for example, may abolish or decrease the tax; the taxpayer may figure out how to avoid (or evade) the tax."<sup>151</sup>

Many types of revenues or expenses can only be recognized in a specific year. "There is no concept of cumulative profits in the *ITA*, so that if an amount is not assessed by the CRA for the appropriate year, it may not be recognized at all."<sup>152</sup>

Timing or temporary differences between book and tax occur due to the earlier or later recognition of income and expenses by either the accounting or tax system. Accounting and tax law are parallel but different systems of rules with different objectives. Commercial accounting requirements are different from taxation requirements. The primary purpose of accounting is to provide information that is useful and relevant to stakeholders, and such information is often future oriented. The primary goal of the income tax system is to collect tax revenues in an equitable, efficient, and simple manner, and such information is often historically oriented.

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<sup>150</sup> Arnold et al, *supra* note 24 at 4.

<sup>151</sup> Paul L Caron, ed, *Tax Stories* (New York: Thomson, 2003) at 58.

<sup>152</sup> Arnold et al, *supra* note 24 at 116.

The main principle of accounting is the matching principle on which accrual accounting is based. Its primary function is to enable stakeholders (especially investors) to extrapolate revenues into the future, match the appropriate expenses to the revenues recognized, and predict future accounting income.

The consistency principle of accounting ensures that entities consistently report their revenues and expenses over time. If changes are made to the way that revenues and expenses are computed, then accounting principles require companies to restate the prior year's financial statements retroactively under the new method. This ensures that accounting numbers are comparable over time and can be extrapolated into the future.

Accounting also relies heavily on the principle of conservatism, which favours understatement rather than overstatement of net income and net assets. The tax system, on the other hand, does not accept an understatement of income.

Hanlon, Laplante, and Shevlin highlight the multiple objectives within the Tax Code itself and how these objectives may conflict with other tax objectives, requiring the authorities to make trade-offs across the multiple objectives. According to these authors, the objectives of the Tax Code are:

[T]o raise revenue to fund government operations and public services, to redistribute wealth to achieve equity and social policy objectives, to encourage (discourage) certain economic activities deemed desirable (undesirable) by policymakers, and to achieve macroeconomic objectives (as a tool of fiscal policy). The tax code is also used as a political tool by the political parties and by individual politicians. The tax code as reflected in the calculation of taxable income is not concerned with providing information useful to shareholders and other interested parties about the performance of the firm (indeed, the tax return and the firm's

taxable income are not publicly disclosed). Thus it is not surprising that the two income numbers often diverge.<sup>153</sup>

Financial accounting relies on reporting for one fiscal year period at a time, with no provisions for reporting for more than a single fiscal year. In contrast, tax rules allow for net operating losses (NOLs) in one period to be carried back and/or carried forward so that firms can offset income and losses and pay income taxes on income after loss carryovers.

According to scholars such as Walker, the timing aspect of the definition of profit has not been well understood by the courts. For example, for many years, “there was a strong school of thought that expenses were only deductible in the year they were incurred, or not at all, as an overriding statutory requirement.”<sup>154</sup>

Timing is very important for taxation because deferring deductions can turn tax on income into a tax on consumption. Geier summarized this point eloquently:

The passage of time is important to the tax accounting system, in contrast, because real liabilities arise year by year based on when items are reported, and the time value of money affects the real definition of the tax base that produces those tax liabilities. A tax base of “income” seeks both to tax the making of an investment (through denial of deduction for capital expenditure, for example) and the tax the return on the investment. Allowing a year-1 deduction for payments not yet made, when there has not yet been a wealth decrease, effectively exempts from tax the investment return on that cash between the time of deduction and payment.<sup>155</sup>

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<sup>153</sup> Michelle Hanlon, Stacie Kelley & Terry Shevlin, “Evidence on the possible information loss of conforming book income and taxable income” (2005) Working paper at 10 [Hanlon et al].

<sup>154</sup> Geoffrey Walker, “Timing and Recognition of Income” 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002) at 8.

<sup>155</sup> Geier, *supra* note 5 at 96.

Other reasons for the timing difference between accounting income and tax income are the statutory or overriding legal provisions. According to Geier, timing is critical for taxation while deferring a deduction is acceptable in accounting, it distorts the tax base for the tax purposes.<sup>156</sup>

### **2.1.3.2 Overriding Statutory Provisions**

The *ITA* contains many provisions that govern the timing of income inclusion. The purpose of these provisions is to eliminate the uncertainty in tax calculation and choices and discretion as to when such income is to be reported. Such clarity is designed to improve simplicity, as well as equity or fairness across taxpayers.

The differences between taxable income and accounting income can be grouped into two categories: temporary differences and permanent differences. Temporary differences are differences between the carrying amount and tax base of an asset or liability in the balance sheet. Most temporary differences are timing differences that arise because of recognizing income in different time periods. Based on the accrual principle, the recognition of income earned vs. income received causes a significant difference between book income and tax income. Common examples of temporary differences are CCAs, accrued expenses, warranty expenses, and consolidated differences.

Permanent differences do not create a difference between the carrying amount and tax base of an asset or liability in the balance sheet. Permanent differences are created by those items which are treated differently in accounting and taxation, and that difference is never expected to

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<sup>156</sup> Geier, *supra* note 5 at 96.

be reversed; these items include tax-exempt investments, meals and entertainment, and life insurance proceeds.

The *ITA* also has specific provisions to include or exclude certain items in the calculation of taxable income. Some provisions deal with the inclusion of various revenue items in profit, whereas other provisions deal with amounts deductible in computing profit. Deductions allowed for tax purposes may exceed those allowed for accounting purposes for reasons of tax policy, whereby certain types of expenditures are encouraged or incentivized.<sup>157</sup> Some deductions are allowed for accounting purposes, but not tax purposes.

The *ITA* has used different criteria to decide the deductibility of expenses during different time periods. The first criterion in the 1917 Act (paragraph 6(1) (a)), which stated that expenses that were not necessary to earn income were not deductible. LaBrie and Westlake criticized this criterion because it placed the courts in the position of being business efficiency experts, a role the courts were not equipped to perform.<sup>158</sup>

The current *ITA* imposes a general limitation on the deductibility of expenses in paragraph 18(1) (a), requiring that deductible outlays or expenses to be made to gain or producing income from business or property. The following criteria are used to determine whether outlays should be deductible for income tax purposes:<sup>159</sup>

1. Expenses should not be of a personal nature;
2. Expenses should not be unreasonable in amount;

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<sup>157</sup> Stan Ross, Philip Burgess & Richard Krever, *Income Tax: A Critical Analysis*, 2<sup>nd</sup> ed, (Australia: LBC Information Services, 1996).

<sup>158</sup> Francis E LaBrie & J R Westlake, *Deductions under the Income War Tax Act: A Return to Business Principles* (Toronto: University of Toronto Press, 1948) at 8/9.

<sup>159</sup> Neil Brooks, "The Principles Underlying the Deduction of Business Expenses," in Brian G. Hansen, Vern Krishna, and James A. Rendall, eds., *Canadian Taxation* (Toronto: De Boo, 1981), 189-249, also see, A Mawani, "Tax Deductibility of Employee Stock Options" (2003) 51: 3 Can T J 1230 [Mawani].

3. The outlay should not be awarded to simply avoid paying income taxes;
4. There should not be any public policy reason to curtail the use of this expense;
5. The payer's wealth or income should be diminished as a result of this outlay;
6. Capital expense should not be immediately deductible but instead amortized over the estimated useful life of the asset.

The timing of deductions is essential since accelerating deductions may allow the taxpayer to reduce the payment of taxes in present value terms. The *ITA* does not have any specific provision that sets forth a general rule for the timing of the deductibility of expenses.<sup>160</sup>

The *ITA* specifically prohibits deductibility of some outlays, such as capital cost, sinking funds, contingent liabilities, and reserves in section 18, with a few exceptions, such as reserve for doubtful debts<sup>161</sup> and the CCA.<sup>162</sup> Some of these deductions are policy tools used by governments to give incentive to specific industries or certain types of expenditures.

### 2.1.3.3 Overriding Legal Provisions

Some provisions are not statutorily prescribed in the *ITA* but developed by the judiciary through case law. The legal definition of income is based on the realization principle, but actual cash flows received play a significant role in determining taxes payable. The matching principle from accounting is also used—e.g., when interest income on a debt obligation is computed based on the accrual method.<sup>163</sup> However, the selective use of the accrual principle makes the legal definition of income more complicated, since the hybrid method may lack an economic justification.

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<sup>160</sup> Carr, *supra* note 14 at 964.

<sup>161</sup> *ITA*, *supra* note 86 at paragraph 20(1)(l).

<sup>162</sup> *ITA*, *supra* note 86 at paragraph 20(1)(a).

<sup>163</sup> *ITA*, *supra* note 86 at subsection 12(3).

Arnold et al. mention some of these legal principles developed through the courts:

- In *Symes*, the Supreme Court concluded that profit in section 9 is a net concept after considering all the deductions.
- Profit does not include capital gains or losses from the disposition of a source of income.
- Uncertain or estimated amounts and anticipated losses or expenditures may not be included in the computation of profit.
- In the absence of any specific provision, profit is determined using the accrual rather than cash method of accounting.
- The operating expenses will be deducted in the year in which they are incurred.
- The deduction of expenses will not depend on the revenue in that period.<sup>164</sup>

The last two criteria do not apply to deductions, such as CCA and scientific research and experimental development deduction (SR&ED), which are considered discretionary, and can, therefore, be deferred to future years if taxpayers are not in a tax-paying position, thereby allowing taxpayers to manage their tax liability over time.

The source concept is a well-established tax principle set by the courts. If the source of any receipt is not determined, then it may not be considered income and is therefore not taxable, e.g., lottery winnings or gambling income that does not come from an organized business.<sup>165</sup>

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<sup>164</sup> Arnold et al, *supra* note 24 at 84-91.

<sup>165</sup> In *Canada v Fries*, SCC decided that strike pay does not come within the definition of “income from a source” within the meaning of section 3 of the *ITA*, *Canada v Fries* (1990) 2 SCR 1322.

Embezzled money is only taxable if it comes from an identifiable source.<sup>166</sup> The Supreme Court of Canada established a two-stage approach to determine whether a taxpayer's activities constituted a source of business or property income.<sup>167</sup>

Taxpayers are not allowed to recognize any loss of capital assets until the underlying assets are sold. In *MNR v Consolidated Glass Ltd.*, the taxpayer attempted to deduct as a capital loss an amount that reflected the decline in value of the shares of his/her subsidiary company. A majority on the Supreme Court of Canada held that the taxpayer could not claim a loss in respect of assets of a fluctuating value until the assets were sold or became worthless so that the loss was irrevocable.<sup>168</sup>

A taxpayer can engage in a transaction for tax reduction purposes only. In *Stuart Investments Limited v The Queen*,<sup>169</sup> it was decided that the business purpose test and the sham test be two distinct tests. According to the Supreme Court, "a transaction cannot be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without independent or *bona fide* business purposes."<sup>170</sup> Justice Wilson held that there was no reason to reject Lord Tomlin's principle that every man is entitled to arrange his affairs to minimize his taxes lawfully in the absence of any clear statutory provision, and the business purpose test is a complete rejection of Lord Tomlin's principle.<sup>171</sup>

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<sup>166</sup> *R v Fogazzi et al*, 92 DTC 6421; [1992] 2 CTC 321.

<sup>167</sup> *Stewart v Canada*, [2002] 2 SCR 645, 2002 SCC 46 at 50 [Stewart].

<sup>168</sup> Vern Krishna, *Income Tax Law*, 2<sup>nd</sup> ed (Toronto: Irwin Law Inc. 2012) at 82 [Krishna].

<sup>169</sup> *Stuart Investments Limited v The Queen*, [1984] 1 SCR 536.

In the case, the appellant's subsidiary incurred substantial losses that could be carry forwarded to future tax years. The appellant sold its assets to the subsidiary, and the subsidiary later appointed an appellant by a separate agreement as its agent to carry on business on its behalf.

<sup>170</sup> *Ibid* at 537 [emphasis in original].

<sup>171</sup> *Supra* note 169.



According to Arnold, the Canadian Supreme Court holds the view that economic substance or realities are irrelevant for tax purposes, and “in the absence of a statutory rule, taxpayers are free to arrange their affairs to avoid tax. Moreover, it is Parliament’s responsibility and not the courts’ responsibility to combat tax avoidance.”<sup>172</sup> The tax authorities were less satisfied with this position and, therefore, in 1988, introduced general anti-avoidance rules (GAAR) to mitigate tax avoidance transactions. GAAR can scrutinize transactions that are tax motivated and carried out primarily to obtain a tax benefit.<sup>173</sup>

The *Consolidated Textile* case endorsed that outlays are deductible only in the year in which they are incurred, but later, the courts started moving away from this rule. “[S]tarting most notably with *Associated Investors*, this general principle was steadily eroded and, in *Canderel* and *Toronto College Park*, was arguably rejected.”<sup>174</sup>

The “disposition” of capital property gives rise to the recapture of CCA and the potential realization of capital gains. Section 54 of the *ITA* defines “proceeds of disposition.” The definition provides some very specific inclusions and exclusions. In most cases, proceeds of the disposition are the value of the consideration received or receivable. Where a deemed disposition (not an actual disposition) occurs, the proceeds are usually deemed to be the FMV of the property at the time of the disposition.

The *ITA* also has rules to recapture excessive CCA claims made when an asset is sold or to allow an additional terminal loss deduction if sufficient CCA has not been claimed over the life

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<sup>172</sup> Arnold, Brian J & Hugh J Ault, *Comparative Income Taxation, A Structural Analysis*, 3 d, (New York, Wolters Kluwer, 2010) at 35 [Ault & Arnold].

<sup>173</sup> Canada Revenue Agency, IC88-2, “General Anti-Avoidance Rule-Section 245 of the *Income Tax Act*” (21 October 1988), online: CRA website < <http://www.cra-arc.gc.ca/E/pub/tp/ic88-2/ic88-2-e.html>>. CRA has now archived this page.

<sup>174</sup> Arnold et al, *supra* note 24 at 401.

of the asset. The market value of the proceeds of disposition determines whether the taxpayer received sufficient CCA claims over the life of an asset (neither recapture nor terminal loss), received more CCA claims than the decline in value as evidenced by the proceeds of disposition (recapture), or received less CCA claims compared with the decline in value suffered at the time of sale (terminal loss). These rules are applicable when there are no assets left in the class and the company has sold the last asset in the class.

The courts have wrestled with the issue of whether the legal owner or the beneficial owner is eligible to claim CCA. In *Canada v Construction Bérou Inc.*, the court decided that legal ownership could be different from beneficial ownership, and a beneficial owner can also claim CCA without having legal ownership. According to the court, “when there was a “disposition” for a party to a contract, the other party made an “acquisition” or obtained the “beneficial ownership” of it.”<sup>175</sup>

In the case of *Hewlett Packard (Canada) Ltd. v Canada*, the taxpayer purchased a new fleet of cars from Ford Motors to replace the fleet it had acquired the previous year. In order to get the benefit of the half-year rule and maximize the CCA available each year, the taxpayer arranged its affairs with Ford so that it would purchase the new fleet immediately before the close of its taxation year and sell the old fleet back to Ford at the beginning of the subsequent taxation year. With this set of facts, the taxpayer claimed CCA for both the old and new fleets over 2 years. The Minister challenged the taxpayer’s entitlement to claim CCA for the old fleet. While the TCC decided against the taxpayer, the FCA decided that there was no disposition unless it was accompanied by a change in beneficial ownership of the fleet, and ownership

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<sup>175</sup> *Canada v Construction Bérou Inc.*, 99 DTC 5869 at 6(FCA).

passes when the parties intend it to pass. Therefore, the taxpayer was entitled to claim the CCA on the old fleet.<sup>176</sup>

All tax decisions rendered by the courts have long-term implications. While siding with the tax authority can offer the government a temporary victory, the long-term impact may not always be favourable. For example, Kahng says:

Thor Power was a victory for the government in its quest to disallow loss deductions, and it established that financial accounting does not determine the proper tax treatment of a transaction. However, in keeping with Martin Ginsburg's famous observation that "every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the commissioner on the hind part," the wall between tax and financial accounting has sometimes been used to the government's detriment.<sup>177</sup>

#### **2.1.3.4 Realization**

The determination of taxable income relies heavily on the principle of realization. Income tax payments involve cash outlays, and therefore, realization became a fundamental concept in taxation from its early days. If the tax is imposed before the actual revenue is received, it can cause a severe cash flow problem for the taxpayer. Also, actual receipts remove any uncertainty regarding the collection of accounts receivable. The general timing principle for tax purposes is that income must be received first and then subject to tax. As Rowlatt J said in a 1928 decision of the House of Lords, for income tax purposes, "receivability" without a receipt is nothing.<sup>178</sup>

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<sup>176</sup> *Hewlett Packard (Canada) Ltd. v Canada*, 2004 DTC 6498, 2004 FCA 240.

<sup>177</sup> Lily Kahng, "Perspectives on the Relationship Between Financial and Tax Accounting" in Anthony C. Infanti, ed, *Controversies in Tax Law A Matter of Perspective* (New York: Routledge, 2015) 93 at 95 [Kahng].

<sup>178</sup> Arnold et al, *supra* note 24 at 220.

As early businesses were based on cash only, income taxes were imposed only on income received, and not income receivable. With receivables and payables becoming part of the business culture and practices, accounting incorporated the accrual principle where creditworthy receivables and payables were considered to have been received or paid. The realization requirement in taxation is a compromise between the theoretical purity of the economic concept of income and administrative feasibility of applying economic theory in practice.<sup>179</sup>

In the *Income War Tax Act* 1917, taxable income was restricted to the income “received.” In the 1946 *Trapp* case, the Exchequer Court stated that the accrual method was not acceptable for income tax purposes and that tax should be levied only on the realized amount.<sup>180</sup> Since taxpayers needed to have the cash to pay taxes, any revenue ought to have been received before the tax payment was imposed. When the tax system is based on actual receipts, it removes any uncertainty regarding the account receivable.<sup>181</sup>

Many scholars have discussed the importance of the realization principle for income tax purposes. For example, Hogg, Magee, and Li conclude that “The non-taxation of unrealized gains is one of the most fundamental aspect[s] of Canadian income tax law.”<sup>182</sup> Arnold et al. summarize that “[i]t is often stated that income must be realized before it is taken into account for income tax purposes.”<sup>183</sup> Holmes concludes that “[a] gain must be realized before it can be treated as income in the legal sense.”<sup>184</sup>

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<sup>179</sup> Krishna, *supra* note 168.

<sup>180</sup> *Trapp v Minister of National Revenue*, 2 DTC 784, at 787; [1946] CTC 30, at 37 (Ex. Ct.).

<sup>181</sup> Brian J Arnold, *Timing and Income Taxation: The Principle of Income Measurement for Tax Purposes* (Toronto, Canadian Tax Foundation, 1983) at 127.

<sup>182</sup> Peter W Hogg, Joanne E Magee & Jinyan Li, *Principles of Canadian Income Tax Law*, 5<sup>th</sup> ed (Toronto: Carswell, 2005) at 81.

<sup>183</sup> Arnold et al, *supra* note 24 at 150.

<sup>184</sup> Holmes, *supra* note 65 at 178.

Given market fluctuations, unrealized profit can be different under various economic conditions. It was therefore considered unjust to tax income before realization. In the British case of *Ostime v Duple Motor Bodies Ltd.*, Lord Reid emphasized “a cardinal principle that profit shall not be taxed until realized; if the market value fell before the article was sold the profit might never be realized.”<sup>185</sup>

The *Friesen* case also refers to realization as being a key taxation principle for the computation of taxable income, with some exceptions such as inventory valuation in case of stock-in-trade.<sup>186</sup> In *MNR v Consolidated Glass Co. Ltd.*, Justice Rand stated that appreciation could not be considered profit before its realization and that actual realization was a necessary prerequisite for income taxes to be assessed.<sup>187</sup>

According to Fisher, “... the tax, to be just, should be levied not according to what he [an individual] might do but what he does do.” However, some writers have objected to the realization criterion used in taxation. For example, Vickery considered the realization criteria for tax purposes to be both arbitrary and inconsistent because “even after the liquidation of the assets of the taxpayer, realized income, as defined by law, fails to correspond to accrued income.”<sup>188</sup>

The realization requirement arguably makes income tax a tax on transactions rather than a tax on economic income.<sup>189</sup> Taxpayers may have control over the payment of tax because they can postpone or defer the realization of income to some future date to postpone the tax

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<sup>185</sup> *Supra* note 95.

<sup>186</sup> *Friesen*, *supra* note 13.

<sup>187</sup> *MNR v Consolidated Glass Co. Ltd.*, 57 DTC 1041, at 1043; [1957] CTC 78, at 83 (SCC).

<sup>188</sup> William Vickrey, *Agenda for Progressive Taxation*, (New Jersey: Augustus M Kelley Publisher, 1972) at 9 [Vickrey].

<sup>189</sup> Krishna, *supra* note 168.

payment.<sup>190</sup> The value of this tax deferral depends on the prevailing interest rate and time period for which the taxpayer deferred realization.<sup>191</sup> However, most critics also recognize that if a tax was imposed before the actual cash was received, the taxpayer could suffer serious cash flow problems. Taxpayers could have accounting profits while lacking the cash to pay taxes.

*Ikea* confirmed that the realization principle in law is the same as in accounting. According to the court, “[t]he “realization principle,” which holds that an amount may have the quality of income even though it is not actually received by the taxpayer but only “realized” in accordance with the accrual method of accounting, is well established in jurisprudence.”<sup>192</sup>

According to Arnold et al.:

The most notable point emerging from *Ikea* is that, while the court referred to the *Canderel* framework, in the end its decision as to the proper timing of the recognition of the tenant inducement payment was based on the realization principle, which—unlike the matching principle—has (according to the court) developed into a rule of law in the tax jurisprudence.<sup>193</sup>

Arnold et al. further argue that any reference to the realization concerning the timing of the recognition of revenue should be avoided except for the disposition of property because “the use of the term “realization” has become too imprecise, and the Supreme Court’s use of the term in *Ikea* adds to the confusion.”<sup>194</sup>

Arnold et al. questioned the use of the term “realization” to describe the timing of income and recommended the use of the term “taxable event” to refer to the time at which revenues or gains are recognized for income tax purposes:

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<sup>190</sup> Krishna, *supra* note 168 at 86.

<sup>191</sup> Krishna, *supra* note 168.

<sup>192</sup> *Ikea Ltd. v Canada*, 98 DTC 6092, [1998] 1 SCR 196 at 37 [*Ikea*].

<sup>193</sup> Arnold et al, *supra* note 24 at 65.

<sup>194</sup> Arnold et al, *supra* note 24 at 288/289.

Business income is now generally recognized when it is earned. Specific amounts may be recognized when they accrue when they are received, when the taxpayer becomes entitled to receive them, or at the end of the year in accordance with the change in their value during the year (the mark-to-market method). The use of the term “realization” to encompass all these different timing rules, in our view, stretches its meaning beyond reasonable bounds and makes it imprecise and misleading.<sup>195</sup>

Talking about the statutory timing rule regarding the concept of a “disposition” of property, Arnold et al. state, “[w]ith respect to gains and losses from changes in the value of the property, the statutory timing rules are generally equivalent to the realization requirement developed by the courts.”<sup>196</sup>

In the *Kruger Incorporated* case, the FCA clearly stated that considering realization principle as an overarching principle runs counter to the decision of the Supreme Court on *Canderel* and *Ikea*. Realization can give way to other methods of computing income under section 9.<sup>197</sup> In the *Canadian General Electric* case, the Supreme Court in a split decision rejected the Minister’s position that realization was mandatory.<sup>198</sup>

The Act contains many exceptions to the realization requirement, including the “lower of cost and market” rule for valuing inventory, mark-to-market rules for certain securities, deemed dispositions, rollover provisions, and rules for the recognition of foreign exchange gains and losses, imputed income for items such as low interest or interest-free loans to employees, prepaid income, and doubtful and bad debt.

According to Miller, such a move away from the realization principle creates potential liquidity concerns for taxpayers:

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<sup>195</sup> Arnold et al, *supra* note 24 at 215.

<sup>196</sup> Arnold et al, *supra* note 24 at 225-226.

<sup>197</sup> *Kruger*, *supra* note 133.

<sup>198</sup> *Supra* note 53.

In an instant, our federal tax system for taxing derivatives would abandon the realization rule that characterized its first hundred years and begin its second century based on economic income. This paradigm shift would represent the most dramatic reform to our federal tax system since its introduction and would do what a century of economists and tax lawyers have said would be impossible.<sup>199</sup>

### 2.1.3.5 Legal Form Versus Economic Substance

The principle of legal form versus economic substance has been well established in accounting theory and practice for a long time. It justifies transactions based on their underlying economic nature rather than their legal form. In general, the legal form is preferred over economic substance for legal purposes, even though some cases have given preference to substance over form (e.g., *Trustco*). *Barclays* was an important case in which the court indicated its strong preference of form over substance.<sup>200</sup> Although this was a British tax case, the decision set a precedent that the legal form of a transaction determines its tax consequences. Unless the transaction can be shown to offend a clear provision in the Act, the final determination of whether there has been an abuse of the Act read as a whole will rest with the courts, not the tax authorities.<sup>201</sup> The 2001 Supreme Court decision on *Singleton* reinforced that legal form is preferred over economic substance.

The principle of substance over form is applied differently for financial accounting purposes and tax purposes. In the case of leverage leasing, for example, it is difficult to understand the true nature of the transaction without considering the economic substance of the

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<sup>199</sup> David S. Miller, “Towards an Economic Model for the Taxation of Derivatives and other Financial Instruments” (2013) Volume 3, Harvard Business Law Review Online 108 at 115.

<sup>200</sup> *Barclays Mercantile Business Finance Ltd v HM Inspector of Taxes* [2004] UKHL 51.

<sup>201</sup> Malcolm Gammie, “Barclays and Canada Trustco: Further Comment from a UK Perspective” (2005) 53:4 Can Tax J 1047.



transaction. If the legal form of the transaction is considered while ignoring the economic substance, such leases can be used as abusive tax shelters.

Accounting income is arguably and conceptually closer to economic substance compared with other types of income. The economic concept stipulates that the economic realities of the transaction are more important than the legal form of the transaction. This concept is important for the reliability of financial statements. Substance over form can be used for legal purposes, and it may be suitable for taxation in limited circumstances. According to Schön:

One of the major elements of financial accounting that might prove relevant in the tax shelter debate is the substance over form principle, which is laid down both in US GAAP and in the International Accounting Standards. Book-tax conformity would lead to a strengthening of this principle in the tax sector.<sup>202</sup>

In law, the legal form of the transaction is critical and usually the sole decision criterion.

According to Porcano and Tran:

To achieve the objective of financial reporting, transactions may need to be re-characterized to reflect their economic substance for financial accounting purposes. Since tax is a contribution enforced by law, naturally the legal form of a transaction is important in determining its impact on the tax liability of the transactors.<sup>203</sup>

In the case of *CCLI*, Justice Miller said it is difficult to reconcile tax laws and commercial practice. According to Miller, our complex tax law will make more sense if it is closer to the commercial practice, but “this approach has not been universally embraced.” He further discussed legal form and economic substance as follows:

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<sup>202</sup> Schön, *supra* note 148 at 145.

<sup>203</sup> Thomas M Porcano & Alfred V Tran, “Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries” (1998) 33:4 *The Intl J of Accounting* 433 at 447 [Porcano & Tran].

Certainty and legal form do trump economic substance, if legal form reflects legal substance. I grapple here with whether a company in the business of financial leasing is, in legal substance, lending money. It is one thing to pit legal form against economic substance, but what if the question is framed as legal form versus legal substance? There are many examples where the courts find the legal form mischaracterizes the legal substance (a common example is a contract between an employer and employee that stipulates the contract is one of an independent contractor).<sup>204</sup>

In the *Shell* case, the SCC ruled that “the court must be sensitive to the economic realities of a particular transaction, rather than being bound to what appears to be its legal form.”<sup>205</sup> The Court further ruled that:

[I]t is well established in this Court’s tax jurisprudence that a searching inquiry for either the “economic realities” of a particular transaction or the general object and spirit of the provision at issue can never supplant a court’s duty to apply an unambiguous provision of the Act to a taxpayer’s transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied.<sup>206</sup>

The leading Canadian case on economic substance is *Canada Trustco*.<sup>207</sup> The court rejected the government’s reassessment on the grounds of economic substance, and the Court found that the purpose of the CCA provisions was to allow deductions based on the legal cost rather than the economic cost of the assets.<sup>208</sup>

According to Li, the recognition of the relevance of economic substance in *Canada Trustco* was a relatively new concept in Canadian tax law.<sup>209</sup> The doctrine of economic substance over form should not be confused with the doctrine of legal substance over form,

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<sup>204</sup> *CCLI (1994) Inc v The Queen*, 2006 TCC 240 at 26.

<sup>205</sup> *Shell Canada Ltd v The Queen*, [1999] 3 SCR 622 at 36.

<sup>206</sup> *Ibid* at 37 [emphasis original].

<sup>207</sup> *Canada Trustco Mortgage Co. v Canada*, [2005] 2 SCR 601, 2005 SCC 54.

<sup>208</sup> Brian J. Arnold, “Policy Forum: Confusion Worse Confounded—The Supreme Court’s GAAR Decisions” (2006) 54:1 Can Tax J 167.

<sup>209</sup> Jinyan Li, “Economic Substance: Drawing the Line between Legitimate Tax Minimization and Abusive Tax Avoidance” (2006) 54:1 Can Tax J 23.

which was already well recognized in Canadian income tax law.<sup>210</sup> When assessing the income tax consequences of a transaction, the terms and conditions of the agreement between the parties must be analyzed to determine their true legal implications.

US courts may arguably hold substance as being more important than form. The case *Frank Lyon Co. v US*<sup>211</sup> indicated a preference for economic substance over form by finding that economic substance is a reality that should be considered. According to Magill, the form has played a much less important part in cases involving trusts than in the decisions on corporate distributions and exchanges.<sup>212</sup>

In the US case of *Gregory v Helvering*, the taxpayer who was the sole owner of a corporation transferred his shares to a new corporation, which then issued all of these shares to the taxpayer. Within a few days, the new corporation was dissolved and liquidated by the distribution of these shares back to the taxpayer, who immediately sold them and made a profit. The Commissioner argued that reorganization was without substance and must be disregarded. The US Supreme Court says that it is a taxpayer's right to decrease the amount of taxes payable using any legal means available, but that the transaction should not be outside the plain intent of the statute. According to the Court, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."<sup>213</sup> The court decided in favour of the Commissioner and stated:

The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction, upon its face, lies outside the plain intent of the statute. To hold otherwise would be to exalt

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<sup>210</sup> Jon D Gilbert, "Principles of Leasing" (2000) 7:1 Can Tax Found 51.

<sup>211</sup> *Frank Lyon Co. v United States*, 435 US 561 (1978).

<sup>212</sup> Roswell Magill, *Taxable Income* (New York: The Ronald Press Company, 1945) at 25 [Magill].

<sup>213</sup> *Gregory v Helvering*, 293 US 465 (1935) at 469.

artifice above reality and to deprive the statutory provision in question of all serious purpose.<sup>214</sup>

### 2.1.3.6 Matching and Accrual Principle

The matching principle is the foundation of accrual accounting, and it requires expenses to be matched to the revenues in the same period in which the revenues are recognized. Revenue is reported when it is considered realized (in the accounting sense), and expenses are matched to revenues after that regardless of whether there is an associated cash outlay. It is generally in the interest of taxpayers to delay paying income taxes, and this could be accomplished by postponing recognition of revenue. The *ITA* contains several provisions that govern the timing of income inclusion—e.g., interest on debt obligations that are due after two or more years.<sup>215</sup>

For many years, Canadian courts rejected the use of accrual accounting for income tax purposes, but gradually, they started embracing it. Now, the courts are actually requiring this method, and “the accrual method is the standard accounting method for measuring business income for tax purposes, with exceptions permitted only where they are expressly authorized by the Act.”<sup>216</sup>

According to Arnold et al., “As a general rule, taxpayers are required by section 9 to use the accrual method of accounting to calculate the income from a business or property.”<sup>217</sup> The acceptance of the accrual method of accounting for income tax purposes has changed the definition of realization for income tax purposes.

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<sup>214</sup> *Ibid* at 270.

<sup>215</sup> *ITA*, *supra* note 86 at subsection 12(3).

<sup>216</sup> Arnold et al, *supra* note 24 at 56 [footnotes omitted].

<sup>217</sup> Arnold et al, *supra* note 24 at 404.

Expenses need to be matched with revenues in the period in which revenues are recognized. The classic example of revenue matching is found in *Vallambrosa Rubber* where tax authorities argued that only 1/7 of the general expenses could be deducted in any particular year because the corresponding revenues were produced by only 1/7 of the trees.<sup>218</sup> The court decided that the company was entitled to the full deduction. In the famous US Supreme Court case *Indopco Inc.*,<sup>219</sup> the Court admitted that matching is a tax value. Geier considers the decision on *Indopco Inc.* “unfortunate” because the Court acknowledged that matching the expenses with the revenue during a tax period gives an accurate calculation of net income for tax purposes. A similar conclusion was reached in *Mooney Aircraft v US*,<sup>220</sup> where the issue was whether the taxpayer’s accrual system of accounting is acceptable for tax purposes.

Matching is an integral part of accounting. However, we cannot exclude matching from the legal basis of taxation, although the judicial concept of matching is narrower than the accounting concept of matching. In a judicial concept, if a particular expense cannot be matched with particular items of revenue, it can still be deducted (for tax purposes) in the year in which it was incurred.<sup>221</sup>

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<sup>218</sup> Carr, *supra* note 14.

<sup>219</sup> *Indopco, Inc v Commissioner* 503 US 79 (1992)

The taxpayer deducted a \$2 million payment to an investment banker for acquisition of a company. The minister classified this payment as a non-deductible acquisition of a capital asset. The taxpayer argued that capitalization would require the payment to be tied to a particular asset (*Commissioner v Lincoln Savings & Loan Association*), and the resulting expense would increase the value of the company. In the *Indopco* case, the outlays were not tied to any particular asset, and there was no increase in the value of the company. Therefore, the taxpayer argued that this expense should be considered an operating expense and deductible in the current year.

<sup>220</sup> *Mooney Aircraft, Inc, v United States of America*, 420 F.2d 400 (5th Cir 1970).

<sup>221</sup> Al Meghji, “The Role of GAAP in Computing Taxable Profit” (1995) Can Tax Found [Meghji].

