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Mindy Herzfeld
University of Florida Levin College of Law, herzfeld@law.ufl.edu

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TAXING BOOK PROFITS: NEW PROPOSALS AND 40 YEARS OF CRITIQUES

Mindy Herzfeld

This paper considers recent domestic and international proposals to use financial statement earnings as the basis for imposing additional or minimum taxes on corporate income and to reallocate corporate profits among jurisdictions. It reviews prior research undertaken in the context of previous proposals to partially substitute financial accounts for taxable income and considers how valid critiques of prior proposals are with respect to current initiatives. It concludes by noting that the concerns raised about earlier proposals have neither been fully considered nor addressed in the recent initiatives.

Keywords: minimum tax, excess profits, OECD, GAAP, IFRS

JEL Codes: H25, F55, M48

I. INTRODUCTION

"Book-tax differences have existed for as long as the corporate income tax" (McClelland and Mills, 2007, p. 780). For almost as long, there have been regular efforts to introduce greater conformity between the two. Over the past four decades, proposals have been periodically made to substitute (in whole or in part) a tax base that relies on profit as reported in financial statements for the legislatively enacted corporate tax base. These proposals generally grow out of the presumptions that taxing book income would provide a simpler, fairer, and more efficient way to tax corporate income and provide less opportunity for corporate tax avoidance (Freedman, 2004; Desai, 2005).

Such efforts for parity between book and tax income, or book-tax conformity, have regularly failed to gain traction. Nonetheless, the idea is again rearing its head both in the international and domestic spheres. Two proposals introduced by the Organisation for Economic Co-operation and Development (OECD) for taxing the digitalized economy rely to a greater or lesser extent on a tax base computed from multinationals' consolidated financial accounts (OECD, 2020a, b). In the United States, at least three leading Democratic presidential candidates for the 2020 election proposed a minimum tax on corporate profits as computed from financial statements, including the Democratic party nominee former Vice President Joe Biden.

The resurgence of interest in the use of financial statement profits as an alternative or substitute tax base prompts a reexamination of the history of similar prior proposals, the

Mindy Herzfeld: University of Florida Levin College of Law, Gainesville, FL, USA (herzfeld@law.ufl.edu)

critiques levied against them, and the reasons for their lack of success. Consideration of the problems highlighted with respect to previous iterations of the idea allows us to determine whether it may be possible to address concerns before moving forward with a plan to tax multinationals based on financial statement profits. Or reconsideration of these concerns may make clear that the detriments of these proposals outweigh their perceived benefits.

Section II of this paper outlines the history of prior proposals for book tax conformity. Section III reviews more recent proposals for taxing multinationals based on financial statement profits, both domestically and internationally. Section IV highlights concerns that have been raised, both about older and more recent proposals. Section V concludes with a consideration of the extent to which concerns raised in other contexts remain valid for proposals made in 2020 and whether it may be possible to modify these proposals to adequately address the problems.

II. PAST PROPOSALS FOR BOOK TAX CONFORMITY

A. The Tax Reform Act of 1986

In response to publicity around a phenomenon in which very large firms with significant accounting earnings were paying little or no tax, the 1986 tax reform introduced a corporate alternative minimum tax (AMT), the stated objective of which was to ensure that “no taxpayer with substantial economic income can avoid significant tax liability” (Joint Committee on Taxation, 1987, p. 432). The AMT calculation, in part, was based on a book income adjustment (the adjustment for business untaxed reported profits), or one-half of the excess of pretax book income as reported in a firm’s financial statements over tentative minimum taxable income earnings (Manzon, 1992). The book income adjustment lasted only a few years before it was replaced by a current earnings adjustment, partly due to concerns over manipulation of book income and potential negative impact on the quality of financial reporting.[1]

Because the short-lived book tax base provided for a naturally circumscribed experiment for examining how conformity might impact financial reporting, several researchers undertook an examination of whether, and the extent to which, substituting financial accounts for the tax code influenced earnings management. The conclusion of Manzon (1992) that at least some firms managed their financial statement earnings in response to the 1986 law change, with the larger implication that tax rules that relied on reported earnings could prompt firms to manage earnings, was consistent with others’ findings. While these studies (e.g., Gramlich, 1991; Boynton, Dobbins, and Plesko, 1992; Dhaliwal and Wang, 1992) generally are cited for the proposition that where a company’s tax burden is dependent on book earnings, companies will engage in strategies to decrease earnings, their methodology has also been subject to criticism (Shackleford and Shevlin, 2001; Choi, Gramlich, and Thomas, 2001).

