THE TIMING OF INCOME RECOGNITION IN TAX LAW AND THE TIME VALUE OF MONEY, by Moshe Shekel

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How governments should tax corporations has been fiercely debated for centuries, with the most controversial topics being the aggregate levels of tax collections and the types of tax incentives granted to corporations intended to spur certain corporate activities. In addition, there are two less-debated, though not less important, questions about recognition of taxable income: (i) when should companies pay taxes if the tax-accruing activities are not contemporaneous with the related cash flows, and (ii) how to account, if at all, for time value differences between the tax-accruing activities and the related cash flows. The answers to these questions have the potential to affect aggregate levels of tax collections in a given year as well as perceptions of fair tax collections.

Moshe Shekel's book endeavors to comprehensively answer the above questions. The book explores tax laws and practices in the United States, the United Kingdom, and Israel, and compares the timing of taxable income recognition across these jurisdictions. Given shortcomings in each jurisdiction, the book proposes alternative methods of income recognition that would better conform to widely accepted tax principles than the current practices do.

In spite of the complexity of this task, Dr. Shekel does an excellent job of orderly presenting discussions of these topics. After a brief introduction in Chapter 1, Chapter 2 provides a general background on accrual-based accounting (GAAP), describes revenue and expense recognition principles, and shows how GAAP treats timing differences between the economic activity and cash flows for cases such as deposits, advances, provisions, and contingent liabilities. These principles, which are similar in U.S. GAAP and IFRS, require that income (i.e., revenues net of expenses) be reported in nominal terms during the period it is earned (the related economic activity occurs). That is, the primary objective of GAAP is to report economic activity, irrespective of associated cash flows.

Chapter 3 explains that tax laws are aimed at maximizing tax collections to fund public expenditures. Furthermore, taxation must conform to principles like non-erosion of capital, tax equity (equitable tax collection), tax neutrality (indifference to mechanics of a transaction), tax certainty (existence of clear legislation), efficiency, and prevention of unjust tax advantages, among others. GAAP is silent with regard to these goals and principles.

In Chapter 4, the book examines differences between the tax laws and GAAP of the three countries. For each country, Dr. Shekel first explains the current legislation and doctrines the current legislation draws upon, then follows with a discussion of case law providing examples. Then, he explores the directives of tax authorities. Finally, he provides the positions of academics as well as his own.

The ensuing three chapters discuss in detail specific items that cause timing differences between income recognition and cash flows in the three countries. Chapter 5 discusses deposits from

customers, Chapter 6 deals with advances from customers, and Chapter 7 considers future expenses incurred by companies.

The book presents the UK tax system as the most consistent of the three because of its strict adherence to GAAP subject to (rarely applied) statutory exceptions. This ‘singular doctrine’ (and the ‘consistent approach’ that derives from it) has great advantages in terms of uniformity, certainty, and convenience. However, this system does not take into account the time value of money, providing unjust tax advantages for those companies exploiting this deficiency. Accordingly, it likely reduces aggregate levels of tax collections.

In contrast, the U.S. and the Israeli tax systems are based on application of the ‘dualistic doctrine,’ which suggests that the objectives of tax and financial accounting differ so much that tax rules should only be consistent with tax values and should not seek conformity with GAAP. Therefore, both countries allow companies flexibility as to the tax reporting method, i.e., accrual basis or cash basis. Furthermore, both systems grant the tax authority and the courts maximum flexibility in defining taxable income on a case-by-case basis to prevent erosion of tax income. For instance, IRC 446a, which states—in the broadest terms—that corporate tax reporting has to ‘clearly reflect income’ is frequently called upon by the courts or IRS in the U.S. to justify deviation from GAAP principles of revenue and expense recognition.

Throughout these chapters, the book successfully argues that applications of the dualistic doctrine in the U.S. and Israel are flawed. This is due to lack of a coherent and efficient method for measuring income, and increased reliance on ad hoc rulings and applications. Sometimes, cases that are very similar economically are treated differently for tax purposes.