The matching principle does not apply to the “running expenses,” which should be deducted in the year of outlay.<sup>222</sup> “The courts have described “running expenses” as expenses that are not referable or related to any particular item of revenue and would include any expenses that are necessarily incurred on a continuing and recurring basis for the general purpose of producing income.”<sup>223</sup>

In the *Oxford Shopping Center* case, the court ruled that matching should only be applied to particular items, and not necessarily just on current expenses, even if they are large payments. Furthermore, there is no specific provision in the Act that prohibits the deduction of the full amount of expenses in the year of payment.<sup>224</sup> In dealing with the issue of whether the taxpayer was required to amortize the expenditure over the 15-year period, Mr. Justice Thurlow stated:

[F]or income tax purposes, while the “matching principle” will apply to expenses related to particular items of income, and in particular with respect to the computation of profit from the acquisition and sale of inventory, it does not apply to the running expense of the business as a whole even though the deduction of a particularly heavy item of running expense in the year in which it is paid will distort the income for that particular year.<sup>225</sup>

Precedents from the *Oxford* case were brought up by the Supreme Court in the *Canderel*, *Toronto College Park*, and *Ikea* cases.<sup>226</sup> According to Carr, the Supreme Court of Canada established in the *Canderel Limited*, *Toronto College Park*, and *Ikea* cases the principles that govern the timing of recognizing income receipts and the timing of deducting income expenses.<sup>227</sup> Carr considers the *Canderel* case<sup>228</sup> in FCA to be an example of the judicial use of

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<sup>222</sup> *Supra* note 46.

<sup>223</sup> Arnold et al, *supra* note 24 at 404.

<sup>224</sup> Cited by Joseph Frankovic, “The Matching of Current Expenses” (1998) 1:21 Can Tax J [Frankovic].

<sup>225</sup> *Oxford Shopping Centres Ltd v The Queen*, 79 DTC 5458, [1980] CTC 7, aff'd 81 DTC 5065, [1981] CTC 128 (FCA).

<sup>226</sup> Carr, *supra* note 14.

<sup>227</sup> Carr, *supra* note 14 at 964.

the matching principle in which Justice Stone held that since the expenses could be matched, they should be matched.<sup>229</sup> However, the Supreme Court rejected this view held by the FCA regarding matching principle. “According to the court, the matching principle of accounting is not an established case-law principle that requires expenses related to items of revenue in future years to be amortized for computing business profit under section 9.”<sup>230</sup>

The court’s ruling in the *Ikea* case was that the matching principle was not an overriding rule of law “and there is no reason to apply it as paramount to or instead of the “realization principle,” which is of fundamental importance in the present circumstances.”<sup>231</sup>

Why do courts come up with their own definition of matching instead of accepting the accounting principle of matching? Meghji responds as follows:

It is suggested that the answer lies in the fact that courts have constantly struggled to balance the certainty and predictability that comes with cash basis accounting against the relevance and “modernity” that comes with accrual accounting. Courts have consistently shown an aversion toward the subjectivity and estimation that characterizes period matching, even though period matching may result in a profit figure that is more in accord with the conception of profit in the modern economy. On the other hand, where matching is possible without significant estimation and the risk of arbitrariness, courts are willing to mandate or allow matching. For example, courts have long accepted the matching that characterizes inventory accounting, where there is generally a clear relationship between the outlays and revenues. *Canderel* and *Oxford Shopping Centres* are significant in that they stand for the proposition that matching is compulsory for items below the gross profit line, but only

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<sup>228</sup> *Canderel Ltd.* was in the business of managing and developing commercial real estate. Due to poor market conditions, the company offered tenant inducement payments to prospective tenants. *Canderel* capitalized the inducement payments for accounting while expensing and deducting them for tax purposes. The minister disallowed the deductions. The Federal Court of Appeal decided in favour of the taxpayer.

<sup>229</sup> Carr, *supra* note 14 at 979.

<sup>230</sup> Arnold et al, *supra* note 24 at 61.

<sup>231</sup> *Ikea*, *supra* note 192 at 39.

where the relationship between the outlay in issue and particular revenues in a future period is clear.<sup>232</sup>

According to Frankovic, this proposition entered the Canadian legal system through a footnote in the *Associated Investors* case, which does not appear to apply to the decision.<sup>233</sup>

Other commentators also believe that matching has no place in taxation, and the practice of matching expenses to revenues earned in the period may distort the tax measurement when there is a significant delay in receipt or payment.<sup>234</sup> Geier explains that matching entered the tax system because the early income tax statutes took the lead from accounting since accounting rules preceded taxation rules.<sup>235</sup>

The early income tax statutes did not define the all-important term “income.” Early judges, seeking guidance to help them in crafting a meaning for the term, understandably imported notions developed in other disciplines. One source of guidance on the meaning of this ambiguous term “income” was, not surprisingly, financial accounting. And thus the rhetoric of the matching principle was accepted almost by rote. And the matching principle adopted from financial accounting endures in many minds as a value in tax as well, particularly since some provisions do seem to require such matching, at least as a descriptive matter.<sup>236</sup>

Frankovic argued that while the Supreme Court rejected the idea that matching principle was a legal concept, it agreed that matching could be applied if it offered a more accurate picture of a taxpayer’s profit.<sup>237</sup> In the *West Kootenay* case, it was proposed that the truer picture could be found using the matching principle.<sup>238</sup> Where there is more than one method of determining income, the courts always go for the “truer picture” approach. Arnold et al. say that “given the

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<sup>232</sup> Meghji, *supra* note 221.

<sup>233</sup> Frankovic, *supra* note 224 at 7-8 [footnotes omitted].

<sup>234</sup> For example, Geier, *supra* note 5 at 115-116.

<sup>235</sup> Geier, *supra* note 5.

<sup>236</sup> Geier, *supra* note 5 at 23.

<sup>237</sup> Frankovic, *supra* note 224 at 2.

<sup>238</sup> Frankovic, *supra* note 224.



right facts and circumstances, the court might conclude that the matching principle can be endorsed as a case-law principle.”<sup>239</sup> Justice Iacobucci in the *Toronto College Park* case commented as follows on the applicability of the matching principle:

The most that can be said in favour of the matching principle is that in cases where expenses can be related directly to specific items of future revenue, it may yield a more accurate picture of income to offset the expenses against future revenue, notwithstanding that the actual expenditures were made or incurred in another year.<sup>240</sup>

The above illustrates that the matching principle is used selectively in many cases. Inventory accounting in taxation is an example of the matching principle. The cost of goods sold is expensed when revenues are earned and in proportion to revenues recognized. Accrued interest (both receivable and payable) is included in the calculation of taxable income.

The *Income War Tax Act* 1917 required explicitly that income should be “received” and expenses should be “laid out or expended.”<sup>241</sup> However, the accrual method was allowed under special circumstances such as that described by Plaxton and Varcoe in the following:

[W]ith respect to the income of persons whose profits are determined using statements of assets and liabilities, including bills and accounts receivable and inventories, “income” should include accrued income as a matter of practical necessity. Furthermore the statute itself provides that the income of a beneficiary from any estate or trust shall be deemed to include income accrued to his credit whether received by him or not.<sup>242</sup>

Convenience was the main reason that the tax system transitioned from a cash basis to an accrual basis, but the US Congress rejected the more accurate present value approach as used in GAAP in favour of what it considered an easier-to-administer system—equity was sacrificed for

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<sup>239</sup> Arnold et al, *supra* note 24 at 64.

<sup>240</sup> *Supra* note 43 at 22.

<sup>241</sup> LaBrie, *supra* note 3 at 88.

<sup>242</sup> Charles P Plaxton & Frederick P Varcoe, *A Treatise on the Dominion Income Tax Law*, 2<sup>nd</sup> ed (Toronto: The Carswell Company, 1930) at 157 [footnotes omitted].

simplicity.<sup>243</sup> According to the US Joint Committee on Taxation, the cash method could not and did not reflect the economic reality of the transactions.<sup>244</sup> However, Frankovic argued that the accrual concept was an accounting concept and could not be justified for tax purposes because legal accrual often differs from accounting accrual.<sup>245</sup>

The matching principle—the foundation of accrual accounting—is one of the fundamental pillars of accounting. It requires revenues to be recognized when earned, not received, and expenses to be recognized as matched to revenues and when incurred, and not necessarily when paid.

Accounting divides the life of a business or reporting entity into time periods of 1 year or less (e.g., quarterly accounting refers to accounting for a calendar quarter). If cash is received, but services are not provided in a particular period, these prepayments are not considered to be income. They become part of income only when earned by way of providing services or delivery of goods. Expenses can be paid in advance but are recognized only when services are received. The computation of accounting income requires that all expenses necessary to earn revenues in a given period be matched to the revenues recognized in a given period.

O'May claims that reported income is often an estimate because of the many activities that may take place across different reporting periods:

If a taxpayer buys raw materials in one year, manufactures finished goods therefrom in another, sells those goods in a third and collects the proceeds in the fourth year, the ultimate gain is obviously not attributable

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<sup>243</sup> W. Eugene Seago, "A Modest Proposal Regarding the Matching Principle" *Tax Notes* (March 26, 2001) 1855 at 1859.

<sup>244</sup> US, The Joint Committee on Taxation, *General Explanation of The Tax Reform Act of 1986 (H.R. 3838, 99th Congress, Public Law 99-514) (JCX-10-87) (1987)* at 474, online: <<https://www.jct.gov/publications.html?func=showdown&id=2355>>.

<sup>245</sup> Frankovic, *supra* note 224.

wholly to any one of these four years nor is there any way of allocating portions of the gain to the operations of the several years which can be said to be the scientific and only proper way. In one such series of transactions the main factor contributing to the gain may be cheapness of buying, in another low cost of manufacture, in another advantageous selling and so on. Further, the transactions of a taxpayer are frequently so interrelated that we cannot ascertain the profile of any given series separately. Commercial profit is in fact, as an eminent English judge puts it, necessarily a matter of estimate and opinion.<sup>246</sup>

Due to the complex nature of businesses, the excess of cash received over cash paid does not reflect the income of the business. The accrual method of accounting permits closer matching of expenses to revenues and thereby offers a better reflection of income that can be extrapolated by users, such as investors and creditors. For example, if revenues in period t+1 are 20% higher, then an investor can try and match expenses that are 20% higher to the higher revenues recognized in period t+1 and thereby predict the net income for period t+1.

According to the Conceptual Framework for Financial Reporting,<sup>247</sup> accrual accounting provides a better basis for assessing prospective or future cash flows compared with more objective information about an entity's current cash receipts and payments. Without accrual accounting, important economic resources and claims to resources would be excluded from financial statements. In the IAS Conceptual Framework for Financial Reporting,<sup>248</sup> the matching principle is defined as follows:

Expenses are recognized in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same

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<sup>246</sup>George O May. "Taxable income and accounting bases for determining it" (1925) J of Accountancy 196, cited in Magill, *supra* note 212 at 193.

<sup>247</sup> CPA, *supra* note 67 at the conceptual frame work for financial reporting.

<sup>248</sup> *Ibid* at OB17.

transactions or other events; for example, the various components of expense making up the cost of goods sold are recognized at the same time as the income derived from the sale of the goods.

Some expenses, such as depreciation of property, plant, and equipment, are allocated based on the systematic and rational allocation procedures. According to the conceptual framework, when economic benefits are expected to arise over several accounting periods, and the association with income can be determined only broadly or indirectly, expenses are recognized in the income statement by systematic and rational allocation procedures. These allocation procedures are intended to recognize expenses in the accounting periods in which the economic benefits associated with these items are consumed or expired.

The matching principle may allow for expenses incurred in one period to be allocated to other periods even when there is no clear ascertainable cause-and-effect relationship between outlays in a particular period to revenues in the subsequent period.<sup>249</sup>

Reporting income in 1 year and postponing deductions to the next may move taxpayers into a higher tax bracket this year and a lower bracket in the following year. This may require prepayment of income tax in the first year followed by a refund in the next year. The net result is different in a present value sense and also adds to the administrative complexity and burden. “Moreover, moving to the cash method will put significant pressure on the constructive-receipt and cash-equivalent doctrines, because taxpayers will have significant incentives to push income into future years.”<sup>250</sup>

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<sup>249</sup> Meghji, *supra* note 221.

<sup>250</sup> *Supra* note 80 at 126-27.

Meghji claims that the courts are gradually moving toward the accrual concept of accounting but that the legal definition of accrual is still much narrower compared with the accountants' definition.<sup>251</sup> The courts have not yet completely embraced accrual accounting, and a significant bias remains toward cash accounting.<sup>252</sup>

### **2.1.3.7 Different Purposes of Financial Reporting and Taxation**

Commercial accounting requirements are different from the requirements of taxation. The main purpose of financial accounting is to provide useful information to stakeholders. The primary goal of the income tax system is to collect revenue. Financial accounting is based on the principle of conservatism, which favours understatement rather than overstatement of net income and net assets. On the other hand, understatement of income may not be acceptable by the tax authorities because it directly translates into less revenue for the government.

The primary users of the financial reports (book income) are investors and creditors. This group is more interested in knowing the performance of the company to measure the quality of controllership of managers and directors. By examining a company's existing cash flows, the current and potential shareholders and lender try to predict future cash flows to make sound business decisions. Accounting standards, such as GAAP or IFRS, are developed to serve this purpose. Accounting information enables the "invisible hand" of capitalism to allocate resources more efficiently by providing useful information to the individual decision maker.<sup>253</sup> Other user

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<sup>251</sup> Meghji, *supra* note 221.

<sup>252</sup> Meghji, *supra* note 221.

<sup>253</sup> Alvin D Knott & Jacob D Rosenfeld, "Book and Tax (Part One): A Selective Exploration of Two Parallel Universes" (2003) Tax Notes 865 [Knott & Rosenfeld].

groups, such as management, tax, and regulatory authorities, are not the main target audience since they often have access to other sources of information.<sup>254</sup>

The main purpose of the tax system is to collect revenue for the government, as well as serve as an economic stabilizer for and a policy tool by the government. It is used to alter corporate behaviour (e.g., encourage investments through accelerated depreciation) and encourage investment in any particular sector both by giving incentives (e.g., small business deduction) and restricting the deductibility of certain expenses (e.g., foreign advertising).

The requirements of a tax system are very different from those of an accounting system. The *Thor Power* case established that the objectives of accounting and taxation are different, thereby making the income calculated based on these two systems very different. The objective of accounting is to provide useful information to various stakeholders, such as the management, shareholders, and creditors, for decision making, whereas the objective of the tax system is to collect revenues. According to *Thor Power Tools Company v Commissioner of Internal Revenue*:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets'. In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even

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<sup>254</sup> *Ibid.*

contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.<sup>255</sup>

The US Supreme Court has separated accounting from taxation. *Thor Power* has become a symbol of the book–tax divide and has helped perpetuate the dual reporting system. Whitaker claims that the US Supreme Court has created a legal wall, which, for nearly three decades, has blocked all efforts to move toward book–tax conformity.<sup>256</sup>

The purpose of the *ITA* is to facilitate the government to collect revenues. The Act by itself has multiple objectives that often conflict with each other—e.g., redistributing wealth to achieve equity and social policy objectives, to encourage or discourage certain economic activities based on the government’s policy or political goals, and to develop a fiscal policy tool for governing.<sup>257</sup>

When the government uses the taxation system for purposes other than revenue collection, this additional function requires a different treatment for various items, and this different treatment may increase the book–tax gap.<sup>258</sup>

It is common knowledge that financial statements are not primarily made for regulators and members of the public, although these parties may find them useful. Furthermore, many amounts in the financial statements are based on estimates and judgments rather than exact depictions.

The potential users of book income are interested in predicting a business’s ability to generate positive cash flows. The objective of the financial information is to provide the decision maker with credible enough, neutral, and unbiased information to make decisions. However, the information presented in the financial statements is subject to the cost–benefit principle. If the

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<sup>255</sup> *Supra* note 4 at 802.

<sup>256</sup> Whitaker, *supra* note 70.

<sup>257</sup> Hanlon et al, *supra* note 153.

<sup>258</sup> Porcano & Tran, *supra* note 203.

reporting entity finds the benefit of disclosing or reporting information is less than the cost of collecting and presenting it, then such information is excluded based on cost–benefit analysis.

With the exception of materiality and the conservatism assumption, all qualitative characteristics of accounting information, such as relevance, reliability, and consistency, could also be valid for taxation. Financial statements based on the latter two assumptions are different from the taxable income calculated without these assumptions, and this is also a reason for the book–tax income gap.

Another reason for the difference between accounting and tax rules is that they both deal with different time periods. Financial reporting is concerned with disclosing prospects for the past, present, and future, whereas taxable income focuses strictly on the taxable period in isolation of everything else.<sup>259</sup> There is no room for uncertainty in the tax system, and therefore, taxable income is generally calculated on historical events that occurred in a given period that can be measured with certainty.

#### **2.1.4 Narrowing of the Conceptual Gap**

As shown in the earlier analysis of cases, courts are reluctantly ruling in favour of allowing more accounting principles as a starting point for determining income for tax purposes. This move is not entirely in one direction, and every now and then, some judge rules in favour of ignoring accounting principles altogether. Therefore, this progress is slow but, arguably, inevitable.

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<sup>259</sup> Freedman, Judith, “Defining Taxable Profit in a Changing Accounting Environment” (1995) 5 Brit Tax Rev 434.



There are many examples where accounting treatment is incorporated into the *ITA*. Some of these examples have already been discussed, such as subsection 10(1), which requires the year-end inventory to be valued at the lower of acquisition cost or current FMV.<sup>260</sup>

Another example where the accounting treatment is incorporated into the *ITA* is given in *Canderel* where the Court mentioned that subsection 18(9) of the Act requires the amortization of certain prepaid expenses over their life.<sup>261</sup>

According to paragraph 12(1) (a), any unearned income will be included in the calculation of taxable income for the services to be rendered and goods to be delivered. Under paragraph 20(1) (m), for the amounts that are included by virtue of paragraph 12(1) (a) during the year, a reasonable amount is a reserve in respect of goods that will be delivered after the year-end and services that will be rendered after the year-end. Paragraph 20(1) (m) also allows for some other reserves.

Subsection 12(3) of the Act requires that certain entities should include accrued interest to their income at the year-end, similar to the accounting treatment of interest income.

When Parliament enacted Part 1.3 (Tax on Large Corporation), it required companies to use the values from their balance sheets to determine taxes. This allowed more accounting rules to be incorporated into tax law. Parliament endorsed the use of accounting rules for tax purposes as a result of the enactment of subsection 183(3).

The analysis so far demonstrates reasonable conformity in selective areas, such as hedging, mark-to-market, and the percentage-of-completion method for long-term contracts.

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<sup>260</sup> *ITA*, *supra* note 86 at subsection 10(1).

<sup>261</sup> *Canderel*, *supra* note 8.

## 2.2 Tax and Book Gap in Computing Taxable Income

The second type of gap is the tax and book gap in computing taxable income. This type of gap arises due to policy-based deductions that may allow more (or less) generous deductions or write-offs (e.g., CCAs) during periods of low (or high) economic growth. This gap also arises as a result of aggressive tax planning and seems to be diverging or growing over time and may be difficult to fix even if it may be desirable to fix some of the gap.

Tax authorities will remain reluctant to give up their key policy lever of offering CCAs that are different from accounting depreciation rates under GAAP, and therefore, any gap resulting from these dual measurement methods may not necessarily be a concern that can be feasibly fixed. The literature and empirical studies show that this issue may be a concern and may need addressing. Courts, in their attempts to address aggressive tax planning, developed a rule that to have a source of income, the taxpayer must have a profit or reasonable expectation of profit.<sup>262</sup> In the case of *Tonn*, Justice Linden observed that:

[T]he phrase "reasonable expectation of profit" is not unknown to the *Income Tax Act*. It is, in fact, found in numerous sections of the Act and is mainly used as a test for discriminating between certain acceptable and unacceptable transactions within the meaning of the sections in which it is found.<sup>263</sup>

Finally, in the case of *Walls v Canada*, the Supreme Court decided that if there is no personal element involved in the activity, the reasonable expectation of profit does not arise for consideration.<sup>264</sup> Although the court acknowledged that the taxpayer was clearly motivated by tax

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<sup>262</sup> *Moldowan v The Queen*, [1978] 1 S.C.R. 480.

<sup>263</sup> *Tonn et al v The Queen*, [1996] 2 FC 73.

<sup>264</sup> *Walls v Canada*, [2002] 2 SCR 684, 2002 SCC 47.

consideration, it confirmed that this motivation did not affect the validity of the commercial nature of the transaction.<sup>265</sup>

Chapter 3 offers evidence of this gap from the literature and from primary empirical evidence.

### 2.2.1 Evidence of the Gap

According to the CRA, the Canadian government is planning to invest over \$444 million to enhance the agency's ability to detect, audit, and prosecute tax evasion—both at home and abroad.

<sup>266</sup> This new funding to crack down tax evasion and fight tax avoidance is expected to yield \$2.6 billion in tax revenues over the next 5 years. This initiative is a clear indication that a problem exists.

According to Canadians for Tax Fairness, unfair and ineffective measures—mostly due to tax deductions—cost the federal and provincial governments over \$20 billion annually.<sup>267</sup> Another study by Toby Sanger shows that five of the tax measures alone cost the government around \$16 billion annually.<sup>268</sup> According to Art Cockfield, there was a significant increase in tax evasion between 2010 and 2015.<sup>269</sup>

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<sup>265</sup> *Ibid.*

<sup>266</sup> House of Commons, Standing Committee on Finance, *The Canada Revenue Agency, Tax Avoidance and Tax Evasion: Recommended Actions* (October 2016) at 37 (Chair: Hon. Wayne Easter).

<sup>267</sup> Canadian for Tax Fairness, “Close Tax Loops to make taxes fairer and simple”, online: <<http://www.taxfairness.ca/en/news/close-tax-loopholes-make-taxes-fairer-and-simpler>>.

<sup>268</sup> *Ibid.*

<sup>269</sup> Zach Dubinsky, “Deals Canada signed to catch tax cheats allow billions in taxes to escape”, CBC (1 June 2016), online: <<http://www.cbc.ca/news/business/canada-offshore-tax-avoidance-corporations-tiea-1.3639597>>.

The US General Accounting Office has estimated that abusive tax shelters have cost the United States \$85 billion over 6 years.<sup>270</sup> One definition of a tax shelter is an instrument that reduces taxable income without a corresponding decrease in accounting income. For example, WorldCom reported \$16 billion in accounting income between 1996 and 2000 but less than \$1 billion of taxable income during the same period. Enron reported a profit of \$1.8 billion during the same time period while reporting a loss of \$1 billion to the Internal Revenue Service (IRS).<sup>271</sup> By comparison, sources estimate that the UK is losing approximately £13 billion per year from tax sheltering activities.

The book–tax income gap received more attention after 1999 when the US Treasury issued a report on corporate tax shelters that showed that during the 1990s, corporate tax returns revealed a significant and increasing trend of higher book income and lower taxable income. The Treasury acknowledges that this increase may be due to the use of tax shelters that reduce taxable income without a corresponding reduction in book income.<sup>272</sup> Due to an increase in tax shelter usage, the IRS established the Office of Tax Shelter Analysis in 2000 with a mandate to monitor tax sheltering activities.

The book–tax differences also have implications for tax policy, since this gap drives some tax policy measures. Manzon and Plesko<sup>273</sup> cite Congress’s enactment of alternative minimum tax (AMT) in 1986 as an effort to increase tax revenue and to ensure that no taxpayer with substantial income can avoid tax liabilities by using tax deductions and credits. One of the goals

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<sup>270</sup> Alan W. Granwell and Sarah S. McGonigle, “U.S. Tax Shelter Regulations: A U.K. Reprise?” (2004) SSRN.

<sup>271</sup> Alan Murray, “Inflated Profits in Corporate Books is Half the Story” *The Wall Street Journal* (2 July 2002), A 4.

<sup>272</sup> Knott & Rosenfeld, *supra* note 253.

<sup>273</sup> Gil B Manzon Jr. & George A Plesko, “The Relation Between Financial and Tax Accounting Measure of Income” (2002) 55 *Tax L Rev* 175 at 212 [Manzon & Plesko].

of President Obama’s 2012 framework for corporate tax reform in the US was to “reduce the gap between book income reported to shareholders, and taxable income reported to the IRS.”<sup>274</sup>

## **2.2.2 Explanations for the Existence of the Taxable Income and Book Income Gap**

After calculating Division B income (net income for tax purposes), Division C deductions are considered to derive taxable income. Division C deductions are those items that the government, for policy reasons, does not want to tax. Division C deductions are mentioned in section 110 -114 of the *ITA*. The net income for tax purposes is used by the government to calculate various tax credits, but taxable income is ultimately used as the basis to determine income taxes payable. Taxable income cannot be negative after accounting for Division C deductions. If taxable income becomes negative, it is considered zero. Here are some Division C deductions available to corporations:

1. Dividends from Canadian Resident Corporations
2. Donations to Registered Charities (up to a maximum of 75% of Division B Income)
3. Net Capital Loss Carryovers (3 years carryback; unlimited years carryforward)
4. Non-Capital Loss Carryovers (3 years carryback; 20 years carryforward)

Division C deductions are used as a policy tool by the government. These deductions almost always make taxable income different from the accounting income because tax policy-driven deductions are not available under accounting rules. The book–tax income gap created by

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<sup>274</sup> Bradley Blaylock, Fabio Gaertner & Terry Shevlin, “The Association between Book-tax Conformity and Earnings Management” (2015) 20:1 Rev of Accounting Studies 141.

Division C deductions may not converge anytime soon and may also not be a major concern. I will now explain some of these deductions in detail.

### **2.2.2.1 Dividends**

For accounting purposes, all dividends are considered as income without any special treatment. For tax purposes, dividends are considered distributions of after-tax profit from corporations to shareholders, either in cash or in kind. A dividend in kind is one paid by something other than cash. Although all dividends are considered income, dividends (other than capital or qualifying dividends) received from resident Canadian corporations are referred to as “taxable dividends.” The taxable dividend is grossed-up and receives a dividend tax credit, whereas dividends from nonresident corporations are simply referred to as “dividends.” There are special rules in the Act about including “taxable dividends” in income.

Taxable dividends are included in the calculation of Division B income/net income for tax purposes. Later dividends are considered as Division C deductions for the calculation of taxable income. Dividend payments are not deductible from the income; rather, they come from after-tax earnings. Taxing dividend income at the corporation level is double taxation, and when shareholders receive these dividends, they are required to pay tax on this income too. This is the reason why dividend income is part of net income for income tax purposes (Division B income) but excluded from the taxable income of the corporation as a Division C deduction.

If an individual taxpayer receives a taxable dividend, the dividend is grossed up by a certain percentage (set by the Act), and this gross-up amount is included in the income. The taxpayer then receives a dividend tax credit which may offset the gross-up. If the dividend is received by a

corporation, it is added to the corporation's income but later deducted when arriving at the taxable income.

The purpose of gross-up and dividend tax credit mechanisms for individual taxpayers is to mitigate the problem of double taxation, as dividends are paid from after-tax income that has been subjected to corporate income taxes and are also taxed in the hands of individual shareholders.

#### **2.2.2.2 Loss Carryovers**

For accounting purposes, losses are simply the amounts by which expenses exceed revenues. When the accounting books are closed at the end of a fiscal year, the net loss is transferred to the shareholder's equity. Under accounting rules, losses are not allowed to be carried back or forward to other accounting periods.

For taxation purposes, losses from any particular source, such as office, employment, business, or property, are deductible in the same year against other sources of income.<sup>275</sup> Section 111 of *ITA* elaborates on the deduction of losses and loss carryovers. Taxation deals with two types of losses: net capital and non-capital. The *ITA* allows non-capital losses or NOLs to be carried back for 3 years to be offset against any positive taxable income in this period or carried forward to any taxable income generated in the next 20 years. Similarly, net capital losses can be carried back for 3 years and carried forward indefinitely—but only to the extent that the taxpayer has net capital gains in those periods.<sup>276</sup> The carried back and carried forward options are very

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<sup>275</sup> *ITA*, *supra* note 86 at paragraph at paragraph 3(d).

<sup>276</sup> *ITA*, *supra* note 86 at section 111.

generous treatments of the losses because it is impossible for any business to survive after sustaining consecutive losses for so many years.

Non-capital losses include losses from the business, losses from the property, and allowable business investment losses. “Allowable business investment loss” is deductible against any source of income in the year of realization.<sup>277</sup>

Hanlon and Maydew argue that the provision to carryback and carryforward operating losses does not treat cyclical industries and stable industries equally. Firms in the cyclical industries would face heavier tax burdens over their lifetime compared with the stable industries.

Hanlon and Maydew suggested that:

To avoid this result, it seems likely that NOL rules would need to be appended to GAAP for tax purposes. To preserve the informational role of financial statements, the effects of NOL carrybacks and carryovers on the income statement would need to be confined to their effects on tax expense, so that pre-tax income would reflect that of the current period.<sup>278</sup>

“Net capital loss” is allowable capital losses minus allowable business investment losses and losses on listed personal property minus taxable capital gain, including net gains from listed personal property.<sup>279</sup> A taxpayer is free to claim any unclaimed carried-over losses in any particular year in any order. However, for optimal planning purposes, the claim must be made in the chronological order in which the loss was incurred.<sup>280</sup>

In the case of *NRT Technology Corp. v The Queen*, the taxpayer acquired a company with non-capital losses. The Minister denied the acquiring company the use of the investee’s non-

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<sup>277</sup> *ITA*, *supra* note 86 at paragraph 3(d); *ITA*, *supra* note 86 at paragraph 38(c).

<sup>278</sup> Michelle Hanlon & Edward L. Maydew, “Book-Tax Conformity: Implication for Multinational Firms” (2008) CESifo Venice Summer Institute 2008 at 15 [Hanlon & Maydew].

<sup>279</sup> *ITA*, *supra* note 86 at subsection 111(8).

<sup>280</sup> *ITA*, *supra* note 86 at subsection 111(3).



capital losses because the acquired business was not carried on for the profit or reasonable expectation of profit in that year. According to the court, the taxpayer acquired a bankrupt business and made no effort to run it. There was no capital injected, and no business plan was documented. There was no reasonable expectation of profit, and therefore, the court rejected the taxpayer's appeal against the Minister's reassessment.<sup>281</sup>

The court reached the same conclusion in the case of *Birchcliff Energy Ltd. v The Queen*, where the Minister disallowed non-capital losses incurred by a predecessor corporation.<sup>282</sup> In the case of *Manac Inc. Corp. v Canada*, the FCA stated that “[i]n enacting subsection 111(5), Parliament intended to prevent companies from speculating in companies with losses to deduct the acquired companies' losses from their income, and to promote the strengthening or survival of business in decline.”<sup>283</sup>

Courts may disallow the deduction of losses based on the reasonable expectation of profit test. Courts are careful in applying the reasonable expectation test because once deductions are disallowed based on these grounds, the taxpayer cannot carry forward such losses to apply in the future in case the activity becomes profitable.<sup>284</sup> The Court further says:

[T]he REOP test is problematic owing to its vagueness and uncertainty of application; this results in unfair and arbitrary treatment of taxpayers. As a result, “reasonable expectation of profit” should not be accepted as the test to determine whether a taxpayer's activities constitute a source of income.<sup>285</sup>

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<sup>281</sup> *NRT Technology Corp v The Queen*, 2013 DTC 1021 [at 110], 2012 TCC 420.

<sup>282</sup> *Birchcliff Energy Ltd v The Queen*, 2015 TCC 232, nullified on procedural grounds 2017 FCA 89.

<sup>283</sup> *Manac Inc Corp. v Canada*, 98 DTC 6605 (FCA).

<sup>284</sup> *Stewart*, *supra* note 167.

<sup>285</sup> *Stewart*, *supra* note 167 at 47.

### 2.2.2.3 Depreciation and Capital Cost Allowance

Depreciation is a measure of an asset's decline in its value over time or its proportion usage. When a firm buys capital assets, such as property, a plant, and equipment, the useful life of these assets extends beyond the current year. As a result, their full cost is not expensed in the year of acquisition. The proper treatment involves capitalizing the acquisition cost and then allocating this capital cost over the useful life of the assets. This allocation of cost is called the depreciation in accounting and CCA for tax purposes.

Accounting depreciation is a systematic allocation of the cost of an asset over its useful life. The terminology is depreciation for tangible assets, amortization of intangible assets, and depletion for natural resource properties. The discussion here focuses mostly on depreciation since amortization and depletion are just an extension of the same concept with similar rules.

There is a difference between depreciation through usage or passage of time and decline in the market value of an asset. The latter requires a revaluation of the asset which is not done as frequently for accounting purposes.

There are various methods used to measure depreciation in accounting. Three methods specifically mentioned in the IFRS to calculate depreciation include the straight-line method, the diminishing balance method, and the unit of production method.<sup>286</sup>

In IAS 16:37, various classes of assets, such as land, land and building, machinery, ships, aircraft, motor vehicles, furniture and fixtures, office equipment, and bearer plants, are mentioned. All assets in one class are depreciated using the same method. For accounting

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<sup>286</sup> CPA, *supra* note 67 at IAS 6.62.

purposes, a depreciation expense is mandatory,<sup>287</sup> and companies are not allowed to postpone the depreciation expense in any particular year. In contrast, the CCA is a discretionary deduction for tax purposes, and many taxpayers may not claim any CCA if they already have a loss before deducting the CCA, or if they have a very low marginal tax rate (making the value of the tax shield low), or if they plan to sell the asset soon (which would trigger recapture).

Accounting also allows reporting entities to change their depreciation policies over time as long as they can justify the change. However, in practice, changes in depreciation methods over time are relatively infrequent.<sup>288</sup>

Unlike accounting where reporting entities are offered some choices on how to calculate the annual depreciation expense, the CCA system effectively limits the taxpayer's choice to one method of depreciation. This limitation is necessary to maintain equitable treatment of all taxpayers.

While full deduction for a capital expenditure is not allowed, paragraph 20(1) (a) allows a deduction of part of the capital cost called the CCA. The Income Tax Regulation Part XI describes the mechanism to calculate the CCA. It divides capital assets into different classes. One group or class of assets uses the same method and rate for the CCA calculation. All depreciable capital assets are required to be classified into one of the prescribed classes described in the *ITA*.

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<sup>287</sup> Under tax rules, CCA is optional, and taxpayers have the option to deduct any amount between zero and maximum allowable CCA.

<sup>288</sup> A Scott Keating & Jerold L Zimmerman, "Depreciation Policy Changes: Tax, Earnings Management, and Investment Opportunity Incentives" (1999) SSRN.

There are 60 different classes of depreciable properties established by Regulation Part XI, each with different rates of an annual CCA. Consistent with accounting, the land is not considered to depreciate.<sup>289</sup> If more than one asset belongs to the same class, the CCA is calculated on the net aggregate balance of the class. In some cases, there are different classes for the same type of assets or different rates for the same class based on their cost or use. For example, most buildings are categorized as Class 1 assets with an annual CCA rate of 4%. However, a manufacturing building has an annual CCA rate of 10%, and a rental property acquired after 1972 with a cost of more than \$50,000 is considered to be in a single-asset class. Similarly, passenger vehicles costing more than \$30,000 are put in a different single-asset class. This classification was designed to give limited discretion to taxpayers.

The half-year rule is a special feature of the CCA system.<sup>290</sup> According to this rule, only half of the allowable CCA is charged during the year of purchase and in the year of sale. This rule applies to all classes with some exclusions and provides some tax-planning opportunities. If a company is planning to buy some assets early next year, it will be better off purchasing the asset during the last month of the current year. This rule will enable the company to claim half the annual CCA for the entire current year.

The *ITA* requires assets be available for use by the taxpayers before a CCA can be claimed.<sup>291</sup> Acquisition and possession of an asset are not sufficient conditions for claiming a CCA. In contrast, accounting rules may allow (but not require) claiming of depreciation even if the asset is not yet in use.

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<sup>289</sup> *Income Tax Regulations* 1102(2).