[1] See Corporate Alternative Minimum Tax: Hearing Before the House Ways & Means Committee, Subcommittee on Select Revenue Measures. House Congressional Record H1022 (April 11, 1989), Statement of Acting Assistant Secretary of Tax Policy John G. Wilkins.

B. 2005 President's Advisory Commission on Tax Reform

In the early 2000s, a rash of accounting scandals that led to the collapse of some large high-profile companies (such as Enron and WorldCom) prompted suggestions for greater book-tax conformity. In this case, the proposals were primarily intended to address a financial accounting problem rather than a tax avoidance problem. In addition to the general concerns that companies were engaging in aggressive earnings management was a specific concern that complex tax avoidance structures and shelters provided corporations with unique opportunities in this regard (Joint Committee on Taxation, 2003). Some economists proposed greater book tax conformity to address "the impulse to characterize profits opportunistically" (Desai, 2005, p. 190). A few tax attorneys suggested that greater disclosure of book-tax differences in financial reports could improve transparency in financial accounting. Canellos and Kleinbard (2002, p. 999) argued that Congress should adopt a "single comprehensive requirement for the *public* disclosure of a detailed schedule reconciling public companies' book and tax income statements and balance sheets." Mills and Plesko (2003) laid out the case for a more detailed (and public) tax return reconciliation schedule, partly as a way of providing a stronger audit tool for the Internal Revenue Service (IRS) and partly as a means of improving transparency in financial statement earnings (Hanlon, 2003).

President George W. Bush's 2005 Advisory Panel on Federal Tax Reform also considered ideas for taxing book income as a way of constraining "opportunism by managers anxious to inflate earnings and legislators anxious to change the tax code frequently" (Desai, 2005, p. 190). While the idea attracted some support, it was not included in the panel's final report, which also failed to include proposals for additional book-tax reconciliation detail in the tax return (Advisory Panel Report, 2005). Although economists generally favored a system with fewer distortions between different sets of accounts and some tax lawyers advocated for conformity to minimize tax planning opportunities, these idealized preferences fell victim to the realities of political economy and the more practical concerns related to the proposals.

The idea that better information about book-tax differences would minimize incentives for tax avoidance resurfaced in 2010 as an IRS proposal for greater disclosure of uncertain tax positions (UTPs) in the corporate tax return. In announcing a new schedule UTP,[2] then IRS Commissioner Doug Shulman said that greater corporate transparency of material tax issues was needed to achieve "certainty, consistency, and efficiency."[3] Pressure on corporations to publicly disclose more details of their tax payments remains fierce in the context of newly adopted rules requiring global reporting of country by country tax data (OECD, 2020c).

C. European Union Proposals

As part of its efforts to develop a common corporate tax base in the early 2000s, the European Commission considered using international financial reporting standards (IFRS,

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2 Announcement 2010-9; 2010-7 IRB 408.

3 See Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City (January 26, 2010), available at 2010 TNT 17-15.

with standards set by the International Accounting Standards Board (IASB)) as the starting point for a proposed new common tax base. Responses to a public consultation on the proposal were divided over how useful IFRS would be in this regard, although there was general support for the idea that IFRS accounts could be a good starting point for the discussion.[4] Among the concerns raised were IASB's status as a private rule-setting organization and the implications of having a private organization rather than European Union (EU) member states deciding upon the tax base (note that European countries also vary in terms of the extent to which their tax systems conform to financial accounting).

