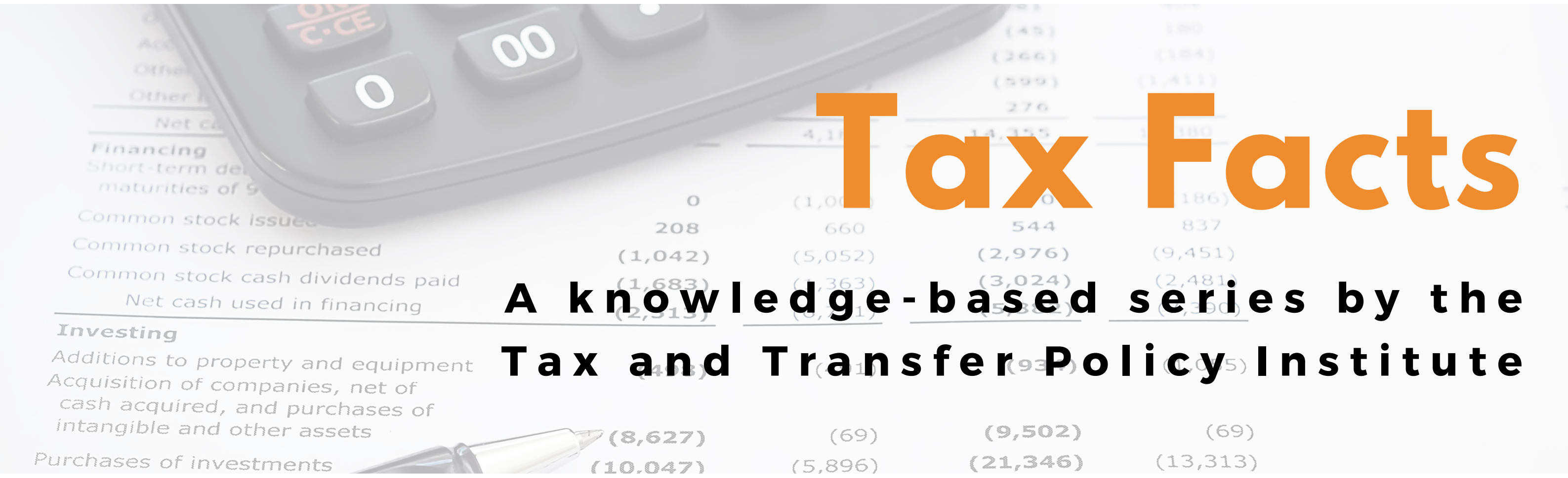

Tax Facts

A knowledge-based series by the Tax and Transfer Policy Institute

Why do accounting and tax concepts differ?

Accounting and taxation concepts are not always aligned. Accounting involves the preparation of information for the purposes of decision-making (and profit-maximisation) by management, owners, creditors and investors. By contrast, the main purpose of taxation is to raise revenue.

How are these concepts different? Why do they differ? Are these differences similar internationally? And what are some of the implications of the differences?

Why do accounting and tax concepts differ?

Since tax and accounting systems have distinct objectives, differences between the two systems have emerged over time. These differences usually emerge from disparities between the two systems' revenue and expense recognition principles. They also tend to fall into two categories: temporary and permanent differences. Permanent differences are revenue or expenditure items that are recognised by accounting rules, but not tax rules, and vice versa. For example, tax concessions for research and development -- where the taxpayer receives a deduction that exceeds actual expenditure -- are only recognised by the tax system. Temporary differences arise when the amount of the revenue or expense is recognised by both accounting and tax standards, but in different reporting periods.

- **Permanent differences:** entertainment expenses, R&D expenditure, goodwill/intangibles, specific industry/sector incentives (small business corporate tax discount), penalties/fines
- **Temporary differences:** depreciation of plant and property, doubtful debts, employee entitlements such as annual leave and long service leave, revenue or expenses received or paid in advance, financial instruments, transfer pricing (including thin capitalisation)

What are the origins of the disparity?