<sup>290</sup> *Ibid.*

<sup>291</sup> *ITA*, *supra* note 86 at subsection 13(26) & 13(29).

The *ITA* also has rules to recapture excessive CCA claims made when an asset is sold or to allow an additional terminal loss deduction if a sufficient CCA has not been claimed. If the proceeds of disposition (selling price) of an asset are higher than the undepreciated capital cost (= original cost of an asset – total depreciation), then this excess depreciation is included in the current income as a recapture.<sup>292</sup> Any proceeds more than the original cost are treated as capital gains.<sup>293</sup> On the other hand, if the proceeds of the disposition of an asset are less than the undepreciated capital cost, then the difference is considered a terminal loss and serves as an additional deduction to reduce the taxpayer's income in the year of the asset sale.<sup>294</sup> These rules are slightly different for the sale of land, building, and passenger vehicles (where land is not a depreciable asset).

Recapture of CCA arises because the taxpayer has claimed excessive CCA in preceding years, and this excessive CCA is recaptured as income.<sup>295</sup> However, the high selling price received may be due to excess demand or limited supply of such assets and may not necessarily indicate that an excessive amount of CCA was allowed.<sup>296</sup>

A CCA is not tax neutral since it affects after-tax cash flows generated by the asset and therefore impacts firms' investment decisions. According to tax statutes, a CCA is not a mandatory expense. The discretionary nature of the CCA deduction makes it an excellent tool for tax planning. During periods of losses, taxpayers can defer their CCA claims to future years by retaining a high undepreciated capital cost (UCC). Forsaking CCA for 1 year does not allow

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<sup>292</sup> *ITA*, *supra* note 86 at subsection 13(1).

<sup>293</sup> *ITA*, *supra* note 86 at paragraph 39(1)(a).

<sup>294</sup> *ITA*, *supra* note 86 at subsection 20(16). To recognize the terminal loss, there should not be any asset left in that class with some exceptions.

<sup>295</sup> To recognize the terminal loss or recapture income, there should not be any asset left in that class with some exceptions.

<sup>296</sup> *Supra* note at 288.

taxpayers to claim double CCA in the subsequent year. However, skipping CCA for 1 year makes the undepreciated cost of assets higher in the following year. This higher UCC allows taxpayers to enjoy a higher CCA claim in future years.

When governments want to encourage investment in any particular sector, they increase the CCA rates and thereby encourage businesses to invest in that sector. For example, the Class 52 (computer equipment) rate was 100% from January 27, 2009, to February 2011. After this period, Class 52 was eliminated for new assets, and computer equipment was placed in Class 50 with a 55% CCA rate.

In the Fall Economic Statement 2018, the government proposed the introduction of an accelerated investment incentive to allow businesses to more quickly deduct the cost of their investment. This incentive will provide an enhanced first-year CCA to the certain eligible capital properties. For the benefit to be obtained, the property should be acquired between November 21, 2018 that becomes available for use before 2028, subject to a phase-out for property that becomes available for use after 2023.<sup>297</sup>

The courts have wrestled with the issue of which owner is eligible to claim the CCA: the legal owner or the beneficial owner. The Court decided that legal ownership can be different from beneficial ownership, and a beneficial owner can also claim a CCA without having legal ownership.<sup>298</sup>

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<sup>297</sup> Canada, Department of Finance, “Investing in Middle Class Jobs”, (Ottawa: 2018) at annex 3.

<sup>298</sup> *Supra* note 175.

#### 2.2.2.4 Goodwill, Intangible Assets, and Impairment

Goodwill is the difference between the FMV of the consideration transferred to acquire the business and FMV assigned to identifiable net assets acquired. From an accounting perspective, goodwill is defined as “an asset representing the future economic benefits arising from other assets acquired in a business combination that is not individually identified and separately recognized.”<sup>299</sup> As a comparison, intangible assets are assets that are identifiable and that have a nonphysical existence and a nonmonetary nature.<sup>300</sup>

Goodwill can be internally generated or purchased in an arm’s length transaction. Internally generated goodwill is not capitalized or set up as an asset. Purchased goodwill is considered to have an indefinite life and therefore not amortized for accounting purposes. According to the IFRS, if there is a strong evidence that an asset has declined in value, a goodwill impairment test needs to be implemented.<sup>301</sup> Financial assets are also reviewed for possible impairment at least once in each reporting period or when there is an indication of impairment.

If the result shows that the carrying value of an asset is more than the future economic benefit of the asset, then goodwill impairment is taken. Reversal of goodwill impairment is not allowed on the grounds of accounting conservatism where good news is not recognized until realized, whereas bad news is recognized if it is reasonably expected.

According to the *ITA*, goodwill and intangibles are considered to be eligible capital property and fall under a new CCA class (14.1) that became effective in January 2017. Eligible

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<sup>299</sup> CPA, *supra* note 67 at IFRS 3, Appendix A.

<sup>300</sup> *Ibid.*

<sup>301</sup> CPA, *supra* note 67 at IAS 36.

capital expenditure was added to this new class at 100% of the cost and is amortized at a rate of 5% on a declining balance basis.

Calculating goodwill is not an easy task. In the case of *Saab v The Queen*, the court found that the CRA made a mistake in calculating the value of goodwill. The court ruled that “if the taxing authorities can base their imposition of a penalty on so fundamental an error due to the complexity of the Act, it seems unconscionable that the penalty can stand.”<sup>302</sup>

In *Teleglobe Canada Inc. v R.*, the taxpayer affirmed that he/she incurred an expense or outlay concerning goodwill and claimed the deduction from the income. The Minister took the position that the taxpayer had made no expenditure concerning goodwill and disallowed the deduction. The court decided that since the purchase price of the assets was equal to the value of the tangible assets acquired, the taxpayer had incurred no expense to acquire goodwill.<sup>303</sup>

#### **2.2.2.5 Reserves and Allowances**

The term “reserve” has different meanings for accounting and taxation purposes, with a significant difference between accounting reserves and tax reserves. For accounting purposes, a “reserve” is an appropriation of income from retained earnings for various reasons. Reserves can be used as a tool for earnings management. Companies can use aggressive estimates for reserves for sales returns, loan losses, or warranty returns. These reserves can be reduced in a future period to increase or smooth retained earnings.

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<sup>302</sup> *Saab v The Queen*, 2005 TCC 331 at 14.

<sup>303</sup> *Teleglobe Canada Inc v R*, 2002 DTC 7517, 2002 FCA 408.



The deduction of a reserve, contingent liability, or a sinking fund is prohibited for tax purposes unless allowed by specific provisions of the Act.<sup>304</sup> Estimated expenses are not tax deductible until the obligation becomes known or certain—e.g., a manufacturing warranty that cannot be estimated until a defective product is returned. In contrast, accounting allows expensing of a reasonable estimate of future returns and makes this expensing mandatory (on the grounds of conservatism). The accounting treatment is motivated by enabling users (usually investors and creditors) to extrapolate a past time series of earnings into a future time series of earnings.

The word “reserve” has been used to designate at least five<sup>305</sup> different categories of items on the balance sheet as follows:<sup>306</sup>

(1) valuation reserves, which indicate the estimated difference between the carried amount and realizable value of some assets;

(2) amortization or depreciation reserves, which document the portion of the cost of assets that have been charged to past operations;

(3) liability reserves, which show the estimate of a known liability, and for which the exact amount may be indefinite;

(4) contingent reserves, which provide for possible losses that may occur in the future; and

(5) surplus reserves, which earmark retained earnings for some specific future purpose.

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<sup>304</sup> *ITA*, *supra* note 86 at paragraph 18(1)(e).

<sup>305</sup> Sidney I. Simon, “Legal Decisions on Accounting Reserves” (1955) 30:3 *The Accounting Rev* 507.

<sup>306</sup> LaBrie, *supra* note 3.

A reserve generally denotes an amount set aside for the future. Reserves are not considered as a legal liability, and therefore, an increase in a reserve is not considered an expense. The *ITA* allows some very specific reserves such as:

- reserve for doubtful debts under *ITA*: 20(1) (l);
- reserve for goods not delivered and services not rendered or deposits on returnable containers (other than bottles), but limited by *ITA* 20(1) (m), 20(6);
- manufacturer's warranty reserve for amounts paid or payable to an insurer to insure liability under a warranty agreement *ITA* under 20(1) (m.1);
- reserve for an amount not due until a later year under an installment sales contract, limited by another rule under *ITA* 20(1) (n), 20(8);
- reserve for amounts not due on installment sales contracts under *ITA* 20(1) (m)(iii);
- reserve for a quadrennial survey under *ITA* 20(1) (o); and
- prepaid rents under *ITA* 20(1) (m) (iii).

In *Doteasy Technology Inc v The Queen*, the taxpayer followed accounting rules for prepayments and claimed a reserve against these prepayments under paragraph 20(1) (m) of the Act. According to the Minister, there was no condition attached to these prepayments, and therefore, the prepayments were absolute and had the quality of income. The court decided that a reserve should be available to the taxpayer under paragraph 20(1) (m), even though the amount was also permitted to be included in income under section 9 as long as it was described in paragraph 12(1) (a).<sup>307</sup> The same conclusion was reached in the case of *Ellis*

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<sup>307</sup> *Doteasy Technology Inc v The Queen*, 2009 DTC 1019, 2009 TCC 324.

*Vision Incorporated v The Queen*, where the issue was a receipt of the license fee for the use of production for a future period.<sup>308</sup>

#### 2.2.2.6 Tax Aggressiveness

The gap between book income and taxable income has been increasing over recent years in both Canada and the US<sup>309</sup>. Consequently, researchers are beginning to investigate the causes for this growing gap. Earlier literature suggested that firms were forced to make trade-offs between tax savings and reported income (e.g., Klassen and Mawani;<sup>310</sup> Mawani;<sup>311</sup> and Shackelford and Shevlin<sup>312</sup>). In this context, a larger book–tax difference could be driven by either increased book income or decreased taxable income, or a bit of both. The earlier literature showed that firms were somewhat reluctant to simultaneously pursue a minimization of taxes payable and a maximization of book income. For example, Mills reports that the “Internal Revenue Service (IRS) proposed audit adjustments increase as the excess of book income over taxable income increases.”<sup>313</sup> Such penalties serve as a brake on aggressive tax planning.

More recent literature (e.g., Frank et al.) suggests that firms can and do simultaneously pursue tax reporting aggressiveness and financial reporting aggressiveness, thereby implying that firms may not need to choose between the two.<sup>314</sup> This finding implies that the increasing gap

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<sup>308</sup> *Ellis Vision Incorporated v The Queen*, 2004 DTC 2024, 2003 TCC 912.

<sup>309</sup> For example, Mihir A Desai, “The divergence between book income and tax income” (2003) 17 Tax Policy and the Economy 169 [Desai].

<sup>310</sup> Kenneth J Klassen & Amin Mawani, “The Impact of Financial and Tax Reporting Incentives on Option Grants to Canadian CEOs” (2000) 17:2 Contemporary Accounting Research 227.

<sup>311</sup> Mawani, *supra* note 159.

<sup>312</sup> Douglas A Shackelford & Terry Shevlin, “Empirical tax research in accounting” (2001) 31:1 J of Accounting and Economics 321.

<sup>313</sup> Lillian F Mills, “Book-tax differences and Internal Revenue Service adjustments” (1998) 36:2 J of Accounting Research 343 [Mills].

<sup>314</sup> Mary M Frank, Luann J Lynch & Sonja O Rego, “Tax reporting aggressiveness and its relation to aggressive financial reporting” (2009) 84:2 The Accounting Rev 467.

between book income and taxable income could be simultaneously driven by increased book income and decreased taxable income. However, the literature has not discussed whether the divergence is driven more by tax sheltering (tax aggressiveness) or earnings management (financial reporting aggressiveness), or equally by both.

Tax aggressiveness is defined in the literature as the “downward manipulation of taxable income through tax planning that may or may not be considered fraudulent tax evasion.”<sup>315</sup> Financial reporting aggressiveness is defined as “upward earnings management that may or may not be within the confines of GAAP.”<sup>316</sup>

One possible explanation for the differences in the empirical literature is that there are some types of firms that may engage more or less in this dual aggressive behaviour. More specifically, it is conceivable that some firms may be trading off between the two goods (book income and tax savings), whereas others may not be trading off as much and may be able to simultaneously pursue both goods. A survey by Cloyd et al. found that (widely held) public firms cared relatively more about financial reporting costs (the costs of reporting lower book incomes) than taxes.<sup>317</sup> The survey also found that managers of public firms are less likely to choose conformity between financial reporting and tax reporting compared with managers of private firms, presumably because widely held public firms face higher levels of financial reporting costs. In other words, when forced to a trade-off between financial reporting income and tax savings, large public firms (presumably widely held firms) tend to choose reporting higher financial income, whereas smaller and private firms put more weight on the tax savings.

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<sup>315</sup> *Ibid* at 468.

<sup>316</sup> *Supra* note 314 at 468.

<sup>317</sup> C Bryan Cloyd, Jamie Pratt & Toby Stock, “The use of financial accounting choice to support aggressive tax positions: Public and private firms” (1996) 34:1 *J of Accounting Research* 23.

Both tax and earnings management literature suggests that concentrated ownership is an essential factor that can influence tax savings and earnings management behaviour (e.g., Ding et al.<sup>318</sup> Kim and Yi;<sup>319</sup> Leuz et al.<sup>320</sup>). Closely held firms may face different financial reporting and tax reporting pressures, and it is possible they may behave differently from widely held firms.

There are several reasons why Canadian firms may behave differently from US firms in terms of tax aggressiveness. First, Canadian firms tend to be more closely owned with more concentrated ownership or more dual-class share structures (Ben-Amar and Andre;<sup>321</sup> Morck et al.<sup>322</sup> Amoaku-Adu and Smith;<sup>323</sup> Smith and Amoaku-Adu<sup>324</sup>). Most of these studies argue that concentrated ownership is associated with less information asymmetry between insiders and outsiders, thereby reducing the pressure to manage reported earnings. Firms facing lower financial reporting pressure may make different trade-offs (i.e., they may pursue more tax savings) compared with firms under higher financial reporting pressure (i.e., they may put more weight on book income).

Tax revenue as a percentage of GDP is higher in Canada than in the US (11.9% vs. 10.1% in 2011) even though the corporate tax rate is lower in Canada than in the US.<sup>325</sup> Milstead reports

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<sup>318</sup> Yuan Ding, Hua Zhang & Junxi Zhang, "Private vs state ownership and earnings management: evidence from Chinese listed companies" (2007) 15:2 *Corporate Governance: An Intl Rev* 223.

<sup>319</sup> Jeong-Bon Kim & Cheong H Yi, "Ownership structure, business group affiliation, listing status, and earnings management: Evidence from Korea" (2010) 23:2 *Contemporary Accounting Research* 427.

<sup>320</sup> Christian Leuz, Dhananjay Nanda & Peter D Wysocki, "Earnings management and investor protection: an international comparison" (2003) 69:3 *J of Financial Economics* 505.

<sup>321</sup> Walid Ben-Amar & Paul André, "Separation of ownership from control and acquiring firm performance: The case of family ownership in Canada" (2006) 33:3-4 *J of Business Finance & Accounting* 517.

<sup>322</sup> Randall Morck, David Strangeland & Bernard Yeung, eds, *Inherited wealth, corporate control, and economic growth*, in *Randall Morck: Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000).

<sup>323</sup> Ben Amoako-Adu & Brian Smith, "Dual Class Firms: Capitalization Ownership Structure and Recapitalization Back into Single Class" (2001) 25:6 *J of Banking and Finance* 1083.

<sup>324</sup> Brian F Smith & Ben Amoako-Adu, "Management succession and financial performance of family-controlled firms" (1999) 5:4 *J of Corporate Finance* 341.

<sup>325</sup> The federal corporate income tax rate in Canada was 15% (excluding the provincial taxes) (11% for small

that Canadian S&P/TSX companies reported average ETRs that were on average 6 percentage points lower than Canadian statutory tax rates, whereas US S&P500 firms reported ETRs that were on average 9 percentage points lower than the US statutory tax rates. As Milstead argues, these statistics suggest that the Canadian tax authority may be enforcing tax collection more diligently or that Canadian companies are pursuing tax minimization strategies less aggressively compared with the US companies.<sup>326</sup>

Canadian and US firms may face different levels of financial reporting pressure (due to differences between the Canadian IFRS and US GAAP, or differences in other financial reporting regulations, or even differences in market efficiency) and tax enforcement, and therefore, firms from different jurisdictions may make different choices regarding the book–tax trade-off.

The separation of management and ownership creates information asymmetry, and managers may use reported earnings as a means to resolve such asymmetry. Managers attempt to meet or exceed shareholders’ expectations regarding earnings. Firms that face lower financial reporting costs may arguably be able to pursue tax planning more aggressively compared with other firms.

In Canada, dividends paid to corporate shareholders are entirely tax-free, allowing (family-owned) economic entities to have complex corporate structures without corresponding tax costs. In contrast, US family firms paying dividends to related corporate shareholders face some level

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business) in 2011 compared with a range of 15% to 35% in the US  
online:<<http://taxfoundation.org/article/federal-corporate-income-tax-rates-income-years-1909-2012>>.

<sup>326</sup> David Milstead, “The 21 TSX stocks paying below average tax rates—and why investors should be wary” *The Globe and Mail* (October 14, 2016) page B10.

of income tax. The different institutional environments between Canada and the US offer an exciting setting to examine the association between ownership concentration and trade-off decisions.

The results have important policy and practice implications. Tax authorities may benefit from knowing which firms are more likely to be aggressive in tax planning and thereby target their scarce auditing and monitoring resources more effectively and efficiently. External auditors can also be more effective and efficient by knowing which firms are more likely to be aggressive in their financial reporting. For example, Lennox et al. find that US public firms engaging in tax aggressiveness are less likely to be involved in accounting fraud.<sup>327</sup> Finally, investors may also be interested in understanding which firms are more likely to be aggressive in financial reporting.

### **2.2.2.7 Effective Tax Rates**

The link between tax reporting and financial reporting may be best reflected in the effective tax rate (*ETR*) metric, with lower *ETR* entities likely reducing income taxes payable and increasing after-tax reported incomes. However, some users, as well as researchers of financial statements of public corporations, may incorrectly perceive earnings management to be tax aggressiveness since *ETR* is a metric for both tax aggressiveness and financial reporting aggressiveness. Tax researchers may see lower *ETR* as predominantly tax aggressiveness, whereas financial reporting researchers may see lower *ETR* as predominantly financial reporting

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<sup>327</sup> Clive Lennox, Petro Lisowsky & Jeffrey Pittman, “Tax aggressiveness and accounting fraud” (2013) 51:4 J of Accounting Research 739.

aggressiveness. The dominant objective may be detectable in analysts' news reports and context, as the following news item in the April 27, 2017, edition of *The Globe and Mail* suggests:

#### Boeing soars on lower tax rate

Boeing Co. on Wednesday reported a 19-per-cent rise in first-quarter profit and lifted its full-year profit forecast, as lower taxes offset declining revenue and lower than-expected margins in its commercial airplane unit.

Boeing's earnings results beat analysts' expectations. But its decision to increase its full-year profit forecast by 10 cents reflected a lower tax rate, which tempered investor enthusiasm.

The world's biggest plane maker said its effective tax rate fell about four percentage points compared with a year ago because of higher stock-based compensation.<sup>328</sup>

In an investigative report published in *Canadian Business*,<sup>329</sup> the authors came up with a short list of 15 companies that used legal strategies over a 10-year period to achieve low effective *ETR*. These companies included First Capital Realty Inc. with an *ETR* of 1.25%; CP Rail with an *ETR* of 1.8%; Manitoba Telecom with an *ETR* of 4.14%; Enbridge with an *ETR* of 14.25%; TransCanada Corp with an *ETR* of 15.52%; and Sun Life Financial Inc. with an *ETR* of 15.86%.

Dyreng et al. document evidence that *ETRs* of US corporations have declined by approximately 10% over the past 25 years.<sup>330</sup> Cook, Huston, and Omer; Yin and Gupta; and Newberry show how firms manage their earnings *via* their *ETRs*. Cook et al. find that higher tax

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<sup>328</sup> "Boeing Soars on Lower Tax Rate", *The Globe and Mail*, (27 April 2017), online: Globe and Mail <<https://www.pressreader.com/canada/the-globe-and-mail-bc-edition/20170427/281998967349844> >

<sup>329</sup> Joe Castaldo, Mark Brown & Mathew McClean, "Which large companies pay the least tax?" (27 February 2014). *Canadian Business*, online:<<http://www.canadianbusiness.com/companies-and-industries/complete-ranking-companies-paying-lowest-taxes/>>

<sup>330</sup> Scott D Dyreng et al., "Changes in Corporate Effective Tax Rates over the Past 25 Years" (2017) 124:3 *J of Financial Economics* 441.



service fees paid to auditors are associated with greater reductions in ETRs between the third and fourth quarters.<sup>331</sup> Yin estimates the 6-year ETRs of 10 industry groups in the US and finds them ranging from a low of 25.72% for the energy sector and 25.84% for industrials to a high of 32.48% for the information technology sector and 32.43% for utilities.<sup>332</sup> Finally, Gupta and Newberry show that ETRs are associated with a firm's capital structure, asset mix, and performance, but not size.<sup>333</sup>

Firms facing higher tax risk—proxied by the volatility of the firms' effective tax rates—often face higher external audit fees. In other words, tax risk is considered a component of audit engagement risk. Abernathy, Rapley, and Stekelberg empirically document a positive association between audit fees and tax risk.<sup>334</sup> However, Abernathy et al. also show that if the external auditors are also engaged in providing tax non-audit services, the positive association between audit fees and tax risk is mitigated or moderated, presumably because of the knowledge spillover. This also suggests that external audit fees could constitute one of the non-tax costs that corporate taxpayers ought to consider in determining their optimal tax planning or tax aggressiveness.

ETRs can be an instrument for tax planning and earnings management. Milstead cites a CIBC World Markets' Institutional Equity Research study to report that lower taxes have accounted for 17% of the earnings growth in the S&P/TSX composite index over the past 30

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<sup>331</sup> Kirsten A Cook, George R Huston & Thomas C Omer, "Earnings Management through Effective Tax Rates: The Effects of Tax-Planning Investment and the Sarbanes-Oxley Act of 2002" (2008) 25:2 Contemporary Accounting Research 447.

<sup>332</sup> George K Yin, "How much tax do large public corporations pay? Estimating the effective tax rates of the S&P 500" (2003) 89:8 Virginia L Rev 1793 [G Yin].

<sup>333</sup> Sunjay Gupta & Kaye Newberry, "Determinants of the variability in corporate effective tax rates: evidence from longitudinal data" (1997) 16:1 J of Accounting and Public Policy 1.

<sup>334</sup> John L Abernathy et al, "Do External Auditors Respond to Tax Risk? Evidence from Audit Fees and Auditor-Provided Tax Services" (2016) SSRN.

years. Furthermore, Milstead reports that out of the 2.74% average annual earnings growth for S&P/TSX companies over the past 20 years, tax reductions have contributed 0.73 percentage points (or 26% of the growth).<sup>335</sup>

A lower ETR could reflect lower statutory tax rates, better tax planning, significant new investments (resulting in higher tax shields from CCAs and other timing differences), research and development tax credits, or historically poor performance creating operating loss carryforwards from previous years. ETRs often deviate within narrow ranges for firms in the same industry. Manufacturing firms tend to have lower ETRs, whereas firms in the retail industry tend to have higher ETRs. However, there remains significant variation in ETRs across firms in the same industry, some of which could be attributable to strategic tax planning.

Differences in ETRs could be driven by differences in financing (i.e., differences in debt tax shields or leasing versus buying), differences in operations (outsourcing versus in-house manufacturing), and/or differences in corporate strategies (e.g., mergers and acquisitions). It is important that tax managers are goal congruent with other financial managers to ensure that a management team as a whole creates and maximizes after-tax firm value.

As shown in the table below, Milstead reports examples of Canadian firms reporting below-average ETRs in their annual reports and the variation within each industry. Being able to reduce ETRs by a few percentage points compared with the industry average could boost earnings and stock prices.<sup>336</sup>

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<sup>335</sup> *Supra* note 326.

<sup>336</sup> David Milstead, “Shifting corporate tax may affect portfolios” *The Globe and Mail* (October 15, 2016) page B10.

**Table 1: Variation of effective tax rates (ETR) across and within sectors**

<b>Industry Sector</b>	<b>Company</b>	<b>5-year Average ETR</b>
Financials	Element Financial	-6%
	Manulife	8%
	Industrial Alliance	13%
<b>Financial Services average</b>		<b>17%</b>
Consumer Discretionary	Gildan	0%
	Hudson's Bay	4%
	Dorel	7%
<b>Consumer Discretionary average</b>		<b>25%</b>
Consumers Staples	Jean Coutu	19%
	Couche-Tard	21%
<b>Consumer Staples average</b>		<b>28%</b>
Industrials	Air Canada	-2%
	CAE Inc.	17%
<b>Industrials average</b>		<b>26%</b>
Information Technology	DH Corporation	8%
	Open Text	12%
	Celestica	12%
	Enghouse	14%
<b>Information Technology average</b>		<b>19%</b>

Utilities	Emera	11%
	Algonquin	12%
	Fortis	16%
<b>Utilities average</b>		<b>23%</b>
Materials	Western Forest	-7%
	Silver Wheaton	1%
	Intertape	3%
	Centerra	9%
<b>Materials average</b>		<b>24%</b>

### 2.2.3 Data Source for Further Empirical Analysis

The Compustat database contains financial data extracted from company filings and footnote codes that complement financial statements. This database carries standardized financial data of more than 20,000 North American public companies, of which around 1,000 are Canadian. Data items are consistent across years, making trend analysis feasible. This archive generally carries around 20 years of financial information, and it is straightforward to filter the data for any particular industry (based on the standard industry classification code or ticker symbol) or any given year.

One concern about Compustat is that the NOLs are financial statement NOLs and not actual tax NOLs. Having accounting NOLs instead of taxable NOLs systematically overstates estimated taxable income in our subsequent algorithms.<sup>337</sup> Other shortcomings about Compustat data include a lack of investment tax credits, a lack of foreign tax credits carryforwards, and the fact that it is split between foreign and domestic income.<sup>338</sup> Compustat also has no data on private companies. There is also a potential for self-selection bias in Compustat since only mature firms tend to be included in this database.<sup>339</sup>

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<sup>337</sup> Wendy Heltzer, “Conservatism and Book-Tax Difference” (2009) 24:3 J of Accounting, Auditing & Finance 469 at 503 [Heltzer].

<sup>338</sup> Terry Shevlin. “Estimating Corporate Marginal Tax Rates with Asymmetric Tax Treatment of Gains and Losses” (1990) 11:2 J of American Taxation Assoc 51.

<sup>339</sup> Thomas C. Omer, Karen H. Molloy, and David A. Ziebart, “Measurement of Effective Corporate Tax Rates using financial Statement Information” (1991) J of the American Taxation Assoc 57.

## 2.2.4 Issues with Measuring Taxable Income from Financial Statements

Several factors limit the ability to estimate taxable income using financial statement data. For example, we cannot retrieve much information about a firm's taxable income from its financial statements due to the range of discrepancies, including differences in the definition of the reporting entity, operating losses, and non-qualified stock option compensation<sup>340</sup>.

Hanlon<sup>341</sup> and Hanlon et al.<sup>342</sup> identify and summarize some problems associated with estimating taxable income from the financial statements:

- The current tax expense under GAAP is not increased or reduced by the tax benefit the firm receives from deducting employee stock options in the US or not deducting stock options in Canada.
- Firms often book contingencies for tax positions that may be reversed upon examination. Failure to account for these contingencies leads to overstated taxable income.
- Tax expense is reported after credits, such as the research and development and foreign tax credits. Grossing up the entire current tax expense would not be a true reflection of income for those firms with tax credits.
- It is hard to identify the appropriate tax rate to use for grossing up the foreign current tax expense. As a result, foreign income may be grossed up with the highest statutory tax rate.

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<sup>340</sup> Manzon & Plesko, *supra* note 273.

<sup>341</sup> Michelle Hanlon, "What Can We Infer about a Firm's Taxable Income from its Financial Statement?" (2003) LVI: 54 Nat'l Tax J 831 [Hanlon].

<sup>342</sup> Hanlon et al, *supra* note 153.

- The different consolidation rules for book and tax purposes cause differences between accounting income and taxable income.

Each of these items introduces measurement error into the estimate of taxable income.

Despite all these problems, Hanlon believes that, in most cases, the book expense provides a fair and accurate assessment of a firm's tax cost.

Plesko compared taxable incomes estimated from financial statements with actual taxable income filed to the IRS and found that there is a significant error in the commonly used financial statement-based measure of the average corporate tax rate used to calculate the statutory corporate tax burden.<sup>343</sup> He found that marginal tax rate (MTR) proxies derived from financial statements appear to provide relatively reliable estimates of the current year's MTR, and the coefficients on these variables only slightly understate the effects of taxation. Plesko concluded that publicly available data appear to have a limited ability to provide the necessary information to measure taxable income because the determination of a firm's tax liability is based on a separate set of rules and not on income reported to shareholders.<sup>344</sup>

Despite all the shortcomings of measuring taxable income from financial statements, this remains the only way to estimate the taxable income of any company. Maybe, a consistent manner of estimating at least reveals a meaningful picture of the trend.

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<sup>343</sup> George A Plesko. "An Evaluation of Alternative Measure of Corporate Tax Rates" (2003) 35 J of Accounting and Economics 201 at 224.

<sup>344</sup> George A Plesko, "Book-Tax Differences and the Measurement of Corporate Income" (1999) National Tax Association Proceedings at 92<sup>nd</sup> annual conference 171.

## 2.2.5 Algorithms for Estimating Taxable Income from Financial Statements

As tax information is considered confidential, various researchers have used models to calculate taxable income from financial statements. There is no single established, well-accepted estimation method for taxable income.

Shevlin estimates taxable income (TI) from financial statement data as follows:<sup>345</sup>

$$TI_t = PTBI_t - (\Delta DT_t / \tau_t)$$

Pre-tax book income (PTBI) is computed as the sum of income before extraordinary items, income taxes, minority interest, and discontinued operations. TI is estimated by subtracting the change in deferred taxes on the balance sheet, grossed up by the statutory tax rate from the PTBI.  $\Delta DT$  is the change in the deferred tax account, and  $\tau$  is the statutory MTR.

This measure is also used by Klassen and Mawani<sup>346</sup> and by Mawani.<sup>347</sup> TI is estimated by subtracting the change ( $\Delta$ ) in deferred taxes on the balance sheet grossed up by the statutory tax rate from the net income before taxes, as follows:

$$TIBL_t = NIBT_t - \Delta DT_t / str_t$$

where TIBL is the taxable income before the loss carryover for period  $t$ , NIBT is the net income before taxes for period  $t$ ,  $str_t$  is the statutory tax rate for period  $t$ , and  $DT$  is the change in the deferred tax balance between the two consecutive balance sheets.

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<sup>345</sup> Shevlin, *supra* note 338.

<sup>346</sup> *Supra* note 310.

<sup>347</sup> Amin Mawani, "Cancellation of Executive Stock Options: Tax and Accounting Income Considerations" (2003) 20:3 Contemporary Accounting Research 495.



There are various assumptions used in the above formula. The estimated TI reflects the firm's worldwide TI. Taxes payable are estimated by applying the statutory tax schedules to the estimated TIs. This assumes all income, both domestic and foreign, is subject to the same tax rates. This assumption is necessary because there is no way to find the proportion of income earned in a foreign jurisdiction.

Furthermore, this measure does not capture the NOLs. Reporting entities can use NOLs to offset taxes payable for the current year. In the absence of this variable, the TI calculated by using this formula is imprecise.

Lev and Nissim estimate TI by grossing up the current portion of the reported income tax expense:

$$\text{Taxable Income} = \frac{\text{Current portion of the income tax expense}}{t}$$

where  $t$  is the statutory tax rate.

Lev and Nissim point to measurement errors, such as the use of the top statutory tax rate, to gross-up the tax expense instead of the average tax rate since not all types of income are subject to the top statutory tax rate.<sup>348</sup> Shevlin<sup>349</sup> and Hanlon<sup>350</sup> also rely on this method. According to Hanlon, the main problem with this method is the overstatement of TI because it ignores NOLs. According to Kvaal and Nobes,<sup>351</sup> the relationship is not exact because current tax expense only relates to profit and loss from continuing operations and excludes tax on items classified as other

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<sup>348</sup> Baruch Lev & Doron Nissim. "Taxable Income, Future Earnings, and Equity Values" (2004) 79 *The Accounting Rev* 1,039.

<sup>349</sup> Terry Shevlin, "Corporate Tax Shelters and Book-Tax Differences" (2002) 55 *Tax L Rev* 427.

<sup>350</sup> Hanlon, *supra* note 341.

<sup>351</sup> Erlend Kvaal & Christopher Nobes, "On the definition and Measurement of Book-Tax Conformity" (2012). Online: <[https://scholar.google.ca/scholar?rlz=1C1CHYI\\_en-GBCA556CA557&um=1&ie=UTF-8&lr&q=related:htZs3cWrJM0KbM:scholar.google.com/](https://scholar.google.ca/scholar?rlz=1C1CHYI_en-GBCA556CA557&um=1&ie=UTF-8&lr&q=related:htZs3cWrJM0KbM:scholar.google.com/)>

comprehensive income. These scholars also think that this measure is a weak proxy for TI owing to the different consolidation rules for accounting and taxation, as well as the inclusion of taxes payable (that may be for the prior year adjustment) in the reported current tax expense.

Wendy Heltzer<sup>352</sup> uses PTBI because book income and TI should include similar revenue and expense items to estimate the book–tax difference. She subtracts minority interest from PTBI to account for the different consolidation practices for the calculation of book income. She further subtracts the change in NOL carryforward from grossed-up total current tax expenses. The current total tax expense is grossed up by applicable statutory rates. The change in NOL carryforward is subtracted to estimate TI.<sup>353</sup>

Hanlon et al. also calculate PTBI by deducting minority interest from PTBI.<sup>354</sup> They estimate the TI by summing up the current federal income tax expense and current foreign tax expense to arrive at the current tax expense. This number is divided by the statutory tax rate, and the change in net operating loss carryforwards is subtracted from this number to obtain TI.

Manzon and Plesko examine financial statements from 1988 to 1999 to estimate TI and to calculate the difference between the amounts of income reported under various rules.<sup>355</sup> They claim that US domestic TI in the current period can be estimated as a current deferral tax expense divided by the statutory tax rate, with the total tax expense being the sum of the current tax expense and deferred tax expenses. They estimate the TI based on the firm’s reported current tax expense.

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<sup>352</sup> Heltzer, *supra* note 337 at 476-477.

<sup>353</sup> This method is also used by Hanlon et al, *supra* note 153.

<sup>354</sup> Hanlon et al, *supra* note 153 at 14-15.

<sup>355</sup> Manzon & Plesko, *supra* note 273.

Hanlon and Heitzman measure the total book–tax income difference as a PTBI minus the current tax expense plus the foreign tax expense grossed divided by the statutory tax rate minus the change in the net operating loss, summarized as follows:<sup>356</sup>

$$\text{Total book–tax difference (BTD)} = \text{PTBI} - ((\text{US CTE} + \text{Fgn CTE})/\text{US STR}) - (\text{NOL}_t - \text{NOL}_{t-1})$$

They also calculate the temporary book–tax difference as deferred tax expenses divided by the statutory tax rate.