These ideas were set aside given general resistance among EU member countries to a common tax base. Although proposals for a common corporate tax base have been renewed, the latest ideas do not incorporate financial statements as a starting point, instead containing a detailed proposal for a common tax base developed by the European Commission.[5]

III. RECENT PROPOSALS

Despite the lack of recent academic literature supporting the use of financial statements as an alternative tax base, politicians in the United States and international organizations have recently revived the idea of imposing taxes based on publicly reported earnings.[6] Their work receives support from a timely paper by Clausing, Saez, and Zucman (2020, p. 8) advocating for a global minimum tax; they argue that a minimum tax is most easily designed based on accounting profits rather than tax definitions of profit. But they also acknowledge that "a tax on book income can also be triggered by deliberate policy differences between the tax base and the accounting definition of profit." Taxing financial statement earnings is in line with campaigns for more taxes on capital and wealth, an outgrowth of popular concerns about rising inequality, highly profitable (primarily tech) companies, and global profit shifting (Saez and Zucman, 2019). These politically motivated proposals would impose taxes on financial statement earnings as an addition to the "normal" corporate tax rather than a substitute.

A. Senator Warren Proposal

In April 2019, Senator Elizabeth Warren, then a candidate in the Democratic presidential primary, released a proposal for a surtax on corporate profits.[7] Her "Real Corporate Profits Tax" plan included a 7 percent surtax on corporate profits in excess of $100 million as

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[4] For a summary of the 2002 consultation, see EC COM(2003)726 (November 24, 2003), https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52003DC0726&from=EN, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges.

[5] See https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en#heading_3.

[6] One of the only recent economics papers evaluating the idea concludes that the idea could lead to a large deadweight loss because of the large responsiveness of financial statement income to taxes (Dharmapala, 2020).

[7] Warren announced her proposal on the website Medium (Team Warren, 2019).

reported in financial statements, premised on the assumption that companies would always want to report as low of a profit figure as possible to the IRS but as high of a profit figure as possible to investors to drive up the company's stock price, bonuses, and other executive compensation. Warren argued that because companies would be hesitant to under-report their profits to investors, using financial statements as an alternative tax base would eliminate incentives for tax avoidance. Pre-pandemic estimates from Warren's advisors were that approximately 1200 companies would be subject to the tax (Team Warren, 2019).

B. Biden Proposal

Vice President Biden has similarly proposed an AMT for corporations with book profits in excess of $100 million. Biden's proposal would require companies with more than $100 million in book income to pay the greater of their normal corporate tax liability or 15 percent of book income. But his plan would allow foreign tax credits and net operating losses to offset that liability (Huaqun, Watson, and LaJoie, 2020).

C. OECD Proposals

In 2019, the OECD announced a two-pronged plan for taxation of the digitalized economy intended to address its members' concerns that profits of digital activities were not being taxed fairly or by the right jurisdictions while also responding to U.S. concerns about a potential ring-fencing of the digital economy (OECD, 2019a, b). The two proposed solutions (or pillars) each involved comprehensive revisions to international tax rules and relied to a greater or lesser degree on a global consolidated tax base adapted from financial statements as a supplement to the domestic tax base calculated under local law. The OECD released detailed blueprints outlining the proposals in October 2020 but attempts to reach agreement were put on hold pending the U.S. presidential election (OECD, 2020a, b). Whether consensus will be achieved on either of the proposals remains uncertain.

1. Pillar One

Part of pillar one of the OECD proposal would require a portion of multinationals' residual profits (known as Amount A) to be reallocated to market jurisdictions (OECD, 2020a). Determination of Amount A starts from a multinational group's adjusted pre-tax profits, which the blueprint says will be derived from consolidated financial statements under the accounting standards of the headquarters jurisdiction. The OECD said that the advantage of this approach was that consolidated financial statements are readily available and not easily manipulated but also said that some book-to-tax adjustments would apply, including exclusion of income tax expenses, dividend income and gains or losses from shares.