Originally under the Income Tax Assessment Act 1922 (Cth) or the Income Tax Assessment Act 1936 (Cth), there was little to no difference between the taxable and accounting income of an enterprise. However, since the early 1940s, a significant divergence has arisen between financial accounting rules and taxation laws. The divergence stems from an expansion of the Australian income tax law from its initial focus on the narrowly defined concept of "ordinary income" to the inclusion of virtually all realised gains and losses of a non-private nature. Some of the notable tax base broadening reforms that contributed to the divergence in income definitions included:

- the introduction of Fringe Benefits Tax (1986) according to which employers pay taxes on the taxable value of specific benefits provided to employees, including certain travel and entertainment [see our Tax Fact #24, "What is fringe benefits tax?"];
- the inclusion in the corporate income tax base of capital gains (1985–86), income from the life insurance industry, income from the gold mining industry (1990–91) and foreign source income;
- replacement of accelerated depreciation with a regime based on effective life (1999–2000);
- the removal of the general investment allowance (1988–89); and
- the removal of the inter-corporate dividend rebate (1999–2000) with the effect that companies now pay taxes on the unfranked portion of dividends received from domestic companies.

Accounting standards evolved differently. Accounting standards in Australia were initially developed by professional accounting bodies and were enforceable under their codes of ethics. From 1966, the professional bodies jointly operated the Australian Accounting Research Foundation (AARF), which ultimately encompassed both the Accounting Standards Board (AcSB) and the Public Sector Accounting Standards Board (PSASB). At the start of 1984, the Accounting Standards Review Board (ASRB) was established by the Ministerial Council for Companies and Securities to review the standards produced by the profession and give them the force of company law. The ASRB was re-established under the Australian Securities Commission Act 1989 and in 1991 was renamed the Australian Accounting Standards Board (AASB) with the AASB's standards applying under the Corporations Law.

Are international approaches similar?

Historically, most jurisdictions have set their own accounting standards as well as tax policy, but this pattern has shifted since the introduction and adoption of International Financial Reporting Standards (IFRS). Broadly, the link between tax and accounting in the United Kingdom and European countries has historically been strong, but has been eroded since the adoption of IFRS to allow greater flexibility for domestic policy makers in relation to taxation policy. Some European countries such as Germany have chosen to maintain strong links between domestic accounting standards and tax law, but have chosen not to adopt IFRS. In contrast, jurisdictions such as the United States and New Zealand have historically had weaker links between accounting and tax principles, but have sought to make linkages between the two systems where possible and where the benefits outweigh the costs.

What are some of the implications of the definitional differences?

One implication of the existence of two concepts is public difficulty understanding them. In some cases, companies may have large accounting profits, but pay no corporate tax. Companies may not pay any income tax for several reasons, all of which are legitimate under tax law. Qantas, for example, made a $1.4 billion dollar accounting profit in 2017 and paid no income tax in that year [2]. Under Australian tax law, Qantas was able to claim deductions on their taxable income due to making losses of $2.8 billion in 2013 [3]. As the two concepts are not comparable, it is perfectly legitimate for a disparity to exist between accounting and taxable income. However, a lack of understanding of the differences can lead to confusion or resentment, particularly among the public.

Another implication of the two systems is the difficulty of international comparisons. No truly unified accounting system exists globally, and as previously mentioned, there are significant variations in standards across countries [4]. Similarly, business taxation is different in each country [5]. As a result, international corporations are forced to examine both the taxation rules and accounting practices of each country. The impacts of double taxation must also be evaluated under a worldwide taxation approach. All of these factors must be considered when comparing the application of taxation and accounting principles internationally.

The complications associated with international accounting and taxation applications makes way for a third challenge: the increased ability of multinational enterprises (MNEs) to exploit accounting and tax differences to their advantage to minimise tax. MNEs, with international taxation and accounting expertise, are able to exploit cross-country differences and devise complex strategies to minimise tax [6]. These international accounting and tax strategies can give multinationals an unfair advantage over solely domestic firms. The Australian Tax Avoidance Taskforce (established via Australian Taxation Office funding) is cracking down on these practices through the implementation of a 'diverted Profits Tax', and new 'anti-hybrid' rules.

TTPI appreciates the research assistance provided by Haydn Daw and Saša Vanek for the preparation of this Tax Fact. This Tax Fact drew heavily on the TTPI working paper, authored by Haydn Daw, and referenced below [1].

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Contact the director at robert.breunig@anu.edu.au | Contact us at tax.policy@anu.edu.au
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