McIntyre and Nguyen determine the domestic profits of a company by subtracting current state and local taxes to determine the net domestic pre-tax profits before federal income taxes and then estimating the company’s federal income taxes currently payable.<sup>357</sup> Current taxes are those that a company is obliged to pay within one fiscal year. Finally, taxes currently payable are divided by pre-tax profits to determine ETRs. McIntyre and Nguyen identify the problem with this measurement approach that includes foreign income, stock option deductions, and a “negative” ETR (which is a tax rebate due to losses from other years).<sup>358</sup>

Hanlon and Shevlin calculate the ratio of TI to book income to assess the book–tax gap.<sup>359</sup> They measure TI by summing up the current federal income tax expense and current foreign tax expense to derive the current tax expense and divide it by the US statutory tax rate applicable for the year to estimate TI (before considering losses). From this, they subtract the annual change in net operating loss carryforwards to estimate TI.

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<sup>356</sup> Michelle Hanlon & Shane Heitzman, “A review of tax research” (2010) 50 J of Accounting and Economic 127 at 140.

<sup>357</sup> Robert S McIntyre & T.D. C Nguyen, “Corporate Income Taxes in the 1990s” (2004) Institute on Taxation and Economic Policy, Washington DC.

<sup>358</sup> *Ibid.*

<sup>359</sup> Hanlon et al, *supra* note 153.

Jackson estimates TI by grossing up current tax expenses with the top statutory tax rate and then multiplying by  $(1-t)$  to make it comparable with net income, which is an after-tax measure.

<sup>360</sup> He then estimates the temporary component of total book–tax differences by grossing up deferred tax expenses.

According to Mills,<sup>361</sup> financial statement information can be used to infer taxation information because IRS audit adjustments increase as the book–tax difference increases. Firms do not manipulate only one set of books, and book income or TI cannot be manipulated independently of each other. Therefore, researchers can continue to use financial income information to infer aspects and estimates of tax effects.

## **2.2.6 Book–Tax Gap of Canadian Companies: 1993–2014**

I have empirically examined the book–tax income gap of Canadian companies over the period of 1993–2014 to determine the trend. During the sample period, Canadian companies used GAAP until 2011 and the IFRS from 2012 onward. My sample includes all Canadian companies listed on the Compustat database that report pre-tax income data.

I use two methods to calculate taxable income and the book–tax difference. The first method considers a change in deferred tax, and the second includes net operating losses. These are the two methods most often used to infer the TI from financial statement data.

### **Method 1**

Under Method 1, PTBI is computed as the sum of income before extraordinary items (Compustat item #18), income taxes (Compustat item #16), minority interest (Compustat item

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<sup>360</sup> Mark Jackson, “Book-Tax Differences and Earning Growth” (2010) University of Nevada.

<sup>361</sup> Mills, *supra* note 313.

#49), and extraordinary items and discontinued operations (Compustat item # 48). As extraordinary items and discontinued operations are stated net of tax, this amount is grossed up by  $(1 - \text{statutory tax rate})$  before being aggregated as suggested above. TI is estimated by subtracting the change in deferred taxes on the two most recent consecutive balance sheets (Compustat item #74) and grossed up by the statutory tax rate as follows:

$$TI_t = PTBI_t - (\Delta DT_t / \tau_t)$$

where PTBI is the reported pre-tax book income,  $\Delta DT$  is the change in the deferred tax account between the two most recent consecutive balance sheets, and  $\tau$  is the statutory tax rate.

## Method 2

The main objection to Method 1 above is that it does not consider NOL. According to the second method (referred to as Method 2), TI is estimated by subtracting the change in NOL carryforward (Compustat item #52) from the grossed-up total current tax expense, where the current total tax expense is the sum of the current federal tax expense (Compustat item #63) and current foreign tax expense (Compustat item #64). If the current federal tax expense is missing (which is the case for most Canadian companies), the current total tax expense is calculated by subtracting differed taxes (Compustat item #50), state income taxes (Compustat item #173), and other income taxes (Compustat item #211) from the total income taxes (Compustat item #16).

Taxable Income =  $[(\text{taxes federal} + \text{Income taxes foreign}) / \text{Statutory marginal tax rate}] - \Delta$  in Tax loss carryforward

where  $\Delta$  is the change in the tax loss carryforward in the current year compared with the previous year.

The book–tax difference calculated using these two methods includes both temporary and permanent differences. I calculate the temporary book–tax difference as follows:

$$\text{Temporary book–tax difference} = \text{Deferred tax expenses} / \text{Statutory tax rate}$$

I analyze data using both methods for two different samples. Sample 1 consists of all the Canadian companies included in the database. Sample 2 consists of all the companies having assets more than \$10 million because the large companies may have more resources to exploit the book–tax difference as claimed by Boynton and Mills.<sup>362</sup> However, the book–tax gaps for both samples are similar—as shown in Figure 1 for Method 1 and Figure 4 for Method 2. Due to the similarity of results, the subsequent tabulation is only for firms with more than \$10 million in assets (Sample 2).

**Sample 1:** All Canadian firms included in the Compustat database during the 1993–2014 period:

Total firm-year observations	20,817
Less: Missing data for pre-tax income	3,148
Firm-years used in this study	17,669

**Sample 2:** All companies with assets more than \$10 million:

Total firm-year observations	20,817
Less: Firm-years with less than \$10 million assets	3,761
Less: Missing data for pre-tax income	3,148
Firm-years used in this study	13,908

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<sup>362</sup> Charles Boynton & Lillian Mills, “The Evolving Schedule M-3: A New Era of Corporate Show and Tell?” (2004) 57:3 Nat’l Tax J 757.

## 2.2.7 Findings

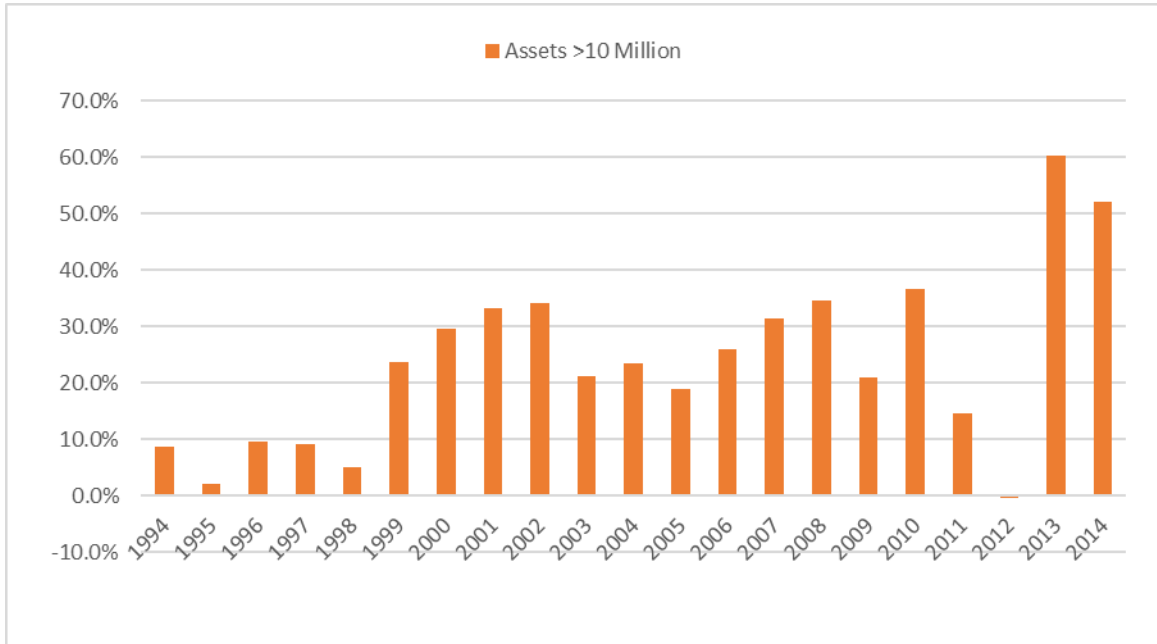
Under Method 1, book incomes and TIs have been diverging over the last decade. The exception was in 2012 when Canadian companies started using IFRS instead of GAAP. The gap was relatively small from 1994 to 1998 and increased significantly during 2013 and 2014.

**Figure 1: Book–Tax Differences–Method 1**



As shown in Figure 2, the book–tax difference as a percentage of book income reached around 60% during 2013 and 2014. During most of the other years, this difference was between 20% and 40% of the PTBI.

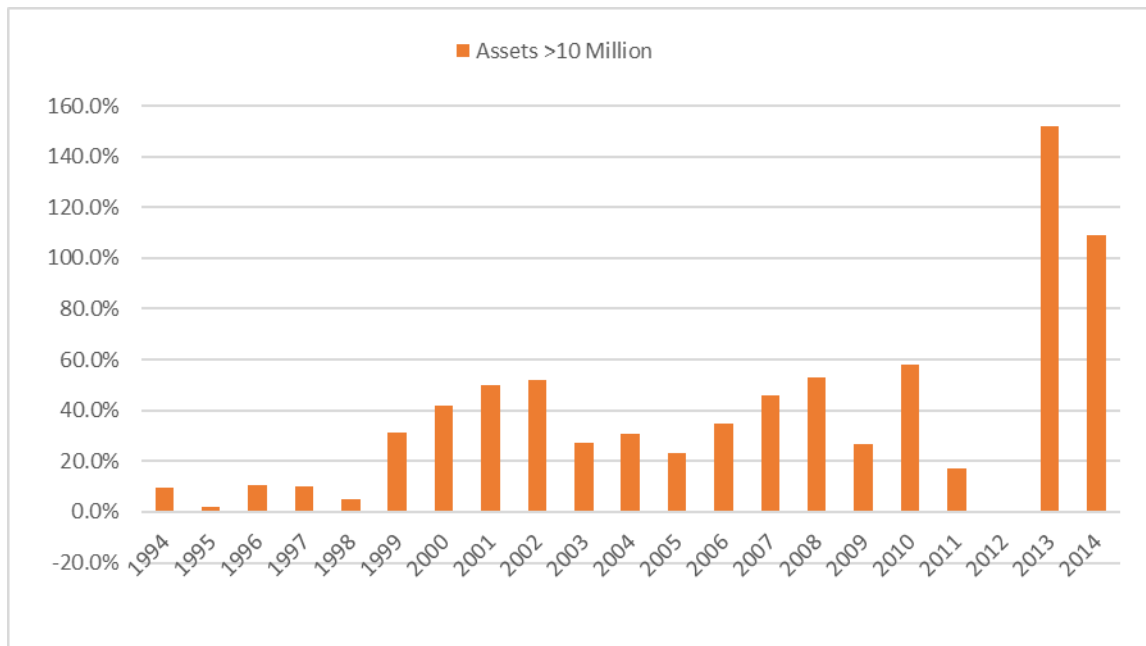
**Figure 2: Book–Tax Differences as a Percentage of Book Income under Method 1**





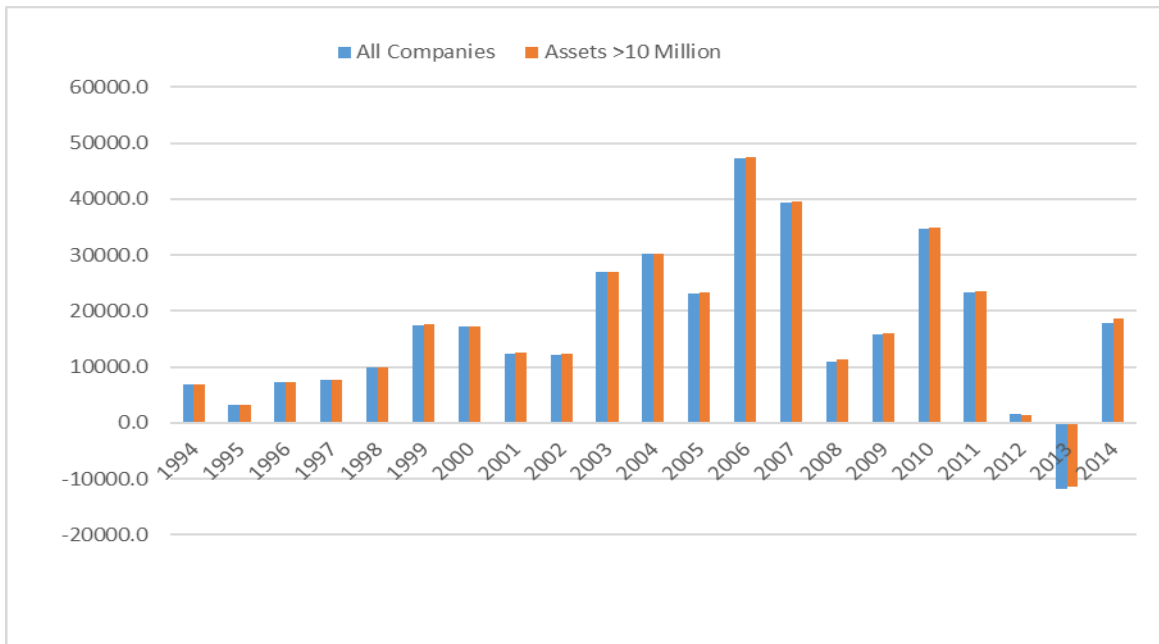
As shown in Figure 3, the book–tax difference as a percentage of TI reached around 160% in 2013 and around 125% in 2014, with a clear upward trend.

**Figure 3: Book–Tax Difference as a Percentage of Taxable Income under Method 1**



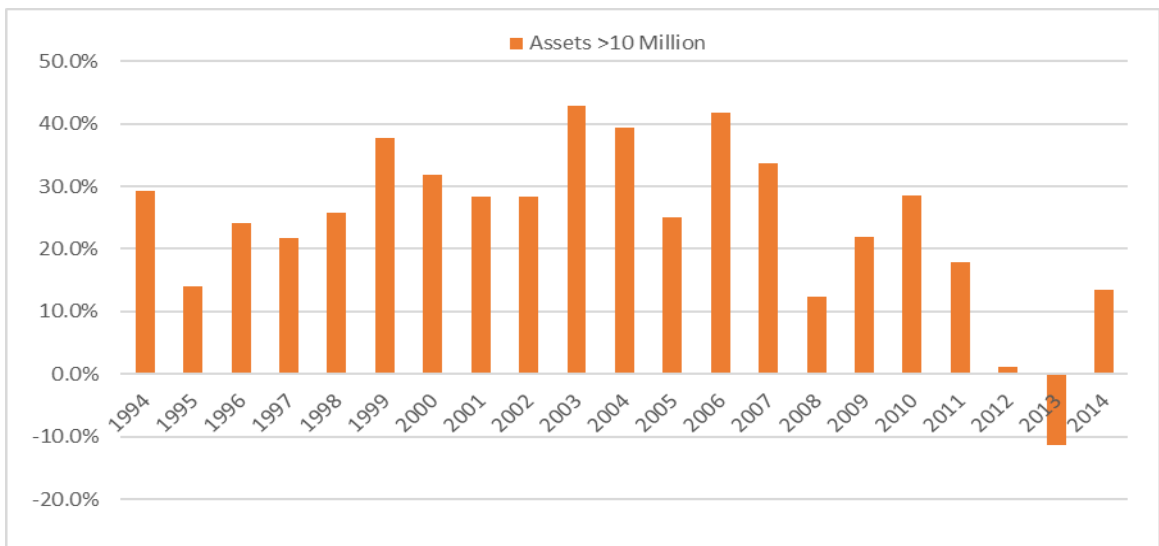
Under Method 2, the book–tax difference increased until 2006 and reached a peak in 2010. As shown in Figure 4, 2013 was the only year when the book income was more than the TI.

**Figure 4: Book–Tax Difference–Method 2**



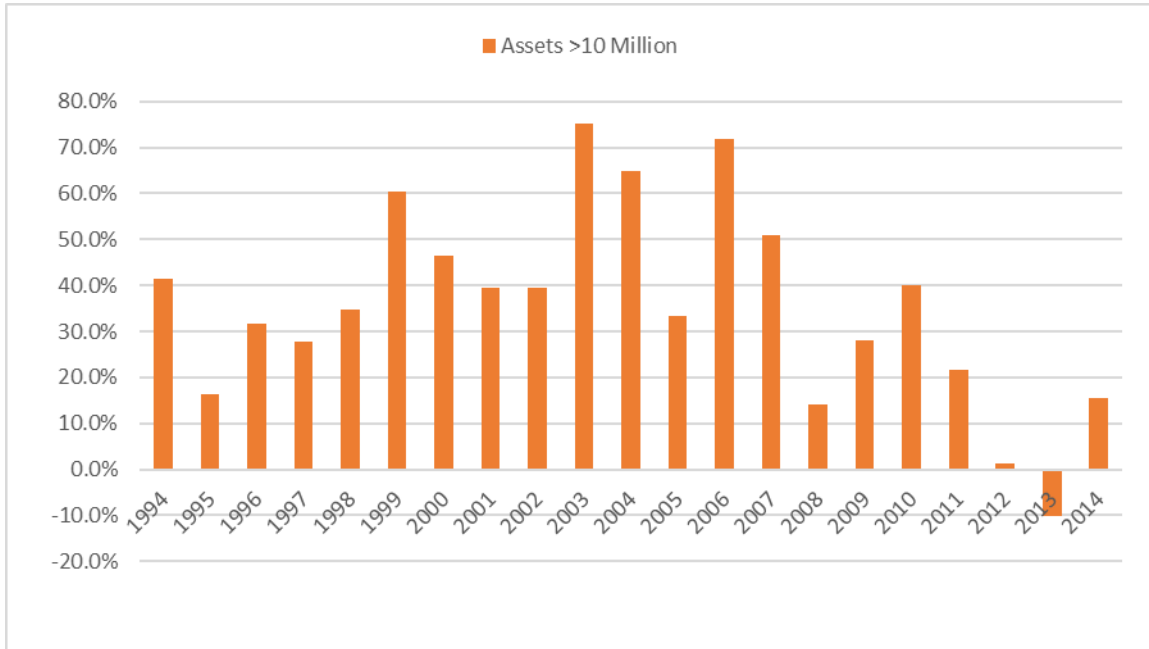
As shown in Figure 5, the book–tax difference as a percentage of the book income is around 20% to 50% for the most part between 1994 and 2014. In 2013, the reported book income was higher than the estimated TI.

**Figure 5: Book–Tax Difference as a Percentage of Book Income under Method 2**



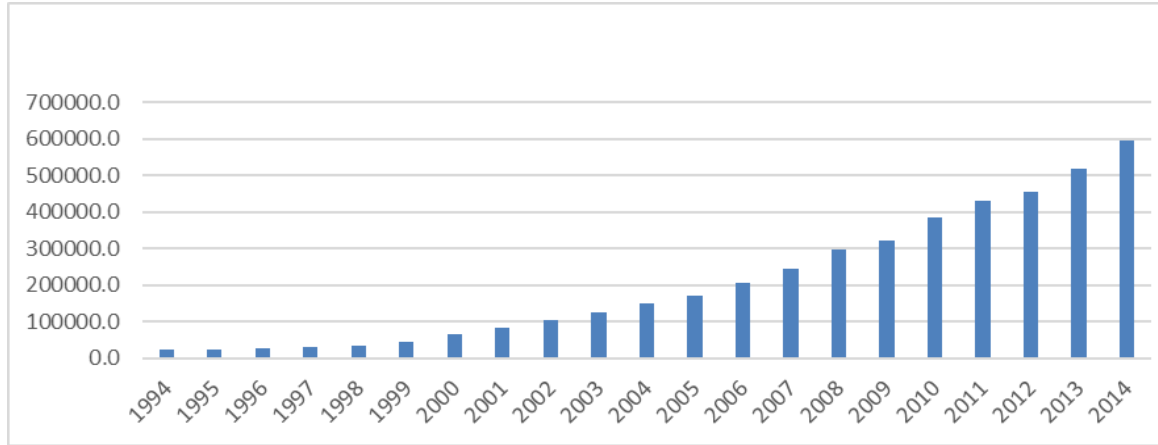
As shown in Figure 6, the book–tax difference as a percentage of TI is generally less than 80%. There is an upward trend in all three samples, except during 2013 when the TI was less than the book income.

**Figure 6: Book–Tax Difference as a Percentage of Taxable Income under Method 2**



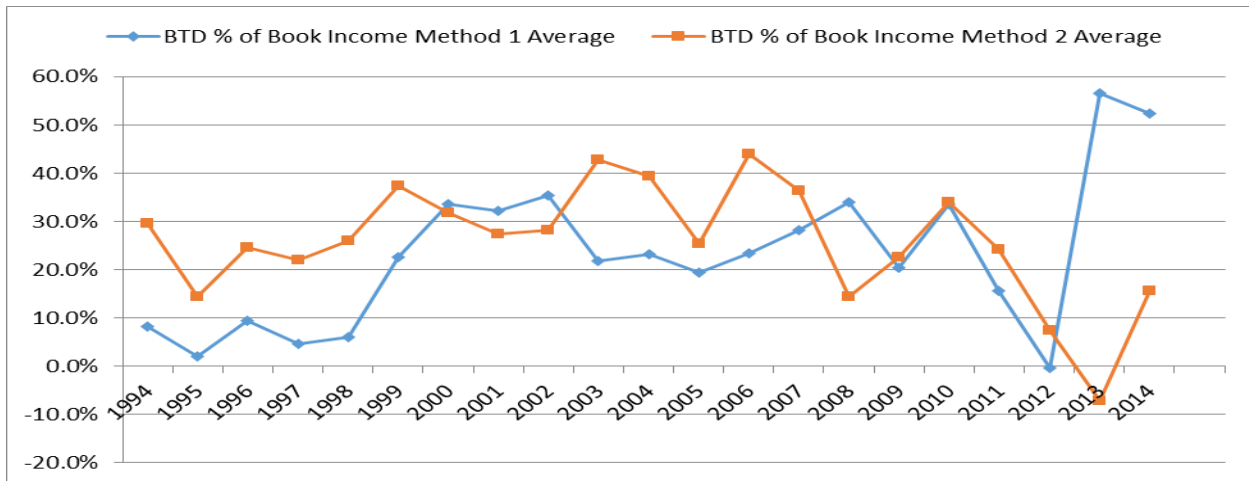
As shown in Figure 7, the temporary book–tax difference calculated using Method 2 shows that there is a constant increase in the temporary book–tax difference for all three samples.

**Figure 7: Temporary Book–Tax Differences**



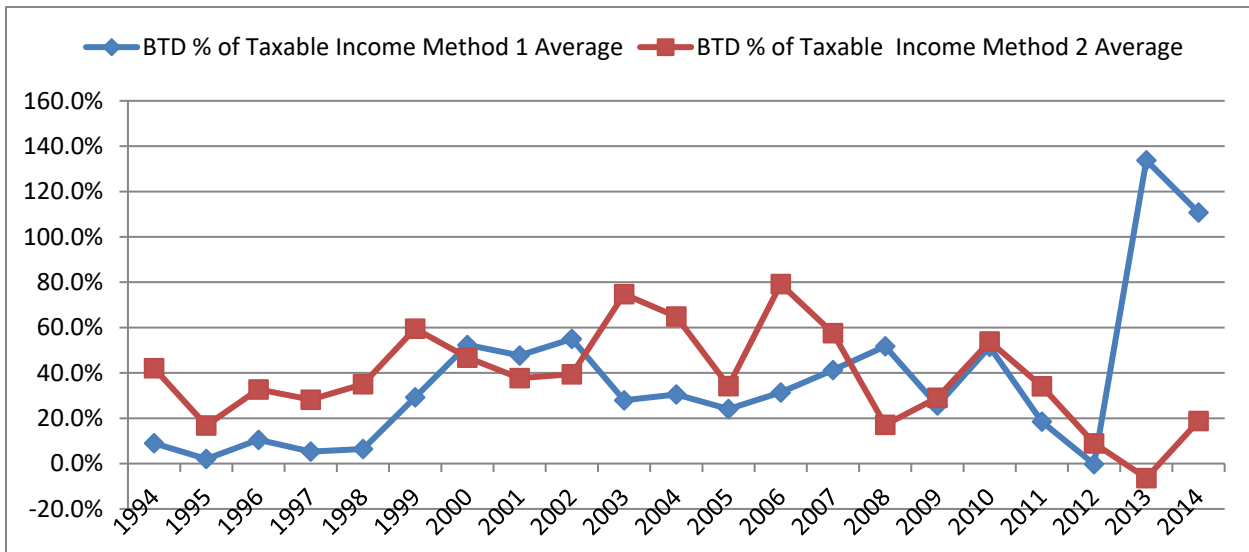
If we compare the averages of all samples calculated using Methods 1 and 2 as a percentage of PTBI, the average of Method 1 is higher than the average of Method 2 in 6 of the 21 years, whereas Method 2 shows a higher value during the remaining 15 years. Method 2 shows a negative book–tax difference in only 1 year. In 2013 and 2014, Method 1 reports a very high book–tax difference as a percentage of book income. The overall average of these two methods during the 21-year period shown in Figure 8 is almost the same: 23.3% for Method 1 and 26% for Method 2.

**Figure 8: Average Book–Tax Difference as a Percentage of Book Income**



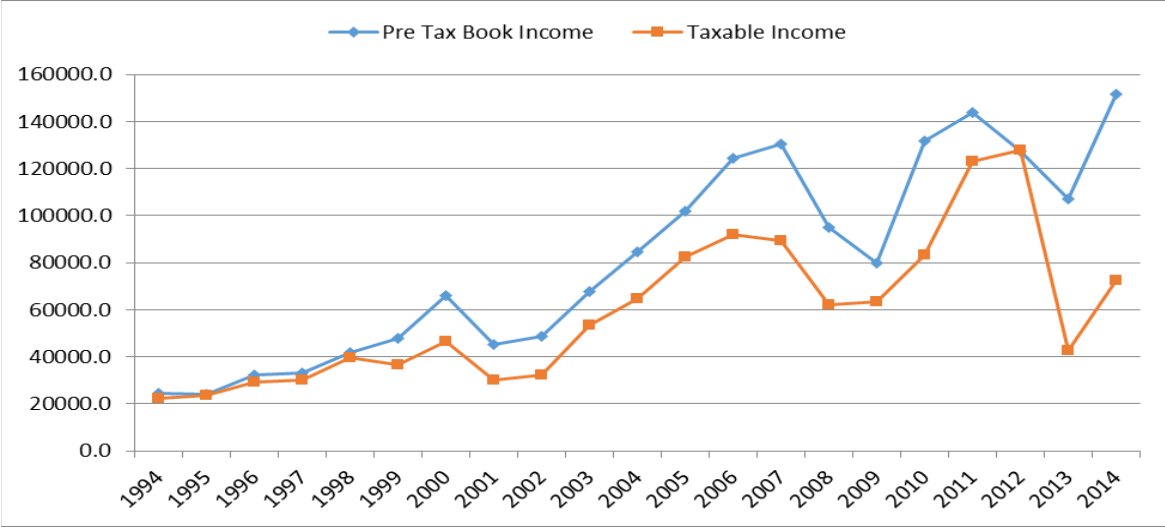
When we compare the average book–tax difference (for all samples) as a percentage of TI for both methods, we see an increasing trend. Most of the gaps reported under Method 1 lie in the 40% to 80% range, with two values (in 2013 and 2014) crossing the 100% threshold. In contrast, the maximum gap under Method 2 is 80%, as presented in Figure 9.

**Figure 9: Average Book–Tax Difference as a Percentage of Taxable Income**



When we compare the graph of the PTBI and estimated TI of Canadian companies (Figure 10), we can find a gradual increase between the PTBI and TI.

**Figure 10: Pre-Tax Book Income and Estimated Taxable Income**



Overall, we can see a growing trend in the book–tax difference in Canada.

### 3 Narrowing the Conceptual Gap

The conceptual gap can be narrowed if income for tax purposes converges to accounting income. The economic, accounting, and legal definitions of income are different, with each attempting to measure the economic activity of an entity for its own purposes. In the early stages in the development of the concept of income, more differences among the three disciplines existed. With the passage of time, the principles of accounting and taxable incomes converged somewhat, and both became closer to the concept of economic income.

In this chapter, I argue that there is a possibility to bring the accounting income closer to the taxable income by enacting very few selective accounting items into the taxable income.

#### 3.1 What Are the Major Issues and Why the Gap Should be Narrowed?

Schön argues that tax preferences will always be around, thereby making it difficult to narrow the book–tax gap. He says:

It has been argued that the introduction of these tax preferences should not be prohibited by comprehensive book-tax conformity. Yet these rules not only deviate from the financial accounting treatment, they also infringe the ability-to-pay principle. Therefore, there are good arguments to do away with exceptions, which distort the tax base and violate the equitable treatment of taxpayers in general.<sup>363</sup>

It is generally assumed that a small number of variables are responsible for the book–tax gap. Manzon and Plesko<sup>364</sup> document that the book–tax income gap has increased over time, with a relatively small set of variables explaining this increase. Pre-1990 book–tax differences could

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<sup>363</sup> Schön, *supra* note 148 at 131.

<sup>364</sup> Manzon & Plesko, *supra* note 273.

be explained by three factors: treatment of depreciation, foreign income, and employee compensation. However, by the late 1990s, only less than half of the difference was explained by these three factors.<sup>365</sup>

According to Weiner, the existence of the book–tax income gap is not a problem. However, there is a concern as to whether this gap is increasing over time.<sup>366</sup> The gap exists for several reasons. It may be due to the temporary accounting difference that can be reversed after the passage of time (timing differences), or it can be caused by tax sheltering activities. Weiner documents that in 1980, US companies reported book incomes that were 8% higher than their taxable incomes. By 2000, this gap grew to 50%, and in 2003, book income was almost twice as high as taxable income.<sup>367</sup>

Although complete alignment of book–tax income is not feasible, there is still a scope for some convergence. It is evident from various studies that increased conformity reduces tax avoidance.<sup>368</sup> Porcano and Tran also opine that complete alignment is neither possible nor desirable. They say:

Having argued that a complete book-tax alignment is infeasible and undesirable in Anglo-Saxon countries, we do not mean that there is no scope for bringing two sets of rules closer to each other. Tax authorities (i.e., the legislature, the judiciary, and tax administrators) can selectively adopt some of the accounting principles and standards to provide a tax base which is clear and certain. ... It is not that financial accounting rules should not be adopted for taxation purposes; it is only an indiscriminate adoption of all financial accounting rules for taxation purposes that will

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<sup>365</sup> Desai, *supra* note 309.

<sup>366</sup> Joann M Weiner, “Closing the Other Tax Gap: The Book-Tax Income Gap” (2007) Tax Notes 849 at 853 [Weiner].

<sup>367</sup> *Ibid* at 851.

<sup>368</sup> Tanya Tang, “Does Book-Tax Conformity Deter Opportunistic Book and Tax Reporting? An International Analysis” (2015) 24:3 European Accounting Rev 441. and T J Atwood et al, “Home country tax system characteristics and corporate tax avoidance: International evidence” (2012) 87:6, The Accounting Rev 1831.



serve neither the needs of a good tax system nor those of a good financial reporting system.<sup>369</sup>

Tang also argues that while full conformity is not feasible, there are potential benefits of increased conformity. Her study provides evidence on the major perceived benefits of conformity.<sup>370</sup>

Former US Treasury Assistant Secretary for Tax, Pamela F. Olson, argues that greater conformity does not mean eliminating excessive book–tax reporting differences. She favours making a few simple but comprehensive sets of differences that “could go a long way to fostering greater confidence in the number and respect for the tax system.”<sup>371</sup>

Accounting scholars such as Atwood, Drake, and Myers oppose the idea of conformity between tax and accounting systems.<sup>372</sup> Their empirical study documented that increasing book–tax conformity would lower earnings quality and result in reported accounting earnings that are less persistent and less highly associated with future cash flows. They even suggested that any move toward partial conformity may result in reported accountings that are less persistent and less closely associated with future cash flows.

Another objection to more conformity is that it would increase the taxpayers’ compliance cost. In reality, the cost would likely be small compared with the benefits of more transparency for all stakeholders.

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<sup>369</sup> Porcano & Tran, *supra* note 203.

<sup>370</sup> *Supra* note 368.

<sup>371</sup> Amy Hamilton & Natalia Radziejewska, “Olson argues for eliminating some book-tax reporting difference” (March 31, 2003) Tax Notes at 1936.

<sup>372</sup> T J Atwood, Michael S. Drake, & Linda A. Myers, “Book-Tax Conformity, Earning Persistence and the Association between Earning and Future Cash Flows” (2010) 50 J of Accounting and Economics, 111.

I agree with Freedman that complete alignment is neither possible nor desirable. The best option is to implement more conformity and more disclosure. As Freedman says:

[I]n any tax system based on profit, the commercial accounts and tax accounts will almost certainly have the same starting place, so the interesting question becomes one of the degrees to which there should be divergence rather than whether there should be divergence at all. In addition, to the extent that there is divergence, who should be the final arbiter of taxable profits in any given case? The matter could be one for the legislature, the courts or the accounting profession or, most probably, some combination of the three, but the relationship between these sources of definition will need management and regulation.<sup>373</sup>

### 3.2 Economic Income and the Carter Commission

There are three underlying concepts of income that have shaped the definitions of accounting and taxable incomes: the accretion concept, the trust concept, and the source concept.<sup>374</sup> The accretion concept defines income as an increase in the economic power of an individual that can be measured with reasonable objectivity.<sup>375</sup> According to Thuronyi, the accretion concept is a continuation of the trust concept. It is not outlined in the statutes but developed through administrative and judicial practices.<sup>376</sup> In the trust concept, income is kept separate from the capital in the trust because income may be distributed or distributable to the beneficiaries, whereas capital is retained or kept intact to generate more income in the future. The differentiation between capital and income is significant for taxation purposes because of different tax rules for income and capital.<sup>377</sup>

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<sup>373</sup> Freedman, *supra* note 2 at 77.

<sup>374</sup> Victor Thuronyi, *Comparative Tax Law*, (The Hague: Kluwer Law International, 2003) at 235/236.

<sup>375</sup> G Edward Philips, "The Accretion concept of income" (1963) 38:1 *The Accounting Rev* at 14.

<sup>376</sup> *Supra* note 374.

<sup>377</sup> According to current tax rules, income is generally fully taxable, whereas capital gains are only 50% taxable.

The origins of the source concept of income have been attributed to an agricultural economy and the definition traced back to Adam Smith's *Wealth of Nations*<sup>378</sup> where he mentioned three sources of revenue: labour, stock, and rent of land.<sup>379</sup> In the source doctrine, income is assumed to come from a source. In income tax laws, if a source of income (office, employment, business, property, and capital gain) is not identified, it may not be taxable.<sup>380</sup> The source concept of income has its roots in the early UK income tax statute where income tax was levied only on those amounts included in various schedules, and each schedule had its own computation rule.<sup>381</sup>

Profit or income is an abstract concept and may have different and multiple meanings in economics, accounting, and taxation. Income does not have a single meaning, "it is not something given in nature which is observable."<sup>382</sup> Conceptually, for various reasons, the definition of income or profit is different in accounting and taxation. Income is essential because recipients live and survive on their income. In economics, Fisher described income as "the most vital concept in economic science."<sup>383</sup> It is vital for governments because it is used as a starting point for the tax base on which many taxes are collected and the base determining many social benefits paid to individuals and corporations.