2. Pillar Two

Although ostensibly designed as a solution for taxing the digitalized economy, pillar two is better characterized as an extension of the OECD's base erosion and profit shift-

ing project (BEPS).[8] Known as the GLoBE (global anti-base erosion) proposal, pillar two is essentially a minimum tax including variations on the 2017 U.S. tax reform, namely, the rule for taxing global intangible low-taxed income and the base erosion and anti-abuse tax (Herzfeld, 2019).

The pillar two blueprint has proposed that profit (or loss) before income tax as determined using the relevant financial accounting standard be the starting point for determining the GloBE tax base, partly as a simplification measure. It said that countries have agreed on a "deductive approach" that starts from the computation of net income for consolidated financial accounting purposes, with specific items to be excluded for policy reasons (OECD, 2020b). The OECD proposes adjusting the accounting profits to take account of certain permanent and temporary differences between financial accounting income and income as computed according to tax rules.

Permanent differences, which arise due to differences between book and tax rules, are the result of different treatment of items of income or loss that will not reverse in the future; an example is the financial accounting standards that treat changes in market value of an asset as giving rise to income or loss in a particular accounting period. If that gain or loss is not subject to tax when the asset is disposed of, then the recognition of income or loss in each year under financial accounting standards gives rise to a permanent difference. Permanent differences may arise, for example, because of differences in treatment for dividends from foreign corporations and gains on the sale of corporate stock, the exclusion of some types of income from the tax base due to domestic policy reasons, or the disallowance of certain deductions (such as interest expense or bribes).

In the blueprint, the OECD outlined approaches to addressing the effects of permanent differences between financial accounting and taxable income and how those differences should be adjusted for in deriving the tax base from the financial accounts without undermining the policy intent and practicality of the GloBE proposal. It made similar recommendations regarding adjustments for temporary differences, such as differences in depreciation methods, allowances for loss carryforwards, and deferred taxes.

To address the complications posed by temporary differences, the OECD had suggested a number of possible solutions such as allowing a carryforward of taxes paid by a subsidiary in one year in excess of the minimum tax rate to be treated as tax paid in a subsequent year in which the local tax paid might be below the minimum tax rate, or allowing the parent corporation's taxes with respect to a subsidiary's income to be refunded or credited against another tax liability when the subsidiary's local tax paid was in excess of the minimum tax rate. Alternatively, deferred tax accounting could determine the tax expense for the period based on the financial income for that period, regardless of the tax due for that same time frame, to eliminate swings in the effective tax rate calculation caused by temporary differences. The discussion draft noted that deferred tax accounting is already used by taxpayers preparing financial statements under most generally accepted accounting principles (GAAP) and that it could eliminate

[8] An outline of the BEPS project is contained in OECD (2013), "Action Plan on Base Erosion and Profit Shifting," http://dx.doi.org/10.1787/9789264202719-en.

swings in the effective tax rate calculation caused by temporary differences (OECD, 2019b). But the OECD also identified concerns with these proposed solutions, such as carryforwards possibly allowing taxpayers to shelter temporary or permanent differences in the determination of the tax base. Most jurisdictions have imposed limitations on loss carryforwards for those reasons, but the OECD noted that such limitations could be complicated to apply and administer. Deferred tax accounting has its own challenges, in part because financial accounting tax expense is partially based on expected future tax liabilities and so involves preparer judgment.

In sum, the OECD's 2020 proposals, while looking to financial accounts for the initial determination of and thresholds for establishing a global minimum tax, also acknowledge that adjustments would be needed to make those accounts workable in the tax context while at the same time recognizing that those adjustments would be fairly complex. As the magnitude of the adjustments the OECD suggests would be needed to financial statements grows to converge with an income tax base, it necessarily raises a question about whether it would make more sense to start with a taxable income base as an initial matter. But starting from any point other than widely accepted financial standards would reveal the radical nature of the OECD proposal, which would result in the creation of a global tax base not enacted by any legislature.