In Chapter 8 two alternative methods that ‘would use the best of both doctrines’ are suggested. The two methods use GAAP as the basis and adjust taxable earnings to recognize the time value of cash flows. The first alternative, the Comparative Value Taxation (CVT) model, recognizes income components (both revenue and expenses) on the date of economic activity or cash flows, whichever is earlier; however, the amount of recognition will be based on only the profit component of the transaction if the economic activity appears earlier. The second alternative, the Saving of Financing Costs (SFC) model, accepts GAAP as given, and only deviates from GAAP by taxing the economic value that arises, if any, because of the timing mismatch between the economic activity and the related cash flows. This is done by assessing the difference between the agreed interest rate and alternative interest rates on unearned revenues or unpaid liabilities. Chapter 9 concludes with a discussion of the superiority of the proposed methods, especially the SCF model, over existing practice.

The presentation of the SFC model as a novel means of taxable income recognition is convincing. A strict adherence to GAAP, while superior to a cash basis or hybrid approach, ignores the time of money and has the potential to generate unjust tax advantages. With an adjustment to GAAP for the interest benefits/losses of timing mismatches between income and cash flows, the SCF would conform to widely accepted tax principles including tax neutrality and equity.

Whether the SFC model will be adopted, given its theoretical appeal, is another question. The answer is possibly negative because of practical considerations, most of which are recognized by

Dr. Shekel. The primary impediment is inertia. The tax system, which is the result of a political process over years of lawmaking, court decisions, lobbying, and administrative directives, sits on a fine balance. Any attempt to overhaul the system is likely to draw resistance from parties who expect to be affected negatively. In addition, there would be practical difficulties in applying the model for things such as estimating the timing of revenues and expenses related with current cash flows, and quantifying the 'alternative financing' benefits that accrue to the company. Nevertheless, I defer here to the author's argument that '…modern economic life dictates the use of evaluations and assessments' and that this is 'preferable to the alternative of disregarding assessments and evaluations, where doing so would lead to absurd results.' (p. 215)

I also wonder whether a possible implementation of SCF would affect financial reporting itself. The proposed method would clearly bring definitions of taxable income and accounting income closer, i.e. it would increase book-tax conformity. How book-tax conformity affects companies' earnings quality has been on the researchers' agenda for some time.[1] Executives are known to have wide discretion in financial reporting as compared to tax reporting. Furthermore, code law income definitions (where book-tax conformity is high) are less timely, particularly in incorporating economic losses.[2] Therefore, there is a strong possibility that executives would underreport their GAAP income in an effort to pay less taxes, resulting in less informative earnings disclosures for the benefit of the outsiders.

That the analyzed tax regimes are in common law countries takes little away from the generalizability of the arguments, as these countries have advanced economies where questions about taxation are consequential and there is reason to believe tax regimes in other countries face similar problems with recognition of taxable income. Yet, given the international perspective the book takes on, one wonders whether a short comparative overview of income recognition in other countries is warranted.

Overall, the book is a truly scholarly piece about the theory and practice of taxable income recognition. Exploring over 500 court rulings and administrative directives from the three sophisticated tax regimes; systematically discussing the pros and cons of different doctrines and case law; and objectively presenting tax practices while making policy recommendations at the same time are no easy tasks. Thanks to Dr. Shekel, the reader ends up attaining a better grasp of the corporate taxing environments in these countries.

This book will be of interest to many practitioners and academicians at different levels. It certainly will help tax practitioners to know more about the relevant timing rules in these countries. I also see substantial benefit for financial accounting researchers, like myself, who want to say more than just 'GAAP and tax income recognition rules differ.'

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[1] 'A Review of Tax Research' (2009) by Michelle Hanlon and Shane Heitzman.

[2] 'The Effect of International Institutional Factors on Properties of Accounting Earnings' (2000, *Journal of Accounting and Economics*) by Ray Ball, S. P. Kothari, and Ashok Robin.