Different people perceive income differently. When an employee thinks about income, he/she assumes money available after all the statutory deductions for payroll and income taxes

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<sup>378</sup> Adam Smith, *Wealth of Nations* at 89. Online: <<http://political-economy.com/wealth-of-nations-adam-smith/>>.

<sup>379</sup> Benjamin Alarie, "Exploring the Source Concept of Income: The Taxation of Poker Winning in Canada" (2011) SSRN at 10.

<sup>380</sup> For example, in *Canada v Fries* case (*supra* note 165), the Supreme Court decided that strike pay is not income because there is no source attached with this income.

<sup>381</sup> Ault & Arnold, *supra* note 172.

<sup>382</sup> Macdonald, *supra* note 61 at v

<sup>383</sup> Irving Fisher cited in Bert N Michell, "A Comparison of Accounting and Economic Concepts of Business Income" *The New York Certified Public Accountant* (October 1967) at 762.

have been made. For businesses, income is a residual cash flow after paying all the business expenses, including taxes. The words “profit” and “income” are presumed to have the same meaning in common usage. The United Nations defines income as the maximum amount available to a household for consumption after the net worth is maintained intact; for a household, the net worth is the current value of assets minus the current value of liabilities.<sup>384</sup>

The definition of economic income is important since accounting and legal incomes are arguably derived from economic income. Some academics, such as Kahng, believe that both accounting and taxable incomes should be based on the principle of accurately measuring the economic income and that the accounting and legal systems should help each other to implement that principle.<sup>385</sup> The concept of “ideal income” is also derived from economic income. Later in this section, I will discuss that concept.

German economists were the first to define the concept of income, to which French and English contributors added commentaries.<sup>386</sup> Schanz offered a comprehensive concept of income that included unrealized gains, all benefits, all valuable services, gifts, inheritances, legacies, lottery winnings, insurance annuities, and speculative gains of all types minus interest charges, capital depreciation allowances, and the influx of wealth during a given period.<sup>387</sup> According to this definition, all incoming items are considered income, and income includes all the means available to a person during a given time period.

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<sup>384</sup> UN, *System of National Accounts 2008*, UN Doc E.08.XVII.29, 2009 at 11.

Online: <<https://unstats.un.org/unsd/nationalaccount/docs/SNA2008.pdf>>.

<sup>385</sup> Kahng, *supra* note 177.

<sup>386</sup> Paul H. Wueller, “Concepts of Taxable Income I” (1938) 53:1 *Political Science Quarterly* 83 at 84 [Wueller].

<sup>387</sup> *Ibid* at 106.

Schanz did not consider proceeds from personal debt to be an increase in an individual's economic power<sup>388</sup> because the asset (proceeds from debt) was offset by the liability owed to the lender. There was no net increase in an individual's economic power. This reasoning is extended to accounting and legal domains.

Gartner challenged Schanz by questioning the inclusion of items, such as capital gains and gifts, in the definition of income that could be taxable under the law.<sup>389</sup> Gartner also concluded that gifts were not part of income since the recipient would have neither a legal nor equitable claim. If an individual gained something valuable without expending some effort, it was merely a windfall gain and not income. If there was consistent effort involved in the form of consciously directed economic activities to gain something, the gain must be considered income. Gartner also discussed the intent of the person as a means of establishing the presence or absence of economic activity. He considered a receipt as income if it carries the legal or equitable title.

Schanz rejected Gartner's concept of income because of its inconsistency and impracticability. He also questioned requiring a taxpayer's intent in determining income even though intent is used extensively in the case of law today—e.g., *Bogardus v Commissioner*.<sup>390</sup>

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<sup>388</sup> Holmes, *supra* note 65 at 58.

<sup>389</sup> Wueller, *supra* note 386 [paraphrased].

<sup>390</sup> *Bogardus v Commissioner*, 302 US 34 (1937) cited in Roswell Magill, Magill, *supra* note 212 at 307.

The stockholders of the Unopco corporation (all of whom were also stockholders of its predecessor, the Universal Oil Products corporation) voted to show their appreciation to some former Universal employees by providing the employees with a "gift or honorarium" a few days after the sale of the stock. The payments were made by cheque accompanied by a note stating that the amount was a gift and thus not subject to income tax.

The plaintiff received \$10,000. The lower courts declared that amount to be additional compensation for services to Universal, but the Supreme Court reversed this decision by a vote of five to four. The gifts were made without any legal or moral obligation, not for any services rendered or to be rendered, or for any consideration given or to be given. The gifts were made in an act of spontaneous generosity in appreciation of loyalty.

According to Schanz, the intent was not a clear criterion because people change their minds in different circumstances.<sup>391</sup>

One group of US economists led by Seligman framed definitions of income in the accrual tradition in much the same way as German economists, whereas another group led by Fisher subscribed to the concept of income resulting from the disposition.<sup>392</sup>

According to Seligman, income should be what is available to individuals after meeting all expenses necessary for earning the income.<sup>393</sup> He considered income to be a flow of wealth that must always be estimated for a definite time period, e.g., annual income. He also included two characteristics of income: realization and separation of income from the source. A gain must not only be realizable but also realized. If it is not realized, there is no income, only appreciation. These two concepts played an important role in deriving the legal definition of income.

Seligman considers income to be fundamentally a source of pleasure, even though in reality, pleasure or satisfaction from any possession can be achieved without selling it (realization). If we consider income in terms of satisfaction, the definition becomes vague since every person has his/her subjective level of satisfaction based on subjective needs and subject to the law of diminishing utility.

Haig came up with a definition of income that was based on a single test of an increase in economic power.<sup>394</sup> According to Haig, a particular item should be considered income if

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<sup>391</sup> Wueller, *supra* note 386 at 108.

<sup>392</sup> Paul H. Wueller, "Concepts of Taxable Income II" (1938) 53:4 Political Science Quarterly 557 [P Wueller].

<sup>393</sup> Edwin R. A. Seligman, *The Income Tax A Study of the History, Theory, and practice of Income Taxation at Home and Abroad* (Toronto: The Macmillan Co. of Canada Ltd., 1911) at 19-20.

<sup>394</sup> Robert Murray Haig et al, ed, *The Federal Income Tax* (New York: Columbia University Press, 1921) [Haig].

receiving that item increased the recipient's economic power.<sup>395</sup> Haig further compared the legal concept of income with the economic concept of income and concluded that taxable income under an income tax law should be closer, approximately, to the true net income as defined by the analysis of an economist and an accountant. He was against any unnecessary departure from the economic concept of income. According to Haig, if we accepted the single criterion of income as an increase in economic power, the courts would be left to answer the following questions:

The questions which the courts would then be called upon to consider would be as to whether the modifications made by Congress and by the Treasury, in attempting to construct a concept of taxable income which will be at once workable and approximately just, are modifications which are reasonable and in conformity with the various constitutional guarantees.<sup>396</sup>

Haig also discussed income taxes and their relationship with income. According to him, a perfect income tax is unattainable due to various imperfections in valuation methodologies, the role of accounting, and administration issues. He argued that accounting income would not align with economic income (as measured by the true accretion of economic power) as long as there are fluctuations in inflation and the purchasing power of money.

If the purpose of income is to measure an individual's economic power, why can't economists agree on a definition of income? Haig's answer to that question was that such a difference is due more to questions of policy than questions of principle. He defined income as "the money value of the net accretion to economic power between two points of time"<sup>397</sup> but

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<sup>395</sup> *Ibid.*

<sup>396</sup> Haig, *supra* note 394 at 15-16.

<sup>397</sup> Haig, *supra* note 394 at 7.

considered the appreciation of a fixed asset as income that was not subject to tax until the asset was sold.

Haig also offered a concept of legal income that was closer to economic income. He said that if his concept were incorporated into a federal statute, it would be better than the prevailing judicial concept of income that separated income and capital:

The definition of income should rest on fundamental economic principles. The definition must be broad enough to iron out all the theoretical difficulties and solve all of the inequities and anomalies. The situation should be held in a mobile, flexible state which will permit the statutory definition of income to become progressively more precise and accurate with the improvement of the technique of our economic environment.<sup>398</sup>

Simons criticized Haig's definition for excluding annual or periodic consumption and for not clearly defining economic power.<sup>399</sup> Simons' definition of income was as follows:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.<sup>400</sup>

Simons objected to the general definition of economic activities. He argued that if we included personal household services as part of income (since such services are part of economic activities), then "even the poorest families could be construed to have substantial income as

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<sup>398</sup> Haig, *supra* note 394 at 27-28.

<sup>399</sup> Henry C Simons, *Personal income taxation, The Definition of Income as a Problem of Fiscal Policy*, (Chicago: The University of Chicago Press, 1938) at 62 [Simons].

<sup>400</sup> *Ibid* at 50.



measured by the cost of self-provided instruction, nursing, cooking, maid service, and other things which the upper classes obtain by purchase.”<sup>401</sup>

Plehn considered income to be a relative term. An item can be income for one person, but not for another. For Plehn, the income needed to have three characteristics: receipt, recurrence, and expendability.<sup>402</sup>

According to Fisher, income from any instrument is the flow of services rendered by that instrument. The income of an individual is, therefore, the total flow of services yielded to him/her from his/her property.<sup>403</sup> Fisher defined income as a series of events and concluded that “for each individual only those events which come within the purview of his experience are of direct concern.”<sup>404</sup>

Fisher considered savings and deficits as the difference between money income and real income. Money income could be more than real income due to savings, and money income could be less than real income due to deficits. Fisher clarified this concept by an example. If a person receives \$100,000 as a dividend, then his/her money income is \$100,000. If he/she reinvests \$70,000, then his/her real income would only be \$30,000. If he/she did not receive any income during the year but spent \$30,000 for living expenses, his/her true income would be \$30,000 even if his/her money income that year was zero. These concepts would later become important when determining income for taxation purposes.<sup>405</sup>

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<sup>401</sup> Simons, *supra* note 399 at 52.

<sup>402</sup> Carl C. Plehn, “The Concept of Income, as Recurrent, Consumable Receipts” (1924) 14:1 American Economic Rev 1 at 5.

<sup>403</sup> Irving Fisher, *The Nature of Capital and Income* (New York: The Macmillan Company 1906) at 101.

<sup>404</sup> Irving Fisher, *The Theory of Interest as Determined by Impatience to Spend Income and Opportunity to Invest It*, (New York: The Macmillan Company, 1930) at 11.

<sup>405</sup> *Ibid* at 10.

Simons perceived a shortcoming in Fisher's definition of income. When Fisher described income in the sense of values available for consumption, income became synonymous with consumption.<sup>406</sup> This concept was a radical departure from the traditional usage at the time and naturally implied a consumption tax rather than an income tax.<sup>407</sup> It seems that Fisher was proposing a concept of income of the "disposition" type that coincided or was identical to the "consumption" criterion.<sup>408</sup>

Hicks' focus was more on consumption. He considered saving as the difference between income and consumption rather than income as the maximum amount an individual could spend during a certain period. The maximum amount an individual could consume in a given period included income for the period plus the cumulative savings.<sup>409</sup> According to Hicks, an individual wants to be better off in the future when he/she saves and worse off in the future when he/she spends more than his/her income. In this way, income serves as a guide for prudent conduct.<sup>410</sup> Hicks defined income in the following way:

It would seem that we ought to define a man's income as the maximum value which he can consume during a week and still expect to be as well off at the end of the week as he was at the beginning.<sup>411</sup>

Hicks excluded windfall gains from the calculation of income while considering interest earned on such gains as part of future income.<sup>412</sup> Hicks also emphasized the periodic nature of income. This periodicity criterion was a defining factor in categorizing a receipt as income. If a

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<sup>406</sup> *Supra* note 404 at 50.

<sup>407</sup> *Supra* note 404 at 50.

<sup>408</sup> P Wueller, *supra* note 392 at 573-74.

<sup>409</sup> John R. Hicks, *Value and Capital; An Inquiry into Some Fundamental Principles of Economic Theory*, 2<sup>ed</sup> (Oxford: Clarendon Press, 1946) at 176.

<sup>410</sup> *Ibid* at 172.

<sup>411</sup> *Supra* note 409 at 172.

<sup>412</sup> *Supra* note 409 at 179.

This is called second generation income and it is taxable in almost all tax statutes.

person is expected to receive the same amount repeatedly in the future period as he/she received in the present, the amount would be considered income. If repeat amounts were not the same, the whole amount might not have been considered income because the capital required to earn income thereon might not have been maintained.

Haig and Schanz measured income as the increase in economic power, whereas Simons measured income as the net change in wealth after consumption or expenditures. These two approaches taken together later formed the basis of the foundation of the concept of income.<sup>413</sup> The Schanz–Haig–Simons (SHS) definition of income is often considered the theoretically robust measure of income and an ideal definition of income. However, it is difficult to implement, and it is not enacted into law in any country in the world due to the practical problems of implementation. Currently, SHS is used only as a benchmark to measure tax expenditures.

From a legal perspective, there are many potential objections to the way in which economists define income. For example, including windfall gains makes the definition too broad. Also, quantifying the unrealized gains is challenging.<sup>414</sup> According to Prebble, the complexity of the modern tax system arises from trying to fit tax law around the “natural facts of economic life” and using the economic definition as an example of that poor fit.<sup>415</sup>

According to the SHS income definition, the income tax base is the total amount of consumption in a given period plus the increase in the economic wealth between a current period and the prior period. In the SHS income definition, there is no distinction between the source of

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<sup>413</sup> Holmes, *supra* note 65 at 68.

<sup>414</sup> *Supra* note 157.

<sup>415</sup> John Prebble, “Why is the Tax Law Incomprehensible?” (1994) 4 British T Rev 380.

income, and the definition also includes all unrealized gains. SHS income can be expressed algebraically as follows:

$$\text{SHS income} = \text{Consumption} + \text{Change in value of assets}$$

The SHS definition is not free of ambiguity, and in many instances, it depends on a value judgment, which makes it different under specific circumstances.<sup>416</sup> The practical problem with the SHS approach is that it is difficult to value assets in every period, and taxing unrealized gains means people may not have the cash flow available to pay their taxes, a situation untenable for most businesses. The formula also does not address the implication of inflation. Furthermore, some expenses that are necessary to earn business income are deductible, whereas some are not, even though they may be required since they are not strictly business related (e.g., personal health-related expenses of the owner). Shoup outlines other problems of the SHS concept:

Gifts, of course, pose one problem. If a pure gift from one person to another is to be counted as income to the donee, should the donor be allowed a deduction for it, in computing his or her taxable income? Schanz and Simons say, no deduction. Haig is inclined to ignore the gift if it is within the family, “on the ground of the essential economic unity of the family.”<sup>417</sup>

The SHS definition of income is based on the measurement of accrued changes in net worth. In the real world, it is impossible to find the accrued receipts and expenses without undertaking or completing the transaction.<sup>418</sup> According to Gammie et al., this measurement of profits always entails the use of discretion, and “this would make taxable income difficult to

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<sup>416</sup> Douglas A Kahn, “Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?” (1979) 78:1 Michigan L Rev 46 at 49-50.

<sup>417</sup> Carl S Shoup, “The Schanz Concept of Income and the United States Federal Income Tax” (1984) New Series, Bd. 42, H. 3 Public Finance Analysis 433 at 442.

<sup>418</sup> Malcolm Gammie et al, *Achieving a Common Consolidated Corporate Tax Base in EU* (Brussels: Centre for European Policy Studies, 2005) at 53-54 [Gammie].

assess, give scope for avoidance and manipulation and impair the equity and efficiency of the tax system.”<sup>419</sup>

A “strict application of the Haig–Simons base would make corporate income tax redundant since income earned at the corporate level would be taxed as it accrues to individuals.”<sup>420</sup> The corporate tax would merely be a withholding device for the corporate income earned by the shareholders, but not paid to them. According to this view, the benchmark corporate income would be the equity income earned by a corporation accompanied by full integration at the personal level.<sup>421</sup>

Fleming and Peroni argue that the SHS definition is based on the ability-to-pay principle because it includes both amounts consumed and amounts saved. They further say that “the SHS definition does provide a principled structure that is useful for testing the efficacy of tax provisions and opposing bad tax policy.”<sup>422</sup>

The SHS definition of income is also less able to correctly measure income during periods of inflation, thereby leading to inflationary gains being taxed.<sup>423</sup> The SHS definition is silent on structural issues, such as the rate structure, the appropriate tax-paying unit, and the appropriate accounting period. There is also no consensus about the treatment of items, such as charitable

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<sup>419</sup> *Ibid.*

<sup>420</sup> Canada, Department of Finance, “Report on Federal Tax Expenditures Concepts, Estimates and Evaluations”, Cat No F1-27E (Ottawa: 2017) at 10.

<sup>421</sup> Robin Boadway, “Policy Forum: The Annual Tax Expenditure Accounts—A Critique” (2007) 55:1 Can Tax J 106.

<sup>422</sup> J Clifton Fleming Jr. & Robert J. Peroni, “Reinvigorating Tax Expenditure Analysis and its International Dimension” (2008) 27 Va Tax Rev 399 at 458.

<sup>423</sup> US, The Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08) (2008) at 6, online:<<https://www.jct.gov/publications.html?func=startdown&id=1302>>.

donations and medical expenses, and the inclusion of imputed income from owner-occupied housing is difficult to administer.<sup>424</sup>

The SHS definition tells us little or nothing about the “proper” tax-paying entity. How can we account for the difference between the tax liability of a married man and that of a single individual with the same taxable income?<sup>425</sup> What about different tax rates for corporations and individuals, or dividends received from one corporation to another?

A strict application of the SHS would require an individual to be taxed on the imputed income he/she derives from living in his/her own home or the imputed income derived from public capital, such as roads.<sup>426</sup> Bartlett cites Norman Ture as claiming that Haig–Simons is responsible for almost everything bad in the Tax Code,<sup>427</sup> although he admits that adopting a pure SHS definition would improve the Tax Code in some ways.

According to Shaviro, support for the Haig–Simon income definition has recently declined, whereas support for consumption taxation is on the rise.<sup>428</sup> Shaviro further points out that the SHS concept of income is largely applicable to individuals, and not as meaningful when applied to other legal tax-paying entities, such as corporations and trusts.

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<sup>424</sup> *Ibid* at 19.

<sup>425</sup> Boris I. Bittker, “Accounting for Federal Tax Subsidies in the National Budget” (1969) 22: 2 Nat’l Tax J 244 at 260.

<sup>426</sup> Institute for Research on the Economics of Taxation, “The End of Tax Expenditures as we know them?” (2006) SSRN at 4.

<sup>427</sup> *Ibid* at 9.

<sup>428</sup> Daniel Shaviro, “The Optimal Relationship between Taxable Income and Financial Accounting Income: Analysis and a Proposal” (2007) NYU Center for Law, Economics and Organization [Shaviro].

### 3.3 Accounting Income Is Closer to Economic Income and the Carter Commission's Recommendations

Since the introduction of the IFRS, the accounting concept of comprehensive income has converged somewhat toward the SHS definition of income. Comprehensive income in accounting attempts to measure the increase in the economic power of a person or entity over a period.<sup>429</sup> This concept is also built upon the notion of horizontal equity:

No differentiation is made between the nature and the source of a person's income. The model does not confine itself to consumption expenditure. Every person's accretion to wealth in any period falls within the tax base. A person cannot artificially dilute his tax base because wealth accretion arises in a particular way or because the accretion is applied in a particular way. Similarly, the economic neutrality objective is also achieved under the foundation concept by ensuring that no one form of income or expenditure is favored over another.<sup>430</sup>

The enactment of mark-to-market is an example that the SHS concept of income is still relevant and that accountants' measurements of comprehensive income can also play a role in defining taxable income.

In accounting, income is recognized when it is earned. Advance payments received are not considered revenue; they are considered prepayments and treated as a liability. Costs or expenses are also recognized when incurred, and advance payment of expenses is treated as an accrued asset (or receivable) on the balance sheet. Given this accrual nature of accounting, cash received less cash paid cannot reflect the income for most complex businesses (other than perhaps a simple lemonade stand). This accrual principle permit makes it possible to match costs to revenues, thereby allowing a more accurate picture of income that can be extrapolated to future periods. According to Macdonald:

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<sup>429</sup> Holmes, *supra* note 65.

<sup>430</sup> Holmes, *supra* note 65 at 83.

Accounting, like most aspects of human endeavor, has evolved over time. This has meant that what accountants do in representing and measuring economic transactions (*accounting practice*) has changed, either generally or with regard to specific transactions. Our understanding and explanation of what they do (formulated as *principles*) have also developed.<sup>431</sup>

Two questions need to be addressed before income can be recognized for accounting purposes. The first relates to whether an item should be recognized as income and the second to when such income should be recognized. For example, advance payments received now for future services can be considered income, but only recognized when the underlying services are rendered in a future period. Recognition of income is complex. For manufacturing organizations, revenue recognition points can occur at various stages of the manufacturing process. In the following example, Magill differentiates between cash income and accrual method on income:

Suppose the taxpayer has (1) obtained a contract for ten machines at \$2,500 each; (2) he acquires the raw materials; (3) he completes the manufacture; (4) he ships the machine; (5) he sends out the bill, net cash thirty days; (6) he receives a check for \$25,000; (7) he deposits the check in his bank. Under cash receipts methods of accounting, the income must be reported at the sixth stage in the operations; under an accrual method, the time of report can be pushed back to the fifth stage, and conceivably earlier.<sup>432</sup>

Accounting statements are usually based on a 1-year time period, although quarterly financial statements are also commonly reported by publicly traded corporations. Income and expenses are also measured for the same consistent time period. According to Magill, complex business operations can make it extremely difficult to appropriately allocate the revenue and

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<sup>431</sup> Macdonald, *supra* note 31 at 11 [emphasis original].

<sup>432</sup> Magill, *supra* note 212 at 195.



expenses in any single period, because each year's business depends on the operations of earlier years and leads to the future years.<sup>433</sup>

The accounting measure of income is based on various principles, such as conservatism. Conservatism requires organizations and individuals to recognize revenues when they are realized and verifiable.<sup>434</sup> One of the main objections to the use of accounting income as a tax base is conservatism. It is said that due to conservatism, principle revenues are recognized later and expenses earlier. In this way, this practice results in fewer tax revenues for the government.

On the other hand, conservatism is one of the most influential principles of accounting and can mitigate management's opportunistic behaviour in reporting accounting numbers.<sup>435</sup> Watts observes that the practice of conservatism has increased during the last 30 years, and this is due to the benefit mentioned above.<sup>436</sup>

An accountant's definition of income is different from other disciplines because it is based on business principles, such as going concern, objectivity, revenue recognition, and stable money unit, all of which have accounting-specific definitions.<sup>437</sup> Alexander et al. claim that while accountants provide a basic formulation for income determination, the legal profession and institutions, such as the judiciary, tax authorities, and regulatory and supervisory agencies, participate or ought to participate in the development of rules dealing with income

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<sup>433</sup> Magill, *supra* note 212 at 193.

<sup>434</sup> Ross L Watts, "Conservatism in Accounting Part 1: Explanations and Implications" (2003) 7:3 Accounting Horizons at 207.

<sup>435</sup> *Ibid* at 208-209.

<sup>436</sup> *Supra* note 434 at 208-209.

<sup>437</sup> Michell, *supra* note 383.

measurement.<sup>438</sup> This is because accounting income tends to be the starting point of taxable income.

Alexander et al. explain the variation between accounting and legal income as follows:

It should not be surprising that rules emanating from so many different authorities should be at variance with one another since each has used the income for purposes of its own and has adjusted its concept of income in accord with that purpose. All concerned, however, have looked to the accountant for the basic formulation of the rules for income determination.

The accountant in his turn has tried to eliminate the element of subjective judgment from the determination of income. He has tried to establish as nearly as possible hard and fast rules of calculation in order to eliminate the guesswork and to ensure precise measurements.<sup>439</sup>

According to Haig, accounting conventions started developing during the period before such reports were used for tax purposes.<sup>440</sup> MacNeal's history of accounting helps us understand the progress of income recognition during the nineteenth century and the arrival of the concept of conservatism in accounting.<sup>441</sup> According to MacNeal, conservatism was required when the mercantile culture started. Lenders needed conservative values of assets offered as collateral. Later on, in the twentieth century, as businesses took the form of public limited companies, accounting conventions based on conservatism remained.<sup>442</sup> As accounting moves toward the IFRS and its fair market value models, the traditional model of conservatism is phasing out.

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<sup>438</sup> Sidney S Alexander, revised by David Solomons, "Income Measurement in a Dynamic Economy" *Studies in Accounting* in William T Baxter & Sidney Davidson, eds, *Studies in Accounting* (London: ICAEW, 1977).

<sup>439</sup> *Ibid* at 39.

<sup>440</sup> Haig, *supra* note 394 at 18.

<sup>441</sup> Paraphrased from Kenneth MacNeal, "What's wrong with accounting? *Studies in Accounting*" *supra* note 438 at 168.

<sup>442</sup> *Ibid* at 178.

The use of accounting principles, such as the matching principle for taxable income, can reduce the variation in tax revenues. Goncharov and Jacob conducted a study of 26 Organization for Economic Co-operation and Development (OECD) countries and found that corporate tax revenues were less volatile in countries that used accrual or the matching principle for tax purposes.<sup>443</sup> They also found that countries allowing accrual accounting collect relatively higher tax revenues during periods of economic growth and relatively lower revenues during times of economic downturn.

Hanlon and Maydew reached the same conclusion. They estimated that, on average, using accrual accounting instead of a cash basis for calculating taxable income reduces the volatility of taxable income, thereby making estimates of tax revenues much smoother and more predictable.<sup>444</sup>

Vickrey recommends accrual income as a sound income tax base since it approximates the SHS definition of income.<sup>445</sup> However, it has not been fully adopted by any tax authority because of the practical problems in measuring net worth. Instead, realized income has become a workable approximation of accrued income.<sup>446</sup>

Some scholars admit that the concept of accrued income is best for taxation but also admit that it cannot be used as a tax base due to practical difficulties,<sup>447</sup> whereas many scholars

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<sup>443</sup> Igor Goncharov & Martin Jacob, "Accrual Accounting and Tax Revenues" (2012) Otto Beisheim School of Management, Germany.

<sup>444</sup> Hanlon & Maydew, *supra* note 278.

<sup>445</sup> Vickrey, *supra* note 188 at 9.

<sup>446</sup> Vickrey, *supra* note 188 at 102.

<sup>447</sup> For example, Vickrey says "The only definition that is completely consistent and free from anomalies and capricious results is 'accrued income,' which is the amount of spending" Vickrey, *supra* note 188 at 9.

consider accrual or matching principle as an accounting concept and do not see its place in determining taxable income.<sup>448</sup>

Accounting rules are arguably based on the reporting entity's experience and not only on logic. GAAP rules are developed through the evolving practice as determined by the practicing members of the profession.<sup>449</sup> McCullers and Schroeder emphasize the importance of actual widespread public accounting practice in the field as the basis of GAAP.<sup>450</sup>

While GAAP may be considered part of ordinary commercial principles, not all ordinary commercial principles are part of GAAP. These reporting principles are designed to offer a fair, conservative, and unbiased perspective of the performance of a business reported consistently. These "principles" are based not on theory, but on the experience of the practicing members. "[T]he rules of accounting, even more than those of the law, are the product of experience rather than of logic."<sup>451</sup> This objection is not valid anymore because the new accounting standards are developed after a long and extensive process of due diligence and research that sometimes takes many years.

GAAP evolves to satisfy the requirements of a diverse group of users. It intentionally retains some flexibility to accommodate complex business transactions. This flexibility makes it difficult to use for taxation purposes.<sup>452</sup> It is difficult to justify using accounting income as the tax base due to its conventions, such as the going concern principle, but Schön suggests that

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<sup>448</sup> For example, see J Frankovic. Frankovic, *supra* note 224, acknowledged that the concept of accrual is an accounting concept. According to Francovic, the concept of accounting accrual is not justified for the tax system because legal accrual often differs from accounting accrual. Deborah A. Geier (Geier, *supra* note 5) voiced the opinion that accrual has no place in taxation.

<sup>449</sup> Geier, *supra* note 5 at 37.

<sup>450</sup> Geier, *supra* note 5.

<sup>451</sup> Geier, *supra* note 5 at 37.

<sup>452</sup> Porcano & Tran, *supra* note 203 at 445.

accounting income can serve as a good starting point for defining taxable income.<sup>453</sup> A practical motive for using accounting income as a starting point is that there may be no other alternative.<sup>454</sup>

What constitutes legal income? The legal definition of income (which constitutes the base for taxation) is the product of statutory provisions enacted by Parliament and legal provisions developed by the courts. To serve the role as a tax base, the taxpayers and tax authorities need a clear, comprehensive, and consistent definition of income since uncertainty can erode a tax system's reliability and, thereby, the taxpayers' underlying confidence.

Income tax by definition is a tax on income; therefore, we need to have a proper definition of income for tax purposes. The legal concept of taxable income that serves as a base for tax calculation is developed based on provisions in statutes and on judicial decisions.<sup>455</sup> The legal concept of income rests on the rules and regulations given in the Act, with further explanations or clarification provided by the courts. As a result, taxable income is created by the legislature and judiciary. Due to the active involvement of the judiciary in the definition of taxable income, the legal concept of income has evolved through the courts.<sup>456</sup>

There are two types of tax systems: schedular and global. Under a global system, all income is aggregated and taxed regardless of the source. Under a schedular system, income is classified by the source, and taxable items are treated differently depending on the nature of the

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<sup>453</sup> Schön, *supra* note 148.

<sup>454</sup> *Supra* note 74.

<sup>455</sup> The *Income Tax Act* discusses various items that should be included or excluded from income and the method of calculating income.

<sup>456</sup> Krishna, *supra* note 168 at 82.

source. Different rules determine the income under each schedule, and different tax rates apply. Losses from one schedule may not be used to offset profits or gains from another schedule.

OECD countries are moving away from the schedular system of taxation toward the global system, although no country is at the endpoint of the continuum with a purely global system or purely schedular system.<sup>457</sup> The main reason for moving away from a schedular income tax system is to reduce taxpayers' incentives to shift reported income from higher-taxed schedules to reported income in lower-taxed schedules. The scheduler system is also relatively more complex and takes up more administrative resources. Also, arguably, it makes progressive taxation harder to implement because the tax is imposed separately on the income of each schedule rather than on aggregate income while restricting the taxpayer's ability to use losses from one schedule to offset gains in another.<sup>458</sup>

Most tax systems – including Canada's – are a blend of the scheduler and global systems. According to Thuronyi, many common law countries have now moved to a global system of income definition where rules for deductions are stated in general terms that can apply to all types of income. However, "judicial concepts of income may hearken back to the old schedules."<sup>459</sup>

The Canadian tax system is based on the classification of income by source, and income does not include any unrealized gains or losses. The realization requirement is a compromise

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<sup>457</sup> Holmes, *supra* note 65 at 29.

<sup>458</sup> Ault & Arnold, *supra* note 172 at 197.

<sup>459</sup> Victor Thuronyi, ed, "Tax Law Design and Drafting" (1998), Volume 2 IMF at xxviii [footnotes omitted].

between the theoretical purity of the economic concept of income and the administrative feasibility of applying the theory in practice.<sup>460</sup>

According to the Meade Report,<sup>461</sup> a good definition of taxable income is a measure of the taxpayer's income in a given year that could be consumed without depleting capital wealth during the year. This measure includes all the capital gains and losses during the period, plus windfall receipts along with wages, dividends, rents, and profits. This definition includes all receipts during the year and is very close to the Schanz–Haig–Simon (SHS)<sup>462</sup> definition of income.

According to Haig, taxable income should be approximately equal to the income defined by an economist and accountant.<sup>463</sup> Haig asserts that it is the government's responsibility to justify the inclusion of an item in the definition of taxable income and clarify when such income shall be taxed. Haig specifies the following characteristic of a sound definition of income:

The definition must be broad enough to iron out all the theoretical difficulties and solve all of the inequities and anomalies. The situation should be held in a mobile, flexible state which will permit the statutory definition of income to become progressively more precise and accurate with the improvement of the technique of our economic environment.<sup>464</sup>

The British Royal Commission's definition of income for tax purposes was the difference between receipts and expenses necessary to earn these receipts.<sup>465</sup> According to the commission:

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<sup>460</sup> Krishna, *supra* note 168.

<sup>461</sup> J E Meade, 'chair' *Structure and Reform of Direct Taxation* (London: The Institute for Fiscal Studies, 1978).

<sup>462</sup> The Schanz, Haig and Simon (SHS) definition of income is considered a superior measure of income for almost any taxpayer.

<sup>463</sup> Haig, *supra* note 394 at 16.

<sup>464</sup> Haig, *supra* note 394 at 27-28.

<sup>465</sup> Lawrence H Seltzer, "Evolution of the special legal status of capital gains under the income tax" (1950) 3:1 Nat'l Tax J 18 at 21.

For Income Tax purposes, speaking in general terms, income is the surplus of receipts over the current expenditure necessary to earn those receipts, regardless of the appropriation of any part of the receipts or surplus for the purpose of writing off or amortizing the capital value of any assets that waste in the process of producing the income. The only wasting assets for which an Income Tax allowance is now made are plant and machinery, and certain buildings that contain [the] plant and machinery.<sup>466</sup>

The Royal Commission on Taxation in Canada (known as the Carter Commission) also provided a workable definition of income that could be used as a tax base. According to this report:

The use of the word “profit” in the general definition of income from a business necessarily means that only net income is to be taxed, that is, gross revenue less the costs incurred in producing it. Such costs are, broadly speaking, of two kinds: those incurred in the day-to-day operation of the business, and an appropriate proportion of those costs incurred for the production (or preservation) of future revenue.<sup>467</sup>

The meaning of legal income is limited by two cardinal principles, with one or both invoked in court cases.<sup>468</sup> The first principle states that the income should include only those amounts arising or resulting from the pursuit of gain.<sup>469</sup> The other principle is that income should be determined according to the ordinary commercial principles, and taxable income means net income, that is, income minus all the necessary expenses.<sup>470</sup>

Some scholars believe that the legal definition of income is narrower than the economic definition due to the court’s involvement in defining taxable income. For example, when the US Supreme Court ruled in *Eisner v Macomber* that a stock dividend was not taxable income, Haig

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<sup>466</sup> *Ibid* at 21.

<sup>467</sup> Canada, *Report of The Royal Commission on Taxation* (Ottawa: Queen’s Printer, 1966) vol 4 at 216 [Royal Commission].

<sup>468</sup> F E LaBrie, *The meaning of income in the law of income tax* (Toronto: University of Toronto Press, 1953)

<sup>469</sup> *Ibid* at 21.

<sup>470</sup> *Supra* note 468 at 24.



commented that such a decision narrows the definition of income and will “bring about results which from the economic point of view is certainly eccentric and in certain cases little less than absurd.”<sup>471</sup>

Canadian courts subsequently expanded the definition of taxable income by incorporating some accounting principles for revenue recognition. For example, in the case of *Maritime Telegraph*, the court held that unbilled but earned revenues are part of income.<sup>472</sup> The same decision was reached in the *West Kootenay* case.<sup>473</sup> In the case of *Ken Steeves Sales*, it was decided that receivables would be included in the calculation of taxable income.<sup>474</sup>

Neither accounting nor legal paradigms offer a precise, narrow definition of income. At best, the *ITA* only tells us what can be included and excluded to calculate taxpayers’ income/profit. The legal definition of income contains inclusions and exclusions of several items. These items may or may not be part of accounting and economic income, and they contribute to differences between legal, accounting, and economic definitions of income. These differences have been diverging because “when the difficulties of using uniform rules for tax and other accounting system[s] became apparent, tax authorities developed tax-specific accounting rules to accomplish the income tax’s goals.”<sup>475</sup> According to Simons:

Tax laws do not really define income but merely set up rules as to what must be included and what may be deducted; and such rules by no means

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<sup>471</sup> Robert M Haig, *The Concept of Income—Economic and Legal Aspects* (New York: Columbia University Press, 1921).

<sup>472</sup> *Supra* note 55.

<sup>473</sup> *Supra* note 56.

<sup>474</sup> *Ken Steeves Sales Limited v Minister of National Revenue*, (1955), 55 DTC 1044(Ex Ct).

<sup>475</sup> *Supra* note 84 at 118.

define income because they are neither exhaustive nor logically coherent.<sup>476</sup>

Due to the absence of a precise definition of income in the Act, the courts developed their tests and frameworks to decide whether or not a receipt was income. The courts established that receipts had to have certain properties, such as inflow, convertibility into cash, periodicity or recurrence, realization, separation from source, and profit-making intentions, to be considered income. This work was done on a more *ad hoc* basis as the early cases came before the courts.<sup>477</sup>

From a Canadian historical perspective, the first definition of income was given in the *Income War Tax Act* 1917 section 3(1). This Act considered income as a net profit for the business, and profit should be measured annually. A detailed definition described what income included (wages, salary, business income, interest, dividend, and annual profit from any other source).<sup>478</sup> This definition excluded gifts, bequests, proceeds from an insurance policy, and capital expenditures, including depreciable property.

According to LaBrie, none of the inclusions and exclusions in section 3 actually defined income.<sup>479</sup> The definition of income was vague because it used the word “mean” instead of “includes.” “[I]t is arguable that the use of this word [means] excludes all meanings not falling within the definition.”<sup>480</sup> In contrast, the current *Income Tax Act* defines a taxpayer’s income for a taxation year as a total of all amounts from a source inside or outside Canada, including office, employment, business and property, and taxable capital gains.<sup>481</sup> According to Holmes, “the

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<sup>476</sup> Simons, *supra* note 399 at 105.

<sup>477</sup> Holmes, *supra* note 65 at 320.

<sup>478</sup> R. Easton Burns, “The Income War Tax Act 1917 A Digest” *The Canadian Chartered Accountant*.

<sup>479</sup> Francis E LaBrie, *The Principle of Canadian Income Taxation* (Toronto: CCH Canadian Limited, 1965) at 25.

<sup>480</sup> *Supra* note 242 at 155.

<sup>481</sup> *ITA*, *supra* note 86 at section 3.

judicial notion of income is not as well conceptualized, and therefore, not as theoretically robust, as the economic and accounting approaches.”<sup>482</sup>

In the legal definitions of income, the periodicity criterion remains relevant. Haig traces how the periodicity criterion entered into the legal definition of income with traces from the early fifteenth-century agricultural society:

The British income tax places very heavy stress upon the annual character of income. For an explanation of this conception, which results in the exclusion from taxable income of gains of an irregular nature, one must go back as far as the fifteen century, when, with an agricultural society where few fortuitous gains developed, the idea of receipts as being annual in character became deeply impressed upon the minds of the people. It became the habit to think of one’s regular receipts as his income, and to consider irregular receipts as additions to capital.<sup>483</sup>

Some scholars question the relevancy of the periodicity criterion when defining income. For example, Schanz did not consider the periodicity criterion relevant to the income calculation. Instead, he said that “the periodicity criterion leads to absurd conclusion.”<sup>484</sup>

The legal concept of income is a concept that excludes many real economic gains.<sup>485</sup> According to Holmes, the legal interpretation of income is based on a basic condition of the ability to pay or taxable capacity. He is critical of the legal interpretation of income and says:

The judicial interpretation of income has failed the tests of horizontal equity (some gains are simply left out of the tax base), vertical equity (excluded capital gains are allegedly largely derived by the ex-ante wealthy members of a society), neutrality (resources are diverted to producing non-taxable gains), and inefficiencies (dead-weight costs to

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<sup>482</sup> Holmes, *supra* note 65 at 320.

<sup>483</sup> Haig, *supra* note 394 at 19.

<sup>484</sup> Wueller, *supra* note 386 at 105.

<sup>485</sup> Holmes, *supra* note 65.

the economy arise from the socially unproductive activity of converting what would otherwise be taxable income into non-taxable gains).<sup>486</sup>

Although he is explicitly referring to the US tax system, legal income in all Anglo-Saxon countries, including Canada, faces similar issues.

According to Alexander et al., the main difference between an economist's and accountant's definition of income is the timing of recognition of gains and losses. Economists tend to book the gains before realization, but accountants consider gains or losses only once the gains and losses are realized. Over the long aggregate run, both measures produce the same aggregate income. However, there are considerable differences in the short term and over different periods.<sup>487</sup>

Courts and legal practitioners reject accounting income because accounting principles have inherent flexibility, and accountants have the freedom to pick appropriate standards to calculate income from a menu of choices. However, such standards are also designed to reduce the role of human judgment.<sup>488</sup> Alexander says that the users of accounting information make subjective adjustments to compensate for the conservatism in the accounting measure.<sup>489</sup>

It may be wishful thinking to come up with a single definition of income that is acceptable to all disciplines. However, can attempts be made at converging the definitions to determine a taxable base? According to Hicks:

[M]ost economic controversies about definition arise from a failure to keep in mind the relation of every definition to the purpose for which it is to be used. We have to be prepared to use different definitions for

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<sup>486</sup> Holmes, *supra* note 65 at 242-43.

<sup>487</sup> *Supra* note 438 at 57.

<sup>488</sup> *Supra* note 438 at 36.

<sup>489</sup> *Supra* note 438 at 36.

different purposes; and although we can often save ourselves trouble by adopting compromises, which will do well enough for more than one purpose, we must always remember that compromises have the defects of compromises, and in fine analysis they will need qualification.<sup>490</sup>

Gammie et al. argue that the income tax base should be as close to accounting profit as possible.<sup>491</sup> There is a deeply rooted interdependence between tax and financial accounting since both systems try to capture the same economic reality.

The SHS income is closely related to the IFRS concept of comprehensive income in accounting. Holmes defines comprehensive income as the increase in a person's economic power over a period. This definition is very close to SHS income and may be used as a starting point for the tax base since it fits with the core tenets of taxation, such as horizontal equity and neutrality.<sup>492</sup> According to Holmes, the legal concept of income is not based on any coherent tax policy principles and therefore not suitable as a basis on which to achieve tax policy objectives.

He says:

The legal interpretation of income needs to be broadened out toward the economists' and accountants' comprehensive concepts of income to better reflect personal attributes described by optimal tax theorists, and to achieve horizontal equity.<sup>493</sup>

The Carter Commission report highlighted that the tax rules of the day were deficient in the areas of revenue recognition, deductions, and the timing of revenues and deductions recognition.<sup>494</sup> It is worth noting that the Carter Commission endorsed the use of an economic

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<sup>490</sup> Cited by Macdonald, *supra* note 31 at 3.

<sup>491</sup> Gammie, *supra* note 418 at 19.

<sup>492</sup> Holmes, *supra* note 65 at 83.

<sup>493</sup> Holmes, *supra* note 65 at 244-45.

<sup>494</sup> *Royal Commission*, *supra* note 467 at 219.

approach to calculating taxable income. The commission believed that “a buck is a buck is a buck,” and all income should be treated equally, irrespective of the source or type:

We are completely persuaded that taxes should be allocated according to the changes in the economic power of individuals and families. If a man obtains increased command over goods and services for his personal satisfaction, we do not believe it matters, from the point of view of taxation, whether he earned it through working, made it through operating a business, received it because he held property, made it by selling property, or was given it by a relative. Nor do we believe it matters whether the increase in economic power was expected or unexpected, whether it was a unique or recurrent event, whether the man suffered to get the increase in economic power, or it fell in his lap without effort.<sup>495</sup>

The income proposed by the commission is very close to SHS standards. Although the SHS definition of income is considered by many as the preferred measure of income, it is widely acknowledged to be difficult to implement and, therefore, has not been enacted into law in any country.<sup>496</sup>

Accounting standards and well-accepted business practices also play an essential role in the formation of the legal definition of income. According to Macdonald, the courts did not initially pay much attention to accounting standards. After 1970, when the accounting profession became more organized and independent, and Accounting Standards Boards were established, courts in all jurisdictions began giving accounting standards due consideration in assessing taxable income.<sup>497</sup>

Does accounting income come close to the SHS income base? This is a relevant and practical question since accounting income is usually the starting point for taxable income in

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<sup>495</sup> *Royal Commission*, *supra* note 467 at 9.

<sup>496</sup> Holmes, *supra* note 65 at 78; also see Hogg et al, *supra* note 182 at 81.

<sup>497</sup> Macdonald, *supra* note 31.

most jurisdictions. Accounting income can approximate economic income even more after making certain adjustments.

To arrive at a usable definition, Holmes has developed an income pyramid. According to him, the broadest definition of income is that of an economist, in which income is considered as an increase in spending power over a particular period, including unrealized value changes. At the next level of the pyramid, accounting income narrows this definition by excluding unrealized gains. The concept of net worth for accountants and economists is different from the legal concept since the latter includes only realized gains, restricts income as emanating from a source, and restricts income to a profit-generating purpose.<sup>498</sup>

According to the IFRS conceptual framework, “profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income.”<sup>499</sup> However, the notion of matching principle deviates accounting income from the SHS definition of income.

Alm believes that there is no personal income tax based on the HS standard and that “the HS standard is effectively “dead” in terms of its actual real-world relevance to income tax design or reform.”<sup>500</sup> However, he admits that there is still a room for these standards:

The Haig-Simons standard is obviously not really dead, and economists—and politicians—will no doubt continue to invoke it, for good and bad reasons. However, I believe that the H-S standard has been modified so extensively in practice that virtually any departure can now be justified.<sup>501</sup>

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<sup>498</sup> Holmes, *supra* note 65.

<sup>499</sup> CPA, *supra* note 67 at the conceptual framework for financial reporting 4:60.

<sup>500</sup> James Alm, “Is the Haig-Simons Standard Dead? The Uneasy Case for a Comprehensive Income Tax” (2018), Tulane Economics Working Paper Series, Working Paper # 1806 at 13.

<sup>501</sup> *Ibid* at 21.

He further says any tax policy should be situation specific and may start with the HS standard. “There is no one-size-fits-all income tax standard.”<sup>502</sup> Accounting is already closer to SHS standards since the adoption of comprehensive income. One possible path is to try to converge accounting and taxable income while taking the fundamental goals of taxation and accounting in consideration. This can only be done by incorporating a few selective accounting rules in the *Income Tax Act*.

### **3.4 Proposed Ways of Narrowing the Gap**

A strong alignment between tax rules and accounting rules will create a small book–tax gap, whereas a weak alignment will create a large gap. In a study conducted by the OECD Working Group on Accounting Standards, three main types of relationships between financial accounting rules and tax rules were identified in OECD member states. First, there are countries (e.g., Norway) where accounting practices are dictated largely by tax rules. Then there are countries (e.g., Canada, the US, and the UK) where accounting rules and tax rules are largely independent of each other. Finally, there are countries in which accounting rules largely determine the taxable base (e.g., France and Germany).<sup>503</sup> There are various ways recommended in the literature to reduce the book–tax income gap. In the following section, I will discuss the pros and cons of these methods.

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<sup>502</sup> *Supra* note 500 at 24.

<sup>503</sup> Porcano & Tran, *supra* note 203 at 9.



### 3.4.1 Complete Alignment

One of the popular solutions for the book–tax income gap is to require taxable income to conform to accounting income. While conformity in theory could include book income being aligned with taxable income, not many people are in favour of this idea because accounting standards are developed by independent bodies through a rigorous mechanism. Compared with tax laws, they are, arguably, free from political pressure. If financial statements were based on tax law, the information content of these statements for investors and creditors would likely be lost. It is generally argued that due to its rigid nature and very specific purpose, income for tax purposes cannot be used for financial statement purposes. For example, Ali and Hwang say that tax rules are not made for capital market participants; therefore, the value relevance of financial statements in countries with more book–tax conformity is compromised.<sup>504</sup>

Those who favour complete alignment say that the gap between book income and tax income creates “opportunities and incentives” for corporations to avoid taxation and engage in accounting fraud.<sup>505</sup> Some scholars believe that only complete book–tax income conformity can remove the opportunities and incentives to manipulate the financial statement and/or taxes payable.<sup>506</sup> This solution is most cost effective and efficient in resolving the issue because entities are not required to waste their resources on attempting to have their cake (reporting high book income) and eat it too (reporting low taxable incomes).

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<sup>504</sup> Ashiq Ali & Lee-Seok Hwang, “Country-Specific Factors Related to Financial Reporting and the Value Relevance of Accounting Data” (2000) 38 *J of Accounting Research*, 1–23.

<sup>505</sup> Whitaker, *supra* note 70.

<sup>506</sup> Whitaker, *supra* note 70; Murray, *supra* note 271; and Desai, *supra* note 309.

Some scholars believe that the adoption of IFRS is a good starting point toward this move. For example, Spengel thinks that there is no fundamental conflict between the IAS and goals of taxation, seeing how the IAS can easily become a tax base:

If IAS serves as a starting point for tax accounting their adoption has to be restricted to those standards that are in accordance with the objectives of tax accounting. Altogether, tax accounting would have to be linked more closely to the company's cash flows which would de facto result (as the case is up to now) in the autonomy of tax accounting.<sup>507</sup>

On the other hand, most scholars believe that if book income is used as the tax base, it would effectively make the accounting organizations (such as IASB and Financial Accounting Standards Board (FASB)) responsible for writing the tax laws for those entities that would be subject to book–tax conformity. Although the government would still determine the tax rate, the tax base would be determined by the principles set by accounting boards.<sup>508</sup> Hanlon et al. also raised the question of whether the US Congress would be able to resist the temptation to interfere with the US standard setter's (FASB) new role. Eventually, Parliament and Congress would start tinkering or interfering with GAAP for the same fiscal and social policy reasons. The result could be a GAAP that looks much like the current Tax Code, and Congress would end up playing some role in the working of FASB.<sup>509</sup> This scenario is not acceptable for many people in situations where the government controls the accounting standards.

Bradley et al. analyzed data from an international panel of firms across 34 countries from 1996–2007 and concluded that higher levels of book–tax conformity will not necessarily lead to

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<sup>507</sup> Christoph Spengel, “International Accounting Standards, Tax Accounting and Effective Levels of Company Tax Burdens in the European Union” (2003) July/August *European Taxation* at 266.

<sup>508</sup>Michelle Hanlon & Terry Shevlin, “Book-tax conformity for corporate income: An introduction to the issues” (2005) 19 *Tax Policy and the Economy* 101 at 10-11 [Hanlon & Shevlin].

<sup>509</sup> *Ibid.*

less earnings management.<sup>510</sup> They found that higher levels of book–tax conformity are associated with higher overall levels of earnings management across the board.

### 3.4.1.1 Should Taxable Income Conform to Book Income?

Some scholars argue that taxation should follow accounting’s lead. This alignment will solve the timing issues because income and expenses will be recognized by accounting and taxation in the same fiscal period. Scholars such as Heltzer believe that the conformity of book income and taxable income means that taxable income will become the dominant income figure because Congress is unlikely to give its control over its revenue source.<sup>511</sup>

Due to the simplicity of the concept of conformity, many taxpayers like this approach. In a survey of hundreds of US tax executives conducted a decade ago, a “significant number” of respondents endorsed book–tax conformity along book–income lines.<sup>512</sup>

In most cases, accounting income is greater than taxable income. If accounting income becomes the tax base, it could increase the government’s tax revenues. During his testimony before the House Ways and Means Committee in the US, Professor Desai favoured complete alignment of book–tax income and claimed that this move would help to reduce the corporate tax. He further argued that this move would eliminate taxpayers’ exploitation of the system.<sup>513</sup>

After the Enron and WorldCom scandals, many scholars expressed the opinion that the increase of the book–tax income gap was responsible for these debacles and that both incomes

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<sup>510</sup> *Supra* note 274.

<sup>511</sup> Heltzer, *supra* note 337.

<sup>512</sup> Whitaker, *supra* note 70 at 724.

<sup>513</sup> US, *Hearing on Corporate Tax Reform, Hearing Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means*, 109th Cong (2007) (Professor Mihir A. Desai).

should conform to each other. In a *Wall Street Journal* article, Murray offered an assessment favouring a narrow book–tax income gap. In the same newspaper, Drucker wrote that he favoured more disclosure to eliminate this gap.<sup>514</sup>

Accounting income is a sound measure of a corporation’s profitability and could serve as the basis of taxation.<sup>515</sup> Accounting income undergoes many internal and external checks and balances, such as a review of internal control systems, internal auditors, and external auditors (a requirement for public corporations). Using accounting income as a tax base could therefore improve accuracy due to multiple checks on the income calculation. As Krumwiede and Witner write:

The income statement/tax return of all public companies undergoes an external review during the annual audit. Public companies have an internal audit department whose primary function is to ensure there are adequate internal controls. With such controls, there is less likelihood of fraud, misallocation of resources, and erroneous accounting treatment.<sup>516</sup>

One issue with the taxation system is that it is very complicated.<sup>517</sup> The possible solution to this problem of complexity is the book–tax income alignment. This move can make the system easier to understand. According to Hanlon et al., linking book–tax income would result in fewer aggressive tax shelters and less income-increasing financial accounting management because firms would have to pay higher taxes when they report higher income.<sup>518</sup>

Simplicity and convenience are two desirable characteristics of any tax system. With the changing nature of the business environment, tax systems in all jurisdictions are becoming

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<sup>514</sup> Jesse Drucker, “Minding the Gap: IRS looks closer at profit disparity” *The Wall Street Journal*, (27 November 2006).

<sup>515</sup> *Supra* note 393.

<sup>516</sup> Tim Krumwiede & Larry Witner, “The Feasibility of a GAAP-Based Income Tax System” *The Tax Magazine* (January 2009) 37 at 43.

<sup>517</sup> Ian Luder, “Tax Legislation—the Creaking edifice” *Accountancy* (10 November 1994) 80.

<sup>518</sup> Hanlon et al, *supra* note 153.

increasingly complex. Convenience and simplicity could be significant advantages of book–tax income alignment. It would be convenient for the companies to calculate only one type of income and easier for investors and other stakeholders to understand the financial and tax liabilities of a company if taxable income were the same as accounting income.

There would be no deferred tax accounts on the financial statements and only one reconciling item, i.e., tax credits. This single reconciling item between book income and tax income would make financial statements easy for users to understand.

If book income were used as a base for taxable income, it would decrease the role of tax legislation. There would be no need to have new tax rules because all the rules would be made by the accounting bodies. According to McClellan and Mills, the legislative process could be limited to setting the tax rate and tax credits. Tax conflicts would be decided in the courts based on accounting rules.<sup>519</sup>

The corporate tax rate could be reduced substantially if book–tax income were aligned, since accounting income for most companies is generally higher than taxable income. If we were to make accounting income our tax base for taxation purposes, we could reduce the tax rate without incurring a corresponding decrease in revenues. By eliminating various tax incentives, the government could afford to reduce the tax rate.<sup>520</sup>

An in-depth study by Wertz in 1998 confirmed that if taxes are charged on the accounting income, it will not hurt tax revenues.<sup>521</sup> According to Desai, if corporations paid taxes on

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<sup>519</sup> John McClellan & Lillian Mills, “Weighing Benefits and Risks of Taxing Book Income” (2007) Tax Notes 779 [McClellan & Mills].

<sup>520</sup> *Supra* note 516 at 37.

<sup>521</sup> McClellan & Mills, *supra* note 519.

reported GAAP income, the top marginal corporate tax rate could be reduced by 15% without a loss of revenue.<sup>522</sup>

According to McClelland and Mills,<sup>523</sup> society has made a substantial social investment in measuring reliable corporate income in the form of GAAP. The government needs to build on this investment and use the existing GAAP infrastructure to measure business income.

If managers try to increase the book income by manipulation, the result will be higher taxes paid to the government. Due to the tax consequences, managers tend not to manipulate a company's profit. The same tax consequences make it unappealing for companies to exaggerate book profit.

Changing tax law is a long process. A bill has to follow a certain protocol to be approved by Parliament. Aligning book-tax income would ease this process as changes would be controlled by accounting bodies without any need for parliamentary involvement. It would be less time consuming to make changes through accounting bodies. In Australia, Zilva explains:

It is suggested that an alignment of tax laws and financial accounting rules would more easily facilitate changes to the tax law to introduce new policy initiatives. For example, in order to currently change taxation law, parliamentary or court intervention is required. However, accounting standards are controlled by the Australian Accounting Research Foundation ('AARF'). Despite the rigorous procedures set by AARF, no parliamentary or court intervention is required to change the accounting standards.<sup>524</sup>

In many countries, the tax system is used to achieve social and economic objectives and as a policy tool by governments, for example, higher taxes on tobacco or increasing the rate of the

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<sup>522</sup> *Ibid.*

<sup>523</sup> McClelland & Mills, *supra* note 519 at 782.

<sup>524</sup> Aldrin De Zilva, "The Alignment of Tax and Financial Reporting Rules: The Case for a new Set of Common Rules" (2005) 66 J of the Australasian Tax Teachers Assoc at 5.

CCA. Every incoming government uses the tax system to implement its own economic agenda in the form of incentives and special deductions to stimulate investments in a particular area.

### 3.4.1.2 Why Should Taxable Income Not Conform to Accounting Income?

There is an equally strong case against aligning book–tax income. Financial statements provide more information about the past and report the cumulative effects of many accounting decisions with the aim of enabling users (investors and creditors) to extrapolate income into and make investing or lending decisions about the future. In contrast, tax returns primarily provide information for the current year.<sup>525</sup> It may therefore not be desirable to align the two incomes.

Although both accounting and tax rules allow managerial discretion, researchers have found that accounting rules offer managers more discretion than tax rules do.<sup>526</sup> Using more discretion may not lead to the desired tax policy objectives of horizontal and vertical tax equity.

According to Shaviro, the reason for more reporting discretion in financial reporting is that financial statements constitute one of many sources of information that the investor can use before investing.<sup>527</sup> On the other hand, taxable income is a monopolistic source of information with no competition. According to Shaviro:

...taxable income has direct economic consequences via its impact on tax liability. Thus, taxable income seemingly ought to matter more, especially if increasing aggressive financial earnings statements would end up being increasingly discounted by observers.<sup>528</sup>

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<sup>525</sup> Manzon & Plesko, *supra* note 273.

<sup>526</sup> Hanlon, *supra* note 341, and Lillian F. Mills & Kaye J. Newberry, “The Influence of Tax and Non-Tax Costs on Book-Tax Reporting Differences: Public and Private Firms” (2001) 23:1 The J of the American Taxation Assoc 1.

<sup>527</sup> Shaviro, *supra* note 428 at 27.

<sup>528</sup> Shaviro, *supra* note 428 at 27.

One of the arguments in favour of alignment is that this move will save the cost of computing two separate incomes. In contrast, Porcano and Tran claim that aligning book income and tax income will likely increase firms' external audit fees because the liability exposure of auditors will increase upon alignment, which means auditors need to do more substantive testing.<sup>529</sup> According to Heltzer, the process of aligning book–tax income may require companies to rewrite all of their contracts and may decrease contracting efficiencies and increase settlement amounts and political costs.<sup>530</sup> McClelland and Mills suggest that complete alignment could harm the US financial reporting system that made the US capital market the strongest in the world.<sup>531</sup>

According to Hanlon and Shevlin, complete alignment will make firms understate accounting income because such understatements will reduce tax liabilities. However, tax sheltering activities could still continue while incomes were being understated.<sup>532</sup> However, if tax were to conform to the financial accounting method of estimating the tax expense, the government would suffer a revenue loss and be subject to deductions based on management expectations, which would be more difficult to verify and audit.<sup>533</sup>

Hanlon et al. quote the statement that acting Assistant Secretary for Tax Policy, John Wilkens, made to the US Congress about the harmful impact of linking accounting and taxable income:

The book income adjustment may be having a detrimental effect on the quality of financial reporting. The linkage between financial statement income and tax liability creates an incentive for corporations potentially subject to the AMT to apply generally accepted accounting principles (GAAP) in a way that reduces the amount of net book income subject to

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<sup>529</sup> Porcano & Tran, *supra* note 203.

<sup>530</sup> Heltzer, *supra* note 337 at 501.

<sup>531</sup> McClelland & Mills, *supra* note 519.

<sup>532</sup> Hanlon & Shevlin, *supra* note 508.

<sup>533</sup> Hanlon & Shevlin, *supra* note 508.



the book income adjustment. Accordingly, general purpose financial statements may provide distorted financial data to investors, creditors, and other nontax users.<sup>534</sup>

The proponents of book–tax alignment consider global acceptance of IFRS an opportunity in favour of alignment. According to Hanlon and Heitzman, when the European Union adopted IFRS as its accounting standards, it seriously considered adopting IFRS as a common consolidated corporate tax base (CCCTB). However, this proposal was not successful due to the opposition of some member states who did not want to give up control of their tax base to a foreign entity, such as the International Accounting Standards Board.<sup>535</sup>

Accounting and taxation serve different purposes. The purpose of taxation is to collect revenue for the government, whereas that of accounting is to provide information to potential investors. The taxation and accounting rules are developed to fulfill the different objectives, which sometimes overlap but otherwise are clearly different from each other. Due to these differences, some scholars believe that book–tax income should not be aligned.

Who can exercise authority over aligned book–tax income? According to Knott et al., the most significant issues with aligning book income and tax income are institutional ability and authority to initiate changes to the system.<sup>536</sup> It is unlikely that governments would leave the taxation decision in the hands of private sector bodies, such as IASB and FASB. Tran also claims that it is not possible that tax administrators would accept their reduced role in the tax system. He further says that the government needs an agency to regulate the financial market. According to him:

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<sup>534</sup> Hanlon et al, *supra* note 153 at 7.

<sup>535</sup> *Supra* note 356.

<sup>536</sup> Knott & Rosenfeld, *supra* note 253.

The government also needs a powerful agency to protect the integrity of the financial reporting system, the capital markets, and the investors. Corporate regulators and the accounting profession would not like to see the tax administrators involved in the accounting standard-setting process, because the objectives and standards of the two systems are different.<sup>537</sup>

It is highly unlikely that the government will be ready to give up its rule as a decision maker if book income and tax incomes are aligned. There are some examples from the US on institutional authority. The LIFO method of inventory is allowed in the US for tax purposes. The IRS originally refused to accept the method, but Congress made the law and permitted LIFO with added conformity requirements. Another example of institutional authority is expensing employee stock options.<sup>538</sup> According to Hanlon and Shevlin, Congress introduced a bill in 1993 to block FASB's plan to require expensing of the fair value of employee stock option grants. In 1994, legislation was introduced that would require the Securities and Exchange Commission (SEC) to approve all new FASB standards. In 2004, the House of Representatives passed a bill that essentially required firms to ignore any new FASB standard requiring the expensing of stock options for other than the top five executives of the firm.<sup>539</sup>

In 1978, the FASB required that oil and gas companies amortize rather than expense intangible drilling costs. The SEC blocked this move due to intense lobbying that emphasized the industry hardships arising from the new accounting rule.<sup>540</sup>

Another reason that supports separating taxation from financial reporting is the need to protect financial reporting from "tax pollution."<sup>541</sup> Tax pollution is the term used to describe

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<sup>537</sup> Porcano & Tran, *supra* note 203 at 449.

<sup>538</sup> Hanlon & Shevlin, *supra* note 508.

<sup>539</sup> Hanlon & Shevlin, *supra* note 508 at 15.

<sup>540</sup> Shaviro, *supra* note 428.

<sup>541</sup> Christopher Nobes, "A Conceptual Framework for the Taxable Income of Business, and How to Apply it

those financial accounting decisions that are made largely based on tax consequences, for example, if an entity charges maximum depreciation expenses allowed for tax purposes even if it is not economically beneficial. We can find more tax pollution in countries such as Germany where financial accounting income is more aligned with taxable income compared with Canada or the US. As Nobes says, “Although tax pollution is not an intended effect of the close linkage of tax and financial reporting, it is an inevitable effect.”<sup>542</sup> This phenomenon of tax pollution is also contrary to the principle of tax neutrality. On the other hand, there is also a chance that accounting pollution will occur in a tax return due to the complete alignment of the book–tax income gap.

There may be an impact on the collection of revenue if taxpayers start managing their earnings to save taxes. If the managers have the authority to make decisions about their tax payment by manipulating their accounting incomes (earnings management), they may report lower income to save taxes. Such a reduction will directly impact the tax revenue collection. This situation can only be avoided by introducing more rules and regulations, but doing that will, in turn, make the tax system more complex.<sup>543</sup>

According to McClelland and Mills, financial accounting is moving from the historical cost model toward the fair market value model for the valuation of assets and liabilities.<sup>544</sup> This fair price model involves judgment by the managers, and it may put governments’ tax revenues at risk.

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Under IFRS” (2003) Certified Accountants Education Trust at 10 [C Nobes].

<sup>542</sup> *Ibid* at 19.

<sup>543</sup> Porcano & Tran, *supra* note 203.

<sup>544</sup> McClelland & Mills, *supra* note 519 at 784.

Accounting rules revolve around professional judgment. The element of professional judgment assures the flexibility of accounting standards. For financial statement purposes, companies have several choices of accounting methods for any particular transaction. In these situations, accountants are required to use their judgment to find the best approach for a true representation of the transaction. This flexibility, however, means one type of transaction can be handled differently in two companies. On the other hand, the tax system is designed to ensure more certainty and equitable treatment across taxpayers, and such objectives may be compromised.

In principle-based accounting systems, such as IFRS, professional judgment plays a more significant role because accountants are free to use their judgment under broad guidance. The role of judgment in accounting is making it more difficult to use accounting income as a tax base. According to Alley and James, “For a tax system to operate successfully within the law it requires a degree of certainty that may not always be appropriate for financial and commercial accounting.”<sup>545</sup>

The tax system uses “rules” and not simply broad “standards.”<sup>546</sup> The flexibility inherent in the accounting standards may therefore not work well for tax purposes.

A complete alignment may not be good for the accounting users either. The primary users of financial statements are potential investors, and the purpose of a financial statement is to provide helpful information to these users for decision making. If book income is aligned to taxable income, the book income may lose its useful characteristics due to the inevitable increased focus

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<sup>545</sup> *Supra* note 33.

<sup>546</sup> Alvin D Knott & Jacob D Rosenfeld, “Book and Tax (Part Two): A Selective Exploration of Two Parallel Universes” (2003) Tax Notes 1043 [Knott & Rosenfeld (part two)].

on taxation. It will be difficult for the investors to make informed investment decisions based on these types of financial statements.

Hanlon, Kelley, and Shevlin<sup>547</sup> used a sample of 66,678 US firm-year observations over the period of 1983–2001 to conduct tests to assess the information content of the book and estimated taxable incomes. The authors concluded that if book income were conformed to taxable income, there would be an approximately 50% loss in the explanatory power of earnings and a loss of value-relevant information in the capital markets.

Ali and Hwang found that the value relevance of earning is lower when tax rules significantly influence financial accounting measurements.<sup>548</sup> Thus, there would be a loss of value-relevant information in the capital markets if book and tax income were aligned.<sup>549</sup> Some experts claim that such alignment would weaken financial accounting, and financial statements would be less reliable for investors.<sup>550</sup> If taxable income is based on book income, this may motivate some managers to manipulate their book earnings to reduce their tax bill. This may hurt the quality of financial statements.<sup>551</sup>

Conservatism is a fundamental principle of accounting. Examples of conservatism include deferring revenue or other gains until they are collected and recognizing losses when they are probable. This desirable principle has detrimental effects on taxation. By making book income a tax base, managers will have the incentive to reduce a company's income (to save the taxes), which will adversely impact the stock market's efficiency. If GAAP were used to measure income, in many cases, the result would be reduced corporate taxable income due to

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<sup>547</sup> Hanlon et al, *supra* note 153.

<sup>548</sup> *Supra* note 504.

<sup>549</sup> Hanlon & Shevlin, *supra* note 508.

<sup>550</sup> Hanlon et al, *supra* note 153 at 19.

<sup>551</sup> G Yin, *supra* note 332.

conservatism in accounting, resulting in less corporate income tax collected. If conservatism were not applied consistently from year to year, then taxpayers might attempt to create reserves and save for a rainy day. During low-income years, taxpayers may take a “big bath”; i.e., they might recognize future losses in the current year. Blake et al. admit that income smoothing is done by many companies from year to year:

In countries with a comprehensive tax accounting link, the tendency toward conservatism will not necessarily apply consistently from year to year. In years when a loss is made[,] excessively conservative provisions against profit in previous years may be written back to profit in order to benefit from tax losses. Thus an “income smoothing” effect arises, whereby profit is understated in good years and overstated in bad years.<sup>552</sup>

In the *Thor* case, the Court noted that “the accountant’s conservatism cannot bind the Commissioner in his efforts to collect taxes.”<sup>553</sup>

Accounting is an evolving profession. If accounting standards cannot address the current needs of the business, they will eventually become obsolete. That is why accounting standards are changing along with the changing needs of business.

There is a possibility that alignment may stop or slow the process of accounting reforms because accounting standard setters would have to focus more on tax collection rather than the measurement of business performance. A more formal alignment of taxation and accounting may limit the evolutionary process of accounting.<sup>554</sup> Taxpayers may resist any such change in accounting principles which has adverse tax consequences, and this resistance may conflict with the international convergence of accounting standards. If the same rules are used for accounting

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<sup>552</sup> John Blake et al, “The Relationship between Tax and Accounting Rules—the Swedish Case” (1997) 97:2 *European Business Rev* at 85 at 86.

<sup>553</sup> Knott & Rosenfeld, *supra* note 253 at 881.

<sup>554</sup> Macdonald, *supra* note 31.

and tax purposes, any accounting-related rule which can increase the tax payment will be opposed by the companies. Therefore, it is assumed that this move would stop the development of both accounting and tax rules.

If book–tax income is conformed in one jurisdiction, it does not mean all countries will start using one set of books for both accounting and taxation. Multinational corporations may still have to maintain second books to provide the information to other jurisdictions. This move requires additional coordination with the other country’s tax treaties, IASB, and economic agreements.<sup>555</sup> This type of coordination is complicated and could increase the administrative burden.

Accounting rules are not equally applied to all types of corporations. There are different rules applied to listed companies (public companies) and small and medium enterprises (SMEs). SMEs operate in a different economic environment. Imposing the same rules imposed on public companies would not be fair to them.

Small or non-publicly traded companies in Canada are not required to use IFRS. Instead, they use a different set of accounting rules (ASPE).<sup>556</sup> In other words, book–tax alignment is not a one-size-fits-all solution that will work for all types of companies.

According to McClelland and Mills, regulated industries, such as banking and insurance, work under statutory rules to protect depositors, and it is not possible that the income reporting system based on book income can be extended to these industries.<sup>557</sup>

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<sup>555</sup> McClelland & Mills, *supra* note 519.

<sup>556</sup> Although if they wish they can use IFRS as their accounting standards.

<sup>557</sup> McClelland & Mills, *supra* note 519.

Converting two sets of books into one set will cause many transitional issues, particularly regarding deferred taxes. According to McClelland and Mills:

Eliminating deferred tax assets and liabilities raises a complex transitional issue. Switching cold turkey from the current tax base to a book income tax base creates big winners and losers. Corporations with net deferred tax liabilities (because of accelerated tax deductions) will no longer have to pay the deferred tax and will get to record additional after-tax book income. However, corporations with net deferred tax assets (because of delayed deductions or unused losses and credits) will not be able to reduce future taxes and will have to record a book expense to write those assets off, absent transition relief.<sup>558</sup>

The auditor's independence is crucial for the proper functioning of capital markets. The greater book–tax conformity poses more threats to the auditor's independence.<sup>559</sup> New regulations may be required to prohibit the audit firms from providing any sort of tax advice.

According to Yin, a tax base that is based on book income would seem to violate a neutrality objective.<sup>560</sup> Similarly situated corporations may end up paying different amounts of taxes depending on the accounting earnings they decide to report in a year.

Comparability and consistency are the central tenets of accounting. Accounting information should be consistent over time for comparison purposes, whereas this is not a requirement for the tax laws. Tax laws mandate that any method that gives a true picture of a company's economic condition is sufficient.

Time is required between identifying a problem and issuing or amending any new or existing standards. In the accounting world, much research and due diligence are required to

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<sup>558</sup> McClelland & Mills, *supra* note 519 at 784.

<sup>559</sup> Christian Nowotny, "Taxation, Accounting and Transparency: The Missing Trinity of Corporate Life" (2008) SSRN.

<sup>560</sup> G Yin, *supra* note 332 at 214.



bring or amend a new standard. For tax purposes, the government can issue new guidance very quickly. In the case of alignment, it will be challenging to make any change about taxation through the accounting channel.

### **3.4.2 Partial Tax–Book Conformity**

Closer alignment between taxable income and reported book income is often raised by regulators and scholars as a solution to tax aggressiveness. The idea of having a single income number for both financial reporting and the tax base offers the virtue of simplicity. However, there is no evidence that complete book–tax conformity would necessarily reduce tax sheltering or tax aggressiveness activities, and it may even result in lower tax revenues from privately held or closely held corporations that do not have external stakeholders monitoring them based on financial reporting. Tying financial reporting to tax reporting may even have a detrimental effect on the quality of financial reporting.<sup>561</sup>

Commercial accounting requirements are different from the requirements of taxation. The primary purpose of financial accounting is to provide useful information to stakeholders, such as investors and creditors. Accounting information enables the “invisible hand” of capitalism to allocate resources more efficiently by providing relevant and predictive information about the reporting entity’s future prospects to investors and creditors.<sup>562</sup>

Besides collecting revenues for government spending, taxation is also used as a policy tool by the government to influence economic behaviour and activities. For example, CCA is often more generous than accounting depreciation because the Department of Finance wishes to

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<sup>561</sup> Hanlon et al, *supra* note 153 at 5-6.

<sup>562</sup> Knott & Rosenfeld, *supra* note 253.

incentivize taxpayers to invest in more property, plants, and equipment to generate more jobs and thereby more economic activities. Other examples include deduction of a reserve, contingent liability, or a sinking fund which is prohibited for tax purposes unless allowed by specific provisions of the Act. In contrast, accounting allows expensing of a reasonable estimate of future returns and makes this expensing mandatory.

While these two systems with their unique objectives need to maintain their independence and integrity, there may be an argument for them to be a little more closely aligned. While complete alignment is neither feasible nor desirable, recent changes in accounting (e.g., move to IFRS) may make it possible to play a slightly more significant role in determining the tax base for corporations.

Recent changes to financial accounting arguably reduce the focus on measuring income and increase the focus on valuing assets and liabilities, leaving profit as a residual difference between gains and losses on net assets over two consecutive reporting dates.<sup>563</sup> In the early days of accounting, the accounting purpose was to determine the profit that could be distributable to shareholders and offer protection to creditors. More recently, the focus has shifted to “investor information.”<sup>564</sup> Schön also argues that the objection of conservatism may not be valid anymore “because modern financial accounting rules try to give investors a faithful and symmetric picture of a company’s financial situation.”<sup>565</sup>

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<sup>563</sup> C Nobes, *supra* note 541 at 37.

<sup>564</sup> Schön, *supra* note 148 at 134.

<sup>565</sup> Schön, *supra* note 148 at 135.

While legislative acceptance of accounting standards for the calculation of taxable income is neither practically nor politically feasible, the time may be right to enact very few selective accounting rules in the Act.

While significant differences exist between accounting income and taxable income, there are areas in practice where some alignment is possible and which the courts may already recognize as being congruent. Adopting accounting standards for tax purposes has to be restricted to those standards that are in accordance with the objective of taxation.<sup>566</sup> For example, as discussed previously, the Act makes it possible to enact the accounting classification and valuation of derivatives and the revenue recognition from long-term contracts in the Act. In these limited areas, there are opportunities to legislate conformity between taxable income and accounting income in Canada to reduce tax compliance costs, court disputes, and uncertainty. The federal government has already introduced an elective mark-to-market regime for derivatives held on income accounts. An election will allow taxpayers to mark-to-market all of their eligible derivatives.

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<sup>566</sup> *Supra* note 507.

### 3.5 Adjustment of Taxable Income

There is another solution in the literature based on the method used in the US for computing the Alternate Minimum Tax (AMT). According to this solution, taxpayers can retain separate tax and financial accounting rules for measuring income but be required to have their taxable income adjusted by a specific percentage of the difference between these two incomes.<sup>567</sup> This adjustment can be levied as a separate AMT that cannot be used to reduce the taxable income.

According to Shaviro, the proposed taxable income adjustment would work as follows:

Publicly traded corporations with at least \$10 million of assets, which under current law must file both a Schedule M-3 and SEC Form 10-K, would be required to adjust taxable income (as otherwise determined) by 50 percent of the difference between such income and modified financial accounting income, which would be the financial accounting income of the tax group as recomputed to use whichever income tax preferences Congress specified. However, reductions in taxable income through the adjustment would be limited to previous increases, with a carry forward for amounts thus disallowed.<sup>568</sup>

Practically speaking, this idea is difficult to implement because first, we would need to make the accounting income of all companies comparable. Under this approach, companies would adopt a more conservative approach and try to reduce their reported accounting income. Companies would be discouraged from replacing capital assets because that transaction would tend to increase accounting income and reduce taxable income due to the different depreciation rules.

A tax based on adjusted book income would cause some distortion and inefficiencies.<sup>569</sup> This rule would be applicable only to public companies and not private companies and thus would

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<sup>567</sup> Shaviro, *supra* note 428.

<sup>568</sup> Shaviro, *supra* note 428 at 62.

<sup>569</sup> G Yin, *supra* note 332 at 214.

create two types of corporate taxpayers. This would also add complexity and uncertainty to the tax and financial reporting processes.<sup>570</sup>

This system is considered an alternative to the one-aligned income system. One income system would be controlled either by the government or by the accounting body. According to Shaviro, this AMT-type proposal would minimize the danger of dominance of any group.<sup>571</sup> Another objection to this approach is that it looks simple on the books but would be difficult to implement since firms have a certain level of discretion in determining their accounting income.

Knot et al. rejected this approach due to complexity and overbreadth.<sup>572</sup> The authors call it a “floor” approach where book income is acting as a floor, and tax will be levied on the excess amount of book income over taxable income. Adjusting book income for this purpose is difficult. According to Knot et al., “given the variety of book–tax differences that exist, a book “floor” would be overbroad, and not just cover tax shelter activity.”<sup>573</sup> They further argue that the subjective scope of financial reporting renders the proposal unreliable:

Treasury considered this proposal in its 1999 study on corporate tax shelters, and rejected it as a way to curb tax shelter activity. First, as Treasury noted, the use of book income as a floor suffers from the same problems that using book income for general income tax purposes does (albeit to a lesser extent). Treasury’s critique in this regard emphasized the subjective nature of financial reporting (GAAP’s “application may vary among companies, among industries, or depending upon the auditors”), and focused on standard-setting limitations.<sup>574</sup>

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<sup>570</sup> G Yin, *supra* note 332 at 214.

<sup>571</sup> Shaviro, *supra* note 428 at 65.

<sup>572</sup> Knott & Rosenfeld (part two), *supra* note 546.

<sup>573</sup> Knott & Rosenfeld (part two), *supra* note 546 at 1063.

<sup>574</sup> Knott & Rosenfeld (part two), *supra* note 546 at 1062. [References omitted, emphasis original]

According to Chorvat and Knoll, adjusting taxable income based on book income (AMT concept) is not a good idea to reduce tax sheltering activities.<sup>575</sup> They proposed that the better way to deal with tax shelters would be to require the corporations to provide more detailed tax disclosures.

### 3.5.1 Specific Incorporation of Paragraphs 12(1) (a) and 20(1) (m)

There are many examples where accounting treatment is incorporated in the *Income Tax Act*. For example, subsection 10(1) requires inventory of a business to be valued at year-end at acquisition cost or current fair market value, whichever is lower.<sup>576</sup> In the *Bernick* case, the Court ruled that subsection 10(1) is an exception to the *Income Tax Act*. According to the Court:

Section 10(1) of the *Income Tax Act* recognizes the well-accepted commercial and accounting principle of requiring a business to value its inventory at the lower of cost or market value. This principle is an exception to the general principle that neither profits nor losses are recognized until realized. As well, it represents a departure from the general principle that assets are valued at their historical cost. The underlying rationale for this specific exception to the general principles is usually explained as originating in the principle of conservatism.<sup>577</sup>

There is no requirement of consistency to calculate taxable income in general. In reality, the principle of consistency may go against the true picture test if we have to follow it. However, consistency is an important pillar of any financial accounting system. In subsection 10(2.1), the principle of consistency is incorporated in the Act for the valuation of inventory. Now, companies are required to use the same methods of inventory valuation for opening and closing inventory.

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<sup>575</sup> Terrence R Chorvat & Michael S Knoll, “The Case for Repealing the Corporate Alternative Minimum Tax” 55 SMU L Rev.

<sup>576</sup> *ITA*, *supra* note 86 at subsection 10(1).

<sup>577</sup> *Supra* note 44 at 25-26.

The Act requires that corporations, partnerships, and certain trusts should only use the accrual method for interest income.<sup>578</sup> These entities should include any interest on a debt obligation that is received before the end of the year or that is accrued before the end of the year. This method is based on the accounting principle of accrual. Companies are required to pay tax on the income which has not yet been received.

When Parliament enacted Part 1.3 (Tax on Large Corporation), it required that companies use the amounts and values contained on their balance sheets. As large companies must follow the accounting standard, by enacting subsection 183(3), Parliament endorsed the use of accounting standards for the tax purposes. According to the FCA, in the *Ford Credit Canada* case:

In my view, in enacting subsection 181(3), Parliament basically chose to adopt a method of computing capital for the purpose of the temporary new tax that was well known to large corporations. The financial statements of large corporations are routinely prepared on an audited basis in accordance with GAAP, and therefore, adopting GAAP as the principal determinant of the capital tax base for most corporations ensured that the new and temporary tax would be relatively simple to implement and administer. However, a complete adoption of GAAP did not occur.

When Parliament determined that deviations from GAAP were desirable, the necessary modifications were made by the enactment of specific legislative provisions. Two important components of capital, “long-term debt” and “reserves,” were given statutory meanings in subsection 181(1).<sup>579</sup>

In the *Canderel* case, the SCC stated that “A good example of the relationship among the provisions of the Act, the principles developed in the case law, and GAAP or well-accepted

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<sup>578</sup> *ITA*, *supra* note 86 at subsection 12(3).

<sup>579</sup> *Canada (Attorney General) v Ford Credit Canada Ltd*, 2007 DTC 5431, 2007 FCA 225 at 20-21.

business principles can be found in s. 18(9) of the Act, which requires the amortization of certain prepaid expenses over the periods of time to which they relate.”

Under paragraph 12(1) (a), any unearned income will be included in the calculation of taxable income for the goods and services that are not yet supplied. A reserve under paragraph 20(1) (m) can be taken for the amounts included by paragraph 12(1) (a).

AMT is an example of using book income as a tax base in the US. Used from 1986 to 1989, AMT was structured to tax the excess of book income over taxable income. AMT was implemented so that no taxpayer with income could avoid tax liability by using tax exclusion, deductions, and credits.<sup>580</sup> Hanlon et al. observed that the use of AMT represented the first time in US history when income tax liability was partially based on financial statements prepared in accordance with GAAP.<sup>581</sup>

The AMT suits those who want to use accounting income as a tax base. While AMT seemed like a good idea, it was extremely complicated.<sup>582</sup> However, although AMT did not work as intended, it did have some relevance as described below:

Despite the AMT’s failure as a means of taxing book income, the 1986–1989 corporate AMT does provide a valuable precedent for the base-broadening changes that a conformed accounting system would require.<sup>583</sup>

The mark-to-market rule assumes that any derivative held by the taxpayer is sold or terminated on the last day of the taxation year and reacquired on the first day of the next year.

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<sup>580</sup> Hanlon et al, *supra* note 153.

<sup>581</sup> Hanlon et al, *supra* note 153 at 7.

<sup>582</sup> Gary A. McGill and Edmund Outslay, “Lost in Translation: Detecting Tax Shelter Activity in Financial Statements” (2004) 5:3 National Tax J 739-756.

<sup>583</sup> Whitaker, *supra* note 70 at 698.



This allows any gain or loss on mark-to-market to be treated as an ordinary gain or loss for taxation purposes. This taxation of “paper gains” is a fundamental shift away from the realization principle. The mark-to-market method was initially required only for financial institutions, but now, it is required for corporations with some conditions under subsection 10.1(1) as an election.

### **3.5.2 Addressing Hedging, ESO, and Percentage-of-Completion Methods**

The taxation of derivatives cannot be handled under existing tax laws, and the entire system of taxing derivatives needs to be redesigned. The courts face great difficulty in coming up with consistent rules to tax financial instruments. According to Raskolnikov:

[I]n the absence of comprehensive reform, it is impossible to tax financial derivatives in a manner that meets any accepted benchmark of an effective and efficient capital income tax. As long as the patchwork of current rules remains in place, symmetry, consistency, and balance will all remain unattainable.<sup>584</sup>

In the recent case of *The Queen v Agnico-Eagle Mines Limited*, the FCA turned down a lower court’s decision regarding the taxpayer’s foreign exchange gains resulting from converting US dollar debentures into common shares. The court decided that such a conversion would not trigger a realization of capital gains despite currency fluctuations.<sup>585</sup> According to the commentary by Ernst and Young on this decision:

If the FCA is correct, then a corporation issuing foreign-currency denominated debentures should always include a conversion feature since it would essentially give the corporation a one-sided bet: the corporation could potentially claim a capital loss if the shares to be issued on conversion go up in value; and if the shares decline, the maximum

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<sup>584</sup> Alex Raskolnikov, “Taxation of Financial Products: Options for Fundamental Reform” (Dec 19, 2011), Tax Notes.

<sup>585</sup> *The Queen v Agnico-Eagle Mines Limited*, 2016 FCA 130; 2016 DTC 5056; [2016] 4 CTC 177.

foreign exchange exposure would be on the principal amount of the debt (i.e., the exposure if there were no conversion feature).<sup>586</sup>

In the case of *Imperial Oil Limited v The Queen*, the taxpayer issued US dollar-denominated debentures at a discount and later redeemed them at a loss.<sup>587</sup> The company claimed the original discount and foreign-currency loss under s. 20(1) (f) (i). The Minister disallowed the deduction, and the TCC upheld the assessment. The FCA rejected the Minister's assessment, but the SCC reversed the FCA decision by a 4-3 majority, saying that foreign exchange losses cannot be claimed under s. 20(1) (f) (i). Instead, they must be claimed as a capital loss under section 39.

In *George Weston Limited v The Queen*, the taxpayer terminated a cross-currency swap and received some proceeds. According to the taxpayer, the profit from this currency swap was a capital gain because the proceeds resulted from foreign-currency fluctuation. The CRA reassessed the company on the basis that proceeds from currency swaps were income and therefore fully taxable. According to the CRA, only derivatives linked to an underlying transaction to purchase or sell a capital asset will be eligible for capital gains or capital loss tax treatment. According to the TCC decision, this swap was entered into as a hedge to protect a capital investment, and therefore, the gain derived from terminating this swap was on capital account.<sup>588</sup>

In *Shell Canada Ltd. v The Queen*, the taxpayer borrowed money from the international market through a complex arrangement. For tax purposes, the taxpayer deducted the interest paid

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<sup>586</sup> Daniel Sandler & Ilia Korkh, "Federal Court of Appeal finds no foreign exchange gain on conversion of US dollar-denominated debentures", Case Comment on *The Queen v Agnico-Eagle Mines Limited* (May 2016) (Knotia).

<sup>587</sup> *Imperial Oil Limited v The Queen*, 2006 SCC 46; 2006 DTC 6639; [2007] 1 CTC 41.

<sup>588</sup> *George Weston Limited v The Queen*, 2015 TCC 42; 2015 DTC 1079; [2015] 4 CTC 2010.

on the income account and reported a capital gain on this transaction. The Minister reassessed the company, reduced the interest expense claimed, and treated the capital gains as income. The TCC set aside the Minister's reassessment, but the FCA allowed the Minister's appeal and held that Shell could claim the net foreign exchange gain on the capital account.<sup>589</sup> The SCC disallowed the Minister's reassessment.<sup>590</sup> In response to this decision, a statutory anti-avoidance rule for weak-currency borrowing was introduced as section 20.3.<sup>591</sup>

In the *Friedberg* case, the SCC decided that the mark-to-market method may better describe the taxpayer's income for some other purposes (e.g., reporting to shareholders), but not for tax purposes. The court further argued that a margin account balance is not an appropriate measure of realized income for tax purposes.<sup>592</sup>

In *Kruger Incorporated v Canada*, the taxpayer started trading the currency option contracts to reduce company's exposure to foreign-currency fluctuations. The taxpayer computed income from dealing in foreign exchange options based on the mark-to-market method. The Minister reassessed and claimed that profit and loss could be recognized only when realized. The TCC agreed with the Minister's assessment and rejected the mark-to-market method used by the company. According to the TCC judge, the mark-to-market method is only available to banks and financial institutions, but not to the appellant company. The court also held that purchased foreign exchange contracts were inventory, whereas the written contracts were not. The tax court judge was also uncomfortable with the different values for option valuation:

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<sup>589</sup> *Shell Canada Ltd v The Queen*, 99 DTC 5669; [1999] 4 CTC 313.

<sup>590</sup> *Supra* note 205.

<sup>591</sup> Arnold et al, *supra* note 24 at 586.

<sup>592</sup> *Friedberg*, *supra* note 134.

This shakes my confidence as to the other market values used by Kruger, not because Kruger was trying to do something nefarious, which it was not, but because of a probable inconsistency in values depending on the different models used by Kruger's counterparties. I may have had more comfort in agreeing with Kruger's valuations if all the contracts were valued using the same models, not a variety of models used by different banks.<sup>593</sup>

The FCA rejected the TCC finding, holding that realization is an overarching principle that applies even in the absence of a provision authorizing or requiring the application of a different method. The FCA concluded that there was no basis on which the TCC judge could reject the appellant's use of mark-to-market accounting in computing income from dealing with foreign exchange options. The FCA further ruled that foreign exchange options purchased by the appellant did not qualify as inventory as they were not held for resale.<sup>594</sup> This is now enacted as subsection 10(15). It was also determined that the difference in valuation amount was not real but due to a clerical error (the use of the wrong discount rate).

The examples mentioned above illustrate the inconsistencies in the courts' decisions in derivatives-related cases. These inconsistencies are likely due to the complexity of financial instruments and the multiple different objectives that drive their use. In the current business environment, many taxpayers use sophisticated derivatives for risk management, and courts may find it difficult to fully understand these instruments. For the new mark-to-market regime, derivative valuations must be conducted every reporting period. It will be challenging for the courts to come up with a true picture of a company's profit. Therefore, the better suggestion is to accept the classification and valuation of hedges based on the financial statements, provided that

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<sup>593</sup> *Kruger, supra* note 133.

<sup>594</sup> *Ibid.*

accounting treatment does not contradict any existing provision of the Act or any accepted legal provision.

The Act is silent about the revenue recognition method for long-term contracts. Therefore, courts have developed their own rules on a case-by-case basis. Similarly, the Minister is not very consistent in demanding any particular method. For example, in the case of *Huang and Danczkay*,<sup>595</sup> the Minister rejected the company's use of the completed-contract method, and in *Trom Electric*,<sup>596</sup> the Minister did not object to the taxpayer's use of the completed-contract method. In *The Queen v Bombardier Inc.*, the court accepted the taxpayer's argument that using the accounting method for the long-term construction contracts (percentage-of-completion) (in the non-digital world) was in accordance with GAAP. The court sided with the taxpayer by holding that accepting the Minister's argument would "amount to allowing the transaction's legal reality to prevail over its GAAP-required commercial reality and to eliminating the effects of the percentage-of-completion accounting method legitimately used by the respondent in keeping with GAAP."<sup>597</sup> The courts reached the same conclusion in *CDSL Canada Limited et al. v The Queen* by accepting the use of the percentage-of-completion method for tax purpose.<sup>598</sup> Based on the discussion in the previous chapter, it is obvious that percentage-of-completion based on IFRS rules is a superior measure of a company's revenues and does not violate any existing statutory or legal provision. Therefore, it is time to enact this method in the Act.

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<sup>595</sup> *Supra* note 144.

<sup>596</sup> *Supra* note 145.

<sup>597</sup> FCA, *supra* note 142 at 36.

<sup>598</sup> *CDSL*, *supra* note 12.

### 3.5.3 The UK Approach

The Accounting Standards Committee (ASC) in the UK was first set up in 1970. Its objective was to develop definitive standards for financial reporting in the UK. In 1990, the ASC was replaced by the Accounting Standards Board (ASB). Since 2005, the UK has adopted IFRS as its accounting standards. As in most jurisdictions, accounting income is a starting point to calculate taxable income in the UK.<sup>599</sup> If there is a specific tax law, it will generally prevail, and accepted principles of commercial accounting are usually the basis for determining tax liability unless there is some statutory provision that requires otherwise. In 1892, Lord Halsbury in *Gresham Life Assurance Society v Styles* stated:

The thing to be taxed is the amount of profits and gains. The word ‘profit’ I think is to be understood in its natural and proper sense—in a sense which no commercial man could misunderstand.<sup>600</sup>

There is a judicial view that the courts in the UK retain the right to modify the income calculated by accounting principles, and the courts retain the right to determine which principle should be applied in particular circumstances.<sup>601</sup> There appears to be a continuing role remaining for the courts, but the extent of this is unclear.<sup>602</sup> UK courts are relying more and more on GAAP:

Over time the courts have relied on British GAAP as a cornerstone of tax accounting and the British Parliament in the 1998 UK Finance Act provided explicitly that profit and loss measurement under tax law should follow the “true and fair view principle” in accordance with financial accounting standards if the tax code does not say otherwise.<sup>603</sup>

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<sup>599</sup> C Nobes, *supra* note 541.

<sup>600</sup> C Nobes, *supra* note 541 at 14.

<sup>601</sup> Freedman, *supra* note 2.

<sup>602</sup> Freedman, *supra* note 2.

<sup>603</sup> Hanlon & Maydew, *supra* note 278 at 48.

According to Porcano and Tran, the early British tax statute imposed a tax on profit without any reference to accounting standards.<sup>604</sup> This practice arose when income tax was reintroduced in the UK in the early nineteenth century, and there were still no widely accepted accounting principles on which to rely. If accounting principles had been well developed when income tax was introduced, the early UK income tax legislation would likely have adopted accounting profit.

Section 42 of the UK Finance Act 1998 says that the profit of a trade, profession, or vocation must be computed on an accounting basis which gives a true and fair view, subject to any adjustment required or authorized by law in computing profits for those purposes. Section 42 was amended in 2002 so that the words “on an accounting basis which gives a true and fair view” were replaced by “generally accepted accounting practice.” Later, a reference to IFRS was added in the section.<sup>605</sup>

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<sup>604</sup> Porcano & Tran, *supra* note 203.

<sup>605</sup> *Finance Act 2002* (UK), c 23, s 64 (3).; Also *Finance Act 2004* (UK), c 12, s 50 (1).

## 4 Narrowing the Book–Tax Gap

The book–tax income gap arises due to policy-based deductions (e.g., CCA) or tax aggressiveness. Any policy-driven deductions are unlikely to be removed. Therefore, they are not an issue. To help manage a tax aggressiveness policy, it would be useful to have more disclosure of certain types of transactions. This would allow the CRA, Department of Finance, and academic researchers to better estimate the book–tax differences in aggregate and evaluate whether and explain why this gap may diverge or converge over time. More disclosure would simplify the CRA’s audit assessments and allow the CRA to more equitably treat all taxpayers reporting similar amounts. Over time, this would reduce taxpayer uncertainty.

### 4.1 Why Should the Book–Tax Gap Be Narrowed?

There is no disagreement about the existence of the book–tax income gap. According to Fan and Mawani, the divergence between book income and tax income may be driven either by increasing tax sheltering or by increasing earnings management, or by both:<sup>606</sup>

The existence of a trade-off between minimizing taxes and maximizing book income seems intuitive since doing more of one increases the marginal cost of the other. Therefore, the larger book-tax gap over time could be driven by either increased book income or decreased taxable income, or both.<sup>607</sup>

If this increase is due to tax evasion activities, it is a real concern. This practice of inflated book income and lower taxable income is not good for either accounting statement users or tax

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<sup>606</sup> Hong Fan & Amin Mawani, “Tax Aggressiveness and closely-held Firms: Evidence from Canada” (2015).

<sup>607</sup> *Ibid* at 2.



authorities.<sup>608</sup> The main problem of the increasing book–tax income gap is that it is either the capital market may be seeing overstated accounting incomes or tax authorities may not be obtaining their fair share of tax revenue or both.

Desai argues that a dual reporting system, active tax management strategies, and earnings management are responsible for a significant book–tax income gap.<sup>609</sup> Wilson found that during the 1990s, there was a rapid growth in tax shelter activities resulting from economic growth. The book–tax income difference grew from \$92.5 billion in 1996 to more than \$159 billion in 1998. His study indicates that those firms that are participating in publicly identified shelters are very aggressive in their tax reporting. The book–tax difference is a useful measure of tax aggressiveness, because book–tax differences are positively and significantly associated with the incidence of tax sheltering activity. Desai concludes that tax shelters are positively related to total book–tax differences and that there is no single reason for the book–tax income difference.<sup>610</sup> Heltzer conducted a study of the book–tax income gap and concluded that the primary cause of the gap is aggressive tax planning and not aggressive financial reporting.<sup>611</sup>

Other research identified inflated book income and not tax planning as the leading cause of the book–tax gap. For example, Plesko calculated a book–tax income gap from Schedule M1<sup>612</sup> and found that there were book–tax differences during the 1990s that reached a peak in 1999.<sup>613</sup>

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<sup>608</sup> Mihir A. Desai, “The Degradation of Reported Corporate Profits” (2005) Harvard University and NBER.

<sup>609</sup> Desai, *supra* note 309 at 9.

<sup>610</sup> Ryan Wilson, “An Examination of Corporate Tax Shelter Participants” (2007) University of Washington Business School at 2.

<sup>611</sup> Heltzer, *supra* note 337 at 503.

<sup>612</sup> This form was used in the US to reconcile book-tax income gap. Now it is replaced with a more elaborative form M-3.

<sup>613</sup> George A Plesko, “Corporate Tax Avoidance and the Properties of Corporate Earnings” (2004) 57:3 Nat’l Tax J 729.

According to Plesko, the main reason for the gap was that the book revenue was excessive when compared with revenues for tax reporting.

Earnings management and tax sheltering are considered two main reasons for the increase in the book–tax income gap.<sup>614</sup> According to Mills and Plesko:

Financial statement users (especially recently) and tax return users (traditionally) view book–tax differences as important because such differences, to the extent not mechanistically determined by standards and laws, could indicate aggressive reporting in one direction or the other.<sup>615</sup>

Lisowsky (2009) conducted a study in which he used financial statements to infer taxable income. He used several variables to estimate domestic taxable income. He concluded that “BTD [book–tax difference] alone appears to be a crude, yet informative (and easily implementable) measure for corporate tax sheltering.”<sup>616</sup>

The tax sheltering activities allowed US firms to avoid over \$10 billion in federal taxes annually.<sup>617</sup> The big accounting firms were found to be complicit in offering advice. For example, the IRS challenged KPMG to sell tax shelters to clients from 1997 to 2001 that created \$11 billion in sham tax losses or \$2.5 billion in tax benefits.<sup>618</sup> This type of tax avoidance undermines the integrity of the tax system because ordinary taxpayers lose confidence in the fairness of the tax collection system.

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<sup>614</sup> Shaviro, *supra* note 428.

<sup>615</sup> Whitaker, *supra* note 70.

<sup>616</sup> Petro Lisowsky, “Seeking Shelter: Empirically Modeling Tax Shelters Using Financial Statement Information” (2009) SSRN at 28.

<sup>617</sup> John R. Graham & Alan L Tucker, “Tax Shelters and Corporate Debt Policy” (2005) SSRN at 3 [footnotes omitted].

<sup>618</sup> *Supra* note 616.

In the US, the Joint Committee on Taxation recognized the problem of inflated earnings and the payment of less tax. According to the report:

In particular, Congress concluded that both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends, to shareholders. Even to the extent that these instances may reflect deferral, rather than permanent avoidance, of corporate liability, Congress concluded that they demonstrate a need for change.<sup>619</sup>

Tax sheltering is a growing problem in the US and UK. The US General Accounting Office estimates that abusive tax shelters have cost the US \$85 billion over 6 years, whereas sources have estimated the loss from shelters in the UK at £13 billion per year.<sup>620</sup> This abusive tax avoidance poses a risk to the integrity of the tax system by undermining the confidence in the fairness of tax collection in general.<sup>621</sup> A tax shelter is like an interest-free loan that the government gives to corporations and that is often never repaid.<sup>622</sup>

It is important to note that not all tax shelters are bad; only abusive tax shelters are the problem. Abusive tax shelters are those transactions in which the tax treatment is different from the financial treatment, and these transactions tend to increase book income while decreasing taxable income.<sup>623</sup> These abusive tax shelters tend to widen the book–tax income gap.

According to Yin,<sup>624</sup> tax shelter activities were present during the 1970s and 1980s, and virtually, every major tax act between 1969 and 1986 contained one or more significant pieces of

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<sup>619</sup> Joint Committee, *supra* note 244 at 433.

<sup>620</sup> *Supra* note 270.

<sup>621</sup> *Supra* note 270.

<sup>622</sup> Whitaker, *supra* note 70.

<sup>623</sup> US, Department of the Treasury, *The White Paper: The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999), online: <<https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Corporate-Tax-Shelters-1999.pdf>>.

<sup>624</sup> George K. Yin, “Getting Serious About Corporate Tax Shelters: Taking a Lesson From History” (2001)

legislation designed to address the tax shelter issue, including new compliance and disclosure requirements.

The book–tax gap has implications for the quality of accounting earnings. Lev and Nissim<sup>625</sup> document that a large book–tax income gap is associated with a lower quality of accounting earnings, indicating the overall aggressive behaviour in financial reporting. A large book–tax gap is also considered a “red flag” by the investors who may reduce their expectations of a company’s future earnings.<sup>626</sup> According to Mills, the IRS proposed increasing audit adjustments as the excess of book income over taxable income increases, so that “firms cannot costlessly maximize financial reporting benefits and tax savings independently.”<sup>627</sup>

A Canadian study conducted by Fan and Mawani finds that tax reporting aggressiveness is negatively associated with financial reporting aggressiveness in Canada.<sup>628</sup> The negative relationship shows that firms make a trade-off between the pursuit of book income and tax savings.

According to Raskolnikov, the book–tax gap is one of the several signs of a severe tax compliance problem and shows that “we are in the midst of a well-publicized shelter crisis.”<sup>629</sup>

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54 SMU L Rev 209 at 214.

<sup>625</sup> *Supra* note 348.

<sup>626</sup> Hanlon, M. “The Persistence and Pricing of Earnings, Accruals and Cash Flows When Firms Have Large Book-Tax Differences” (2005) 80:1 Accounting Rev 137.

<sup>627</sup> Mills, *supra* note 313 at 344.

<sup>628</sup> *Supra* note 606.

<sup>629</sup> Alex Raskolnikov, “Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty” (2006) Columbia Law and Economic Working Paper no. 284 at 24.

## 4.2 Focusing on Aggressive Tax Planning

Since policy-driven deductions, including Division C deductions, are unlikely to be curtailed, the only remaining reason to seek convergence of the book–tax gap is to curtail aggressive tax planning. Even if book–tax income is not converged, disclosure of such a gap could curtail some of the aggressive tax planning. For example, while Lenter, Slemrod, and Shackelford favour limited disclosure, they also describe many advantages of complete disclosure (e.g., making tax returns public), though regulators always reject this idea:

First, it could put pressure on legislators to improve the tax system. Second, it could induce corporations to resist aggressive tax reduction strategies if they fear that disclosure of their low tax payments would trigger a negative consumer response; whether it would provoke a negative investor response is less clear, as more transparency could conceivably induce a race to the bottom of low tax liability. Finally, it could contribute to better functioning of financial markets if it sheds new light on the information presented in financial statements.<sup>630</sup>

If companies disclose more information about their tax returns, the public can better understand the company's actual financial position.<sup>631</sup> Disclosure can help investors and other users of the information to make correct decisions about the company.

However, corporate tax returns can be lengthy and complicated and can confuse even the experts. Full disclosure of corporate tax returns will burden the reader with information overload. Instead, of curbing financial reporting abuses, disclosing tax returns may confuse rather than enlighten investors.<sup>632</sup> McGill and Outslay, who offer insight into many corporate strategic and

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<sup>630</sup> David Lenter, Joel Slemrod & Douglas Shackelford “Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives” (2003) 56: 4 Nat'l Tax J 803 at 803.

<sup>631</sup> Weiner, *supra* note 366.

<sup>632</sup> Knott & Rosenfeld (part two), *supra* note 546.

competitive intelligence schemes, find full disclosure to be an extreme measure. About the privacy of tax return, they say:

Historically, tax return privacy has been a sacred right with virtually no exceptions. However, the recent public disclosure of KPMG's client names in a tax shelter dispute with the IRS opens a crack in the privacy door previously thought to be sealed shut. Commentators are rightly concerned with this precedent. But disclosure is not an all-or nothing proposition and probably should not require release of tax returns. More disclosure, perhaps in line with the recommendations by Citizens for Tax Justice, would likely make a corporation's tax status more transparent and perhaps help analysts (including academic researchers) and policymakers understand how the current tax rules are applied domestically and internationally.<sup>633</sup>

The Tax Executive Institute (TEI), an association of industry tax professionals, opposes any proposal to make copies of tax returns available to the SEC or the public.<sup>634</sup> It argues that such required disclosure would breach a company's privacy rights and also unwillingly force the company to give its proprietary information to its competitors. The confidentiality of tax returns has been a long-standing policy, and full disclosure may violate the confidentiality of tax return information. If managers know that all the information in their tax returns will be made public, they could withhold some vital information for fear that the competition could access this information and obtain undue benefits. Knott et al. explained TEI's fear that tax return information coupled with advertising expenses would give competitors too much information about a company's marketing strategies and cost structure.

Some argue for a different confidentiality rule for individuals and corporations. According to Knott et al., corporations are a "legal fiction." Privacy is a central pillar of a voluntary self-assessed system. Without the assurance of confidentiality, taxpayers would be reluctant to

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<sup>633</sup>Gary A McGill & Edmund Outslay, "Did Enron Pay Taxes?: Using Accounting Information to Decipher Tax Status" (2002) Tax Notes (Special Report) 1125 at 1136.

<sup>634</sup> Knott & Rosenfeld (part two), *supra* note 546.

disclose their complete financial positions. According to the authors, confidentiality arguments are compelling when it comes to individual taxpayers, but much less persuasive when applied to publicly traded corporations.<sup>635</sup> Knott et al. argue that it is very hard to present a compelling case that corporations are entitled to the same privacy protection as individuals.<sup>636</sup> Some scholars do not agree with the confidentiality argument since most information spreads rapidly in the digital world. Some academics such as Desai contend that tax returns compromise nothing about proprietary material not already available to the public:

Given the other means available to preserve the integrity of ideas from abuse by competitors (including patents; most obviously), it is somewhat unclear why confidential tax returns are required for this purpose. More generally, it is not clear what proprietary ideas would become accessible by competitors through the public disclosure of tax returns that is not already available, or should be available, through public financial statements.<sup>637</sup>

From the above discussion, it is clear that full disclosure may not achieve the desired benefits of book–tax income alignment and will not reduce the complexity of the tax system, and regulators will still need to enact rules and regulations to control tax sheltering activities.

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<sup>635</sup> Knott & Rosenfeld (part two), *supra* note 546.

<sup>636</sup> Knott & Rosenfeld (part two), *supra* note 546.

<sup>637</sup> Desai, *supra* note 309 at 23.

### 4.3 Why Greater Disclosure Can Be Effective

The detailed disclosure of material corporate transactions that may be arising from tax shelters can improve the transparency of a taxpayer's book–tax differences. A uniform format of disclosure will improve consistency across taxpayers and over time periods, thereby improving the effectiveness and efficiency of the CRA's audits and assessments. The additional disclosure will enable the CRA to identify tax-aggressive transactions and allow it to de-emphasize low-risk tax returns.<sup>638</sup>

The US Treasury and SEC do not favour publication of tax returns, pointing to their detail, complexity, and the fact that competitors could potentially use them. However, there may be a consensus that the book–tax reconciliation information already required of taxpayers should be improved and perhaps publicly disclosed.<sup>639</sup> In a letter sent to Senate Finance Committee Chair Charles E. Grassley, Treasury Secretary Paul H. O'Neill asked for more transparency through Schedule M-1:

We believe that there may be other alternatives to explore that might improve both the tax and financial reporting systems without unnecessarily infringing upon taxpayer privacy or undermining tax compliance efforts, for example, eliminating some of the myriad differences between book and tax accounting would go a long way toward demystifying both corporate financial statements and the book/tax reconciliation on Schedule M-1 of corporate returns. In addition, we are taking a hard look at ways in which corporate tax returns could be made more transparent, through changes to Schedule M-1 and otherwise. Such transparency would seem to be a necessary first step before considering disclosure of that information—otherwise the incentive to manipulate the

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<sup>638</sup> These points are taken from Michael P. Donohoe & Gary A. McGill, "The Effects of Increased Book-Tax Difference Tax Return Disclosures on Firm Valuation and Behavior" (2011) 33:2 J of American Taxation Assoc 35.

<sup>639</sup> Knott & Rosenfeld, *supra* note 253.



tax numbers will be increased. Changes may also be appropriate to the tax footnote in the information provided to the SEC on Form 10-K.<sup>640</sup>

Grassley asked the government about the inadequacy of the current tax footnote disclosure and asked for more information about the taxes paid in the footnote disclosure.<sup>641</sup> According to Hanlon et al., it is likely that increased disclosures about the difference between book income and taxable income will provide additional information that is useful to investors and other stakeholders.<sup>642</sup> The President's framework for business tax reform suggested that there should be more transparency by including greater disclosure of annual corporate income tax payments.<sup>643</sup>

Stakeholders may only be interested in knowing summary or limited information from a tax return. In this context, more disclosure may be better than full disclosure. According to Lenter et al., the current system fails to disclose some vital information to investors. Therefore, it may be a good idea to increase disclosure, and there is no constitutional obstacle for disclosing such limited information to the public on the grounds that it would offer social benefits:

The case for considering limited public disclosure of corporate tax return information rests on the fact that it would contribute to the transparency of the tax system by clarifying the tax payments of corporations in and of themselves, relative to other corporations, and relative to the income they report on their financial statements. Tax information on financial statements does not currently reveal tax liability in most cases. By definition, increasing disclosure means that some information that is now private becomes public. We believe there is no constitutional obstacle to forgoing the privacy of this information, and so the case must be made on the basis of whether there are overriding societal benefits. We find this case to be compelling enough that we look forward to the next step of

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<sup>640</sup> *Supra* note 371.

<sup>641</sup> Knott & Rosenfeld (part two), *supra* note 546 at 1068.

<sup>642</sup> Hanlon et al, *supra* note 153.

<sup>643</sup> US, A Joint Report by the White House and the Department of the Treasury, *The President's Framework for Business Tax Reform*, (2012), online: <<https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-Report-Business-Tax-Reform-2012.pdf>>.

considering the best form of disclosure and the details of its implementation.<sup>644</sup>

## 4.4 The US Approach

The Securities Exchange Act of 1934 created the SEC and vested it with the authority to set and oversee financial reporting standards. In 1973, the SEC decided to keep the standard setting in the private sector and created the Financial Accounting Standard Board (FASB). Both the SEC and the American Institute of Certified Public Accountants (AICPA) have recognized guidance issued by FASB as authoritative. Since then, the SEC has delegated responsibility for setting the rules of financial accounting to the private sector—namely, the AICPA, FASB, and the Public Company Accounting Oversight Board (PCAOB), the latter of which was created by Congress in 2002—under the assumption that business and accounting experts have greater “expertise, energy and resources” than the federal government when it comes to assessing US business transactions.<sup>645</sup> Although the Sarbanes-Oxley Act of 2002 established the PCAOB and specified additional requirements for auditor independence, it confirmed, rather than altered, the FASB’s authority to establish GAAP.<sup>646</sup>

According to § 446 of the US Tax Code, “taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.”<sup>647</sup> This suggests that taxable income from business cannot be determined

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<sup>644</sup> *Supra* note 630 at 827.

<sup>645</sup> Whitaker, *supra* note 70 at 687.

<sup>646</sup> Knott & Rosenfeld, *supra* note 253.

<sup>647</sup> IRC, § 446, (LII).

without reference to GAAP.<sup>648</sup> The taxpayer is free to use any method of accounting provided that it reflects his/her/its accounting income. According to Porcano and Tran:

It appears that the US Congress did not want to develop tax accounting methods. Instead, it assigned this responsibility to tax administrators, the Internal Revenue Service (IRS). The US Congress did not define what is a clear reflection of income. It did state, however, that income measurement would be subject to any subsequent Treasury Regulations. Thus, financial accounting rules were adopted for tax purposes subject to the regulation of the US Treasury.<sup>649</sup>

From 1920 to 1960, GAAP income was considered the superior measure of income. However, starting in the 1960s, reliance on GAAP for tax purposes began to decrease. In 1970, the US President's Task Force on Business Taxation showed concern over divergence and recommended more conformity. The Treasury and IRS were moving toward conformity, but the AICPA favoured conformity between financial and tax accounting while opposing any mandatory financial statement eligibility test. The AICPA's concern was that this type of requirement would negatively impact the formation of accounting principles.<sup>650</sup> Accounting principles might start to favour tax-saving methods. Apparently, the AICPA did not want the government to determine GAAP. Any accounting method (cash, accrual, or hybrid) is allowed in the code provided that this method "clearly reflects income."<sup>651</sup> Arguably, GAAP and accounting for tax purposes lost its cache in 1979 with the *Thor Power* case when it was decided that the decision of finding the best method is upon the government, and IRS can reject any method used by the taxpayer based on the income test.<sup>652</sup>

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<sup>648</sup> Porcano & Tran, *supra* note 203.

<sup>649</sup> Porcano & Tran, *supra* note 203 at 433.

<sup>650</sup> Porcano & Tran, *supra* note 203, [paraphrased]

<sup>651</sup> IRC, § 446 (b), (LII).

<sup>652</sup> Porcano & Tran, *supra* note 203.

The IRS introduced Schedule M-3 in 2004. This schedule is used to reconcile a corporation's financial statement income and taxable income. Schedule M-3 is a redesign of the 40-year-old Schedule M-1. The M-3 divides corporate income and deductions into several categories and requires the taxpayer to reconcile the amount in each category for tax purposes with the comparable amount attributable to that category in the financial statements. This schedule contains more than 90-line items detailing components of book-tax differences.

The objective of Schedule M-3 is to make differences between book income and taxable income more transparent.<sup>653</sup> Aggressive tax planning can increase organizational complexity, thereby resulting in less financial transparency.<sup>654</sup> The focus of the M-3 on book-tax differences suggests that such amounts (book-tax difference) can provide valuable information to the tax authorities about firms' tax positions and thereby increase the taxpayer's financial transparency.<sup>655</sup> This schedule enables more consistent reporting of book-tax differences and makes certain book-tax items easier for the IRS to scrutinize.<sup>656</sup> With the help of this schedule, the IRS can perform risk analysis more quickly and accurately, saving tax audit resources.<sup>657</sup> The primary purpose of this schedule is to achieve greater transparency of corporate transactions and help tax authorities to analyze returns more efficiently. The US Treasury expects that the IRS

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<sup>653</sup> Maurizio Bovi, "Book-Tax Gap. An Income Horse Race" 92005), Institute for Studies and Economic Analyses (ISAE), Working paper no. 61.

<sup>654</sup> Karthik Balakrishnan, Jennifer Blouin & Wayne Guay, "Does Tax Aggressiveness Reduce Financial Reporting Transparency?" (2019) 94:1 The Accounting Rev 45.

<sup>655</sup> *Supra* note 638.

<sup>656</sup> Allison Rosier, "Schedule M-3 is here for partnerships: How will it affect your funds?" (2006) 2:3 PwC Alternatives.

<sup>657</sup> Charles Boynton & William Wilson, "A Review of Schedule M-3: The Internal Revenue Service's New Book-Tax Reconciliation Tool" (2006) Institute of Petroleum Accounting, University of North Taxes at 3.

will be able to reduce its audit review cycle time.<sup>658</sup> Any entity that reports total assets equal to or greater than \$10 million at the end of a taxation year would be required to file a Schedule M-3.<sup>659</sup>

According to Donohoe and McGill, Schedule M-3 constitutes one of the most important new sources of information for the US Treasury and the IRS in the last 40 years.<sup>660</sup> They also cite FASB member Katherine Schipper as saying that this schedule has provided a far more detailed and effective roadmap than any other disclosure. If adopted in Canada, such a schedule could provide additional, consistent disclosure that would increase the effectiveness of CRA audits.

## **4.5 Greater Transparency with a Proposed New Canadian Schedule**

I am proposing a new and consistent disclosure in the form of an additional schedule that would be mandatory for all corporations. The proposed schedule would be similar to Schedule M-3 used in the US. It would offer information beyond what is currently reported in Schedule 1 (Net Income (Loss) for Income Tax Purposes) to reconcile between financial statement income and taxable income. This new schedule could be required only for companies with assets exceeding \$10 million.

Schedule M-3 is an attempt to identify book–tax differences and a more efficient way to assess the causes of the book–tax income gap and whether they are produced by temporary or permanent differences. I am recommending that the CRA introduce a similar new schedule of book–tax income reconciliation in Canada. Such a form should provide information to the CRA regarding transactions or practices responsible for the divergent gap between book income and

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<sup>658</sup> *Supra* note 362.

<sup>659</sup> US, Internal Revenue Service, Cat. No. 38103Y, “Instructions for Schedule M-3 (Form 1120)” (19 November 2018).

<sup>660</sup> *Supra* note 638.

taxable income. It will be cross-referenced from the taxpayer's financial statements to the taxpayer's income tax return.<sup>661</sup>

This new schedule should be mandatory for all companies with assets of \$10 million or more—similar to the threshold for Schedule M-3. My quantitative analysis of book–tax differences shows that book–tax income gaps are more significant for companies with more than \$10 million in assets. This new schedule can be tailored to Canadian needs and need not be as detailed as the M-3.

The existing Schedule 1 (Net Income (Loss) for Income Tax Purposes) that is part of the corporate income tax return (T2) currently provides a reconciliation between the corporation's net income (loss) as reported on the financial statements and its net income (loss) for tax purposes. The primary purpose of this schedule is to calculate net income (loss) for income tax purposes. However, the CRA cannot adequately evaluate the compliance risks or tax aggressiveness because the schedule provides insufficient information about the book–tax income gap. The primary purpose of the new M-3 form is to provide more disclosure about components of book–tax differences. Increased transparency always has a deterrent effect on abusive tax sheltering and leads toward improved tax compliance.

Unlike the US, the Canadian schedule need not report retroactively for the past 5 years. Income can be broken down into domestic income and foreign income only. As in Part II of Schedule M-3, the differences between book income and tax income can be categorized into temporary and permanent. This section could contain fields for interest income, accrual of cash

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<sup>661</sup> Charles E Boynton et al. "Schedule M-3 Profiles of Schedule UTP Filers by IRC Section Cited" *Tax Notes* (October 12, 2015) 249.

adjustment, hedging transactions, mark-to-market income, cost of goods sold, sale versus lease, unearned and deferred revenue, income recognized from long-term contracts, imputed interest, and gain and loss on the disposal of capital assets.

This new schedule could also include “reportable transactions” that deal with aggressive tax avoidance.<sup>662</sup> The six categories of reportable transactions currently required to be disclosed include listed (tax avoidance) transactions, confidential transactions (for which at least \$250,000 of advice fees were paid), transactions with contractual protection (if tax benefits do not materialize), loss transactions exceeding \$10 million per year for corporations, transactions with significant (greater than \$10 million) book–tax difference, and transactions generating a tax credit of \$250,000 or more with an asset holding period of 45 days or less.<sup>663</sup> When taxpayers highlight their own questionable position for the government, tax compliance can improve, and tax uncertainty for taxpayers can be reduced.<sup>664</sup>

Table 3 below describes some of the transactions that corporate taxpayers could be required to summarize in a separate schedule to the CRA every year. These transactions are adapted from the US Schedule M-3. Its usage in the US suggests that it would be politically acceptable in Canada. Such a form could also be regularly updated to incorporate new categories of transactions and remove existing categories of transactions.

The objective of such a form would be to simply allow the CRA to identify taxpayers with these transactions for greater scrutiny and perhaps for more equitable assessments. The

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<sup>662</sup> Canada Revenue Agency, "New Reporting Requirements: Reportable Transactions" (26 June 2013). online: <<http://www.cra-arc.gc.ca/nwsrm/fctshts/2013/m08/fs130830-eng.html>>. CRA has now archived this page.

<sup>663</sup> John O. Everett, Cherie Hennig, & William A. Raabe, “The Schedule M-3 Compliance Maze: Unanswered Questions” *Tax Notes* (March 19, 2007) at 1108.

<sup>664</sup> *Supra* note 626.

values estimated in the temporary and permanent difference columns could allow the CRA to assess whether pursuing such transactions for assessments would be cost beneficial and allow the Ministry of Finance to better estimate future tax revenues in an aggregate sense. It would also allow the CRA, Department of Finance, and academic researchers to better estimate book–tax differences in aggregate and evaluate whether and explain why book–tax income may diverge or converge over time. The form would simplify the CRA’s audit assessments and allow the CRA to more equitably treat all taxpayers reporting similar amounts. Over time, this would reduce taxpayer uncertainty.



**Table 2: Reconciliation of accounting income with taxable income on tax return**

<b>Income (Loss) Items</b>	<b>(a) Income (Loss) per Income Statement</b>	<b>(b) Temporary Differences</b>	<b>(c) Permanent Differences</b>	<b>(d) Income (Loss) per Tax Return</b>
1. Net income (loss) from equity method –domestic corporations				
2. Net income (loss) from equity method –foreign corporations				
3. Listed transactions or “transactions of interest”				
4. Non-routine loss transaction $\geq$ \$3 million not already reported on this schedule				
5. Transactions generating $\geq$ \$5 million book–tax difference				
6. Transactions generating tax credit of $\geq$ \$200,000 with asset holding period of $\leq$ 45 days				
7. Hedging transactions				
8. Mark-to-market income (loss)				
9. Sales versus lease (if categorized differently for accounting and tax purposes)				
10. Unearned or deferred revenue				
11. Income recognition from long-term contracts				
12. Stock option and other equity-based compensation				

## **Selected Explanations for Table 2**

Rows 1 and 2: These two rows would require information on the differences between accounting consolidation and tax consolidation. Both accounting and tax rules require the use of the equity method when the parent company makes a strategic investment in a controlled subsidiary. However, the definition of control is different in accounting and taxation, and these two rows would summarize the impact on accounting income and taxable income.

Row 3: These transactions are defined as a “transaction that the IRS and Treasury Department believe is a transaction that has the potential for tax avoidance or evasion, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction.”<sup>665</sup> The purpose of this line is to get more information about such transactions. For example, it would include basket contracts, in which transactions denominated in derivative contracts are designed to receive a return based on the performance of a basket of referenced securities. Such basket contracts are designed to defer income recognition and convert short-term capital gains or ordinary income (taxed at a higher rate) into long-term capital gains (taxed at a lower rate).<sup>666</sup> Another example in this category would be one in which corporate shareholders transfer their corporate income by purportedly donating a corporation’s nonvoting stock to a tax-exempt organization while retaining the economic benefits of ownership, or one in which corporations claim inappropriate deductions for payments made through a partnership.<sup>667</sup>

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<sup>665</sup> IRS, “Transactions of Interest” (5 December 2017), online: IRS <<https://www.irs.gov/businesses/corporations/transactions-of-interest>>.

<sup>666</sup> *Ibid.*

<sup>667</sup> IRS, “Listed Transactions” (5 December 2017), online: IRS <<https://www.irs.gov/businesses/corporations/listed-transactions>>.

Row 7: This row reports all hedging transactions, with columns (b) and (c) reporting the differences between how such transactions are dealt with for accounting and tax purposes. For example, hedging gains and losses reported using the mark-to-market method for accounting, but realization method for tax purposes would be reported in this row.

Furthermore, this row could ask taxpayers to separately report the amounts of foreign currency hedged on account of capital (to lock in future receivables and other assets or to lock in future liabilities) and the amounts hedged on account of income/expenses (to lock in current year's revenues or expenses), even though the accounting treatment may be similar or different based on other criteria. Canada does not have specific income tax legislation on how foreign-currency gains and losses are taxed and relies on judge-made laws to establish the general principles in this area. Information in Row 7 would simplify the CRA's assessments on whether to allow hedge accounting for tax purposes and in time would also reduce the uncertainty of the tax outcome for taxpayers. For example, in *Saskferco Products Inc. v The Queen*, the TCC did not allow the taxpayer to use hedge accounting on its repayment of the principal amounts of the debt for tax purposes.<sup>668</sup> In the case of *George Weston Limited v The Queen*, the TCC agreed with the company that swap is a legitimate hedge if used to mitigate foreign exchange risk concerning net investments in foreign operations.<sup>669</sup>

Row 8: This row summarizes transactions that use mark-to-market for both accounting and tax purposes and would highlight when different methods were being used for accounting and tax purposes. For example, in *Albert D. Friedberg v The Queen*, the taxpayer reported gains and losses on long and short positions (on gold futures) based on "lower of cost or market" whereby

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<sup>668</sup> *Saskferco Products Inc v The Queen*, 2007 DTC 1183, 2007 TCC 462.

<sup>669</sup> *Supra* note 588.

gains were recognized as income only when sold (or realized), but losses were recognized immediately even if the position was not closed (or realized).<sup>670</sup> This accounting method allowed the taxpayer to close his losing positions and defer gains on his winning positions until after the taxation year-end, thereby deferring income. The Crown argued that mark-to-market accounting was more appropriate, and it required symmetric inclusion (on an annual basis) of both unrealized gains and losses. Expert accounting witnesses testified that while mark-to-market method was considered superior for accounting, the lower-of-cost-or-market method remained acceptable under GAAP and under accepted business practices (of reporting bad news immediately but deferring good news until it is realized).<sup>671</sup> In the case of *Kruger Incorporated v Canada*, the TCC disallowed the use of the mark-to-market method.<sup>672</sup> On appeal, the FCA ruled that the appellant was entitled to compute the income derived from its foreign exchange option contract by the mark-to-market method of accounting.<sup>673</sup>

Information in this row would explicitly carve out any differences between tax and accounting valuation methods that the taxpayer used. It would also carve out the resulting amounts of tax in the middle columns, which are being deferred. By relying on information in this row, the CRA would be able to treat all taxpayers similarly, thereby improving equity and taxpayer certainty.

Row 9: This row summarizes sales and lease transactions that are reported differently for accounting and tax purposes. Canadian courts have accepted that lease classification financial reporting may also be acceptable for tax purposes. For example, in *CCLI Inc. v The Queen*, both

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<sup>670</sup> *Friedberg, supra* note 134.

<sup>671</sup> *Ibid.*

<sup>672</sup> *Kruger Incorporated v The Queen*, 2015 TCC 119.

<sup>673</sup> *Kruger, supra* note 133.

the TCC and FCA agreed with the taxpayer on treating its equipment leases as finance leases and subsequently claiming a CCA on the leased equipment for tax purposes.<sup>674</sup> Sale and lease transactions are often structured by taxpayers to enable one party to the transaction to enjoy favourable CCA deductions, and this row would highlight such transactions. *Canada Trustco Mortgage Co. v Canada* is an example in which the taxpayer entered into a complex arrangement that allowed it to defer paying taxes on the amounts of profits reduced by the CCA deductions.<sup>675</sup> Information reported in this row would allow the CRA to assess such transactions much more readily, thereby reducing the CRA's audit costs and, eventually, taxpayers' uncertainty.

Row 10: Column (a) would summarize revenues that were deferred from a prior financial accounting year, whereas Column (d) would summarize revenues recognized for tax purposes in the current year, but recognized in a different year for accounting purposes. In the case of *Bombardier Inc. v The Queen*, the TCC decided that advanced payment received from the customer net of any corresponding expense should be reflected on the balance sheet and not considered an income or expense for the year.<sup>676</sup> Information in this row would make it easier for the CRA to assess taxpayers like Bombardier and treat all taxpayers in a similar situation equitably. This would reduce the CRA's audit cost as well as reduce taxpayers' uncertainty. The audit would be seen as less of a lottery process and more of a certainty.

Row 11: This row would highlight the income or loss (for both accounting and tax) on contracts accounted for under a long-term contract method of accounting. In *The Queen v Bombardier Inc.*, the FCA accepted the taxpayer's argument that the use of the percentage-of-completion method for its long-term construction contracts was in accordance with GAAP. The court ruled

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<sup>674</sup> *Supra* note 204; 2007 FCA 185.

<sup>675</sup> *Supra* note 207.

<sup>676</sup> *Supra* note 142.

that accepting the Minister’s argument “amounts to allowing the transaction’s legal reality to prevail over its GAAP-required commercial reality and to eliminating the effects of the percentage-of-completion accounting method legitimately used by the respondent in keeping with GAAP.”<sup>677</sup> The tax court reached the same conclusion in *CDSL Canada Limited et al. v The Queen* where it accepted the use of the percentage-of-completion method for both accounting and tax purposes.<sup>678</sup>

Row 12: This row summarizes transactions that deal with employee stock options and other equity-based compensation that may rely on Black-Scholes or other valuation techniques for financial accounting purposes and a different realization-based method for tax purposes. The financial accounting valuation may be based on the vesting schedule of the equity-based compensation, whereas the tax expense may likely depend on whether the payout to the employee was made in cash or stock.

This type of large-scale policy and reporting change requires an extensive set of transition rules.<sup>679</sup> This schedule will initially increase compliance costs for taxpayers and tax audit costs for the CRA, but both would likely level off after a transition period.<sup>680</sup> It is estimated that taxpayers’ compliance burden will increase by at least 85 hours to complete this form, but that time will decline substantially after the transition period.<sup>681</sup> US scholars have estimated that the new M-3 form reduced net taxpayer burden over the long term because taxpayers’ audit costs

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<sup>677</sup> *Supra* note 142.

<sup>678</sup> *CDSL*, *supra* note 12.

<sup>679</sup> Hanlon & Maydew, *supra* note 278.

<sup>680</sup> Ilya A Lipin, “Failing Corporate Tax Transparency and the Immediate need to reduce overburdening duplicative tax reporting requirements” (2012) 27:119 *Akron Tax J* 119.

<sup>681</sup> *Ibid.*

went down and taxpayer certainty increased.<sup>682</sup> As almost all corporate tax returns are filed using software, these new schedules will be easily accommodated. The one-time costs will likely be primarily borne by software development companies at a small incremental cost to taxpayers. Greater certainty for taxpayers would eventually translate into lower compliance costs for taxpayers. The CRA can more effectively and more efficiently use its resources by focusing the scope of its audit on more risky transactions identified by this form.

Taxpayers would, of course, fear that detailed disclosures may lead to a decline in the use of viable tax-planning opportunities, resulting in higher tax burdens in the future.<sup>683</sup> Studies suggest that, on average, firms save \$4 for every \$1 invested in tax planning.<sup>684</sup>

To reap the full advantage of this new form, the CRA may also want to establish a separate Office of Tax Shelter Analysis, similar to what the IRS did in the late 1990s. This office can monitor and analyze the new schedule with audit resources focused on taxpayers with a higher number of questionable transactions. It could publish a list of “transactions of interest” which it could communicate pre-emptively to the taxpayers so that taxpayers could be warned for audit purposes. Such a list could be updated every few years.

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<sup>682</sup> *Supra* note 657 at 3.

<sup>683</sup> *Supra* note 638.

<sup>684</sup> *Supra* note 638

## 5 Summary and Conclusion

Accounting income can play a more significant role in determining taxable income, and thereby help narrow the gap between tax law and accounting. There are two major types of gaps between taxable income for tax purposes and accounting income as calculated under. The first one is a conceptual gap in computing income or profit. Case law and section 9 of the *Income Tax Act (ITA)* are often different from accounting principles used to calculate income. Examples of the conceptual gap include differences between accounting measurement principles and tax statutory provisions in areas such as hedging, mark-to-market, and the percentage-of-completion method for revenue recognition. Principles for measuring accounting income rely more on accrual methods, whereas statutory tax provisions and case law rely more on the realization principle. The realization principle requires cash flows to be received before income taxes can be imposed on the underlying net income since cash is necessary to fulfill tax obligations. This realization principle is a foundational principle embedded in tax law, and judges often refer to it as a tax law principle.

Chapter 2 discussed how this conceptual gap in computing profit may be narrowing over time as recent case law incorporates more accounting rules in determining income for tax purposes. Examples of applications of the matching principle or accrual accounting can be found in areas such as hedging, mark-to-market, and percentage-of-completion.

The second type of gap is the book–tax gap in computing taxable income. This type of gap, which arises due to policy-based deductions, including Division C deductions, which may allow more (or less) generous deductions or write-offs (e.g., capital cost allowances) during periods of low (or high) economic growth. Aggressive tax planning has also led to a growth in the book–



tax/tax–book gap. The gap seems to be diverging or growing over time and may be difficult to fix even if fixing only some of it may be desirable.

Tax authorities would and should be reluctant to give up their key policy lever of offering CCAs, for example, that are different from accounting depreciation rates under GAAP. Any gap resulting from these dual measurement methods may not necessarily be a concern that can be feasibly fixed. Chapter 3 offered some empirical evidence of this gap found in the literature and in primary data analysis conducted for this dissertation.

After describing the two types of gap, Chapter 3 explored reasons why the conceptual gap (the first type of gap) should be narrowed, the problems in narrowing the gap, and the issues arising if the gap is not narrowed. The exploration was motivated by the ideal notion of income and how the Carter Commission envisioned an ideal tax base. Carter described economic income as being closer to reflecting a taxpayer's ability to pay income taxes. I argued that accounting income is closer to the notion of Carter's ideal taxable base or economic income than any current notion of income determined by the statutory provisions and case law.

Chapter 3 proposes specific ways of narrowing the gap by outlining how recent statutory provisions, such as paragraph 12(1) (a) and 20(1) (m), better reflect accounting conventions and how these provisions may narrow the conceptual gap. Court cases are analyzed to illustrate how judges are recognizing the merit of the accountants' matching principle in a wide range of areas such as hedging, employee stock options, and the percentage-of-completion method.

Chapter 4 discusses the reasons why the book–tax gap (the second type of gap) should be narrowed, the problems encountered in narrowing the gap, and the issues arising if the gap is not narrowed. Since book–tax gap is driven by policy-based deductions, I argued that it is more

difficult to legislatively eliminate because policy makers cannot be expected to give up their tax policy tools when they are trying to drive economic growth.

This book–tax gap is also driven by taxpayers’ aggressive tax planning. I argue for some disclosure about the book–tax gap, which, if consistently required and enforced, may shed some light on taxpayers’ aggressive tax-planning behaviour. This will be useful to stakeholders, such as tax authorities, policy makers, employee groups, and groups advocating for corporate sustainability reporting (CSR). If carefully evaluated, such disclosure may also shed light on the ETRs imposed on corporate income, which could contribute to the societal debate on horizontal and vertical tax equity.

Currently, corporations may be able to truthfully claim that they pay the very last cent in taxes that they owe under tax legislation without shedding any light on how much in taxes they actually pay. The latter is not disclosed based on the grounds that such disclosure by corporate taxpayers would impair their strategic or competitive advantages. However, such lack of disclosure may actually be holding back the societal debate on horizontal and vertical tax equity.

The counterargument is that there may not be any need for more universal accounting disclosure since the CRA can always ask for more disclosure from relevant taxpayers. However, seeking such additional disclosure on a case-by-case basis can be costly and cumbersome given the CRA’s limited audit resources and can lead to greater tax litigation brought about by both taxpayers and tax authorities. While there is no large-scale empirical evidence in this area, greater disclosure consistently applied can curb some tax-aggressive transactions as well as tax litigation.

This dissertation has examined whether some of the accounting principles and conventions used can be relied upon more explicitly in determining or assessing taxable incomes. If feasible, it could improve the conformity between accounting income and taxable income and reduce the gap between accounting income and taxable income. Understanding and incorporating select accounting conventions in assessing taxpayers' returns may allow tax authorities to be more effective and more efficient. Such an alignment would be implemented only in certain areas where accounting standards are more developed and more uniformly accepted without much debate. The alignment would also be restricted to areas where the courts have experienced difficulty in coming up with one acceptable legal principle due to the lack of any statutory provision. This is manifested in disagreements across levels of courts for the same set of facts and circumstances.

With all the differences in reporting objectives and measurement methods, accounting income forms the starting point for determining taxable income for most taxpayers, suggesting that much of accountants' use of consistency and matching principle flows through to legal measure of taxable income. Taxpayers do not keep two sets of books—one for financial reporting to capital market stakeholders and one for determining taxable income for the tax authorities. Thus, many of the principles for measuring accounting income, e.g., conservatism, materiality, and cost–benefit analysis, usually flow down to the measurement of taxable income.

However, the legal concept of deducting expenses in the period in which they were incurred continues to be a strong contender for determining taxable income and usually supersedes the matching principle when convenient for the taxpayer. Furthermore, tax policy researchers have their own set of criteria for what should be deductible for tax purposes, and this differs somewhat from the matching principle.

In its 1998 decision in *Canderel*, the Supreme Court of Canada characterized accounting income as part of “well-accepted business principles,” thereby offering support for accounting income as a starting point in determining the taxable base. The Supreme Court seemed to allow taxpayers to consider accounting income as an option in that they could use it as a starting point to compute taxable income but were not necessarily obliged to use it since “generally accepted accounting principles (GAAP) are not rules of law but interpretive aids.”<sup>685</sup>

The *Canderel* decision has been used by taxpayers to justify relying on accounting principles when those principles result in lower taxes compared with some of the vaguely defined statutory provisions of the *ITA*. In many disputes before the courts, accounting principles or “well-accepted business principles” can and do offer insights that can determine whether the taxable incomes reported by such taxpayers are appropriate. Courts generally give due weight to the expert evidence of accountants, but they do not feel obliged to act on the advice of an accountant. At the same time, the courts now recognize the problem of second-guessing accounting practice: “If we reject the statements of approved accountancy practice, then where are we to look for the criterion?”<sup>686</sup>

More specifically, we can enact the accounting classification and valuation of derivatives and the revenue recognition from the long-term contract in the Act. In these limited areas, there are opportunities to legislate conformity between taxable income and accounting income in Canada to reduce tax compliance costs, court disputes, and uncertainty. The federal government has already introduced an elective mark-to-market regime for derivatives held on income

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<sup>685</sup> *Canderel*, *supra* note 8.

<sup>686</sup> Macdonald, *supra* note 31 at 37.

account. This elective regime will allow taxpayers to mark-to-market all of their eligible derivatives.

The recommendation of this thesis is not to incorporate IFRS or other GAAP as a whole into the *ITA* but instead to formally accept certain specific areas of accounting (such as hedging, mark-to-market accounting, and the percentage-of-completion method) in tax administrative practice because the courts have already recognized the enduring nature of such accounting conventions and accepted them as appropriate for computing taxable income. Until the courts rule otherwise, the CRA's assessment practice and taxpayers' compliance burden and taxpayer certainty could be enhanced by recognizing such accounting conventions in the tax administration process.

While legislative acceptance of accounting standards to calculate taxable income is neither practically nor politically feasible, the time may be right for increased and consistent disclosure of book-tax differences in a separate schedule. Such a measure may mitigate the diverging book-tax gap without requiring drastic changes to existing accounting and taxation systems.

I therefore recommend required disclosure of a new form that reconciles tax income and book income for all large corporate taxpayers. Consistent and uniform disclosure would help investors and creditors and allow the CRA to much more effectively and efficiently audit unusual transactions. While the initial compliance cost to complete this new disclosure may be high, it is not expected to remain high as new software is developed and learning by the tax community evolves. A corresponding Office of Tax Shelter Analysis would further help the CRA in its audit capabilities.

This study contributes to the literature by exploring economic, accounting, and legal definitions of income in a setting with new, updated transactions. It deconstructs the book–tax gap into two components and discusses issues and solutions for narrowing the gap. It empirically estimates the gap between accounting income and taxable income, and the reasons for their divergence in recent years. The study recommends enactment of specific areas of accounting into the *ITA* and more disclosure of the differences between book income and tax income. In an interesting example of fortuitous timing (and no doubt an inadvertent and unintended endorsement), while I was writing my thesis, the federal government of Canada actually introduced an elective mark-to-market regime for the derivatives, which is one of my recommendation.

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