IV. THE ARGUMENTS AGAINST

The discussion below considers objections that have been raised against earlier proposals for book-tax conformity and summarizes comments the OECD received on its proposals for taxation of the digitalized economy, focusing on the financial accounting aspect of those proposals. Proposals made by U.S. 2020 presidential candidates were not well developed and so have received but high-level critiques.

A. Book and Tax Profits Diverge for Good Reasons

As commentators and the courts have recognized, financial accounting differs from taxable income because of their differing objectives (Freedman, 2004).[9] Users of financial statements need different types of information about a company's earnings than do government tax administrators. While financial accounting is designed to provide a fair and accurate assessment of a company's financial condition and economic performance, income tax rules are intended to result in a verifiable tax base (Freedman, 2004; Graham, Raedy, and Shackelford, 2012).

The primary purpose of taxes, and the tax laws that implement and enforce the collection of taxes, is to raise revenues to meet government needs. Good tax rules accomplish this goal in the most equitable and efficient way possible while also reflecting the fact

[9] The U.S. Supreme Court has recognized the appropriateness of this divergence in *Thor Power Tool v. Comm'r*, 439 U.S. 522, 542-3 (1979), stating that "[g]iven th[e] diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable."

that taxpayers need to be able to pay amounts owed when assessed and that government administrators need to be able to monitor, collect, and enforce the rules. This goal is best met, and tax avoidance is most easily prevented and addressed, when tax rules are simple and objective.

The goals of the tax system share some similarities but also important differences with those of financial accounts, the primary purpose of which is to provide investors, creditors, and other stakeholders with relevant and reliable data to enable them to make well-informed investment decisions (Graham, Raedy, and Shackelford, 2012). To achieve this goal, and in contrast to tax rules, financial accounting standards give managers flexibility and discretion in presenting their income calculations and also permit different industries to develop different standards.

In addition to the primary goal of revenue collection, governments often use the tax rules as a means of modifying taxpayer behavior to achieve social or economic policy goals. Elected officials often enact tax incentives or penalties in order to encourage businesses to undertake particular activities such as investment in new equipment. Special tax rules that allow for accelerated depreciation, and are intended to encourage business investment, provide one of the most significant differences between book and tax income. This is because tax rules often allow for faster depreciation than do financial accounting rules, the result of which is that companies with significant capital expenditures and financial accounting profit may report little (and perhaps no) taxable income. Conforming financial accounting to tax rules in this regard would mean that businesses that make heavy capital investment might appear less profitable. Or it could remove governments' ability to exercise this fiscal policy tool.

Different treatment of losses in book and tax accounts also often reflects the government's use of fiscal policy to manage economic cycles. Tax rules that allow taxpayers to carry over losses from one year to the next help smooth out the arbitrariness of taxable years and provide an important cushion against economic downturns. But no such motivation guides financial accounting standards, which are specifically intended to provide a snapshot of earnings in a particular period (McClelland and Mills, 2007). Conforming book and tax income with respect to the timing of loss recognition would not improve information quality for investors and would deprive legislatures of these tools to address economic crises.[10]

Differences in the objectives of the two systems are also apparent in the timing of recognition of items of income and loss. In order to ensure that the rules operate fairly and efficiently and only subject persons to tax when they are able to pay, most tax systems generally incorporate a realization concept in which tax is owed only upon the occurrence of an event in which gain is realized (Freedman, 2004). But the realization principle is less relevant for financial accounting rules, which instead of requiring full recognition of income at the time a sale is made, often require companies to estimate how much of their receivables will become uncollectible when preparing financial

[10] In both of the most recent acute financial crises, Congress acted to expand the ability of taxpayers to carry over losses in order to alleviate the financial impact of the crises. See Herzfeld (2020).

reports. Financial accounting rules require preparers of income statements to conduct an ongoing assessment of the creditworthiness of their customers and debtors in order to provide investors and other creditors with a more accurate understanding of the company's financial health. Accelerating income recognition even when some receivables might not be collected could result in profits and assets being overstated or associated costs not being properly matched to revenues. Importing the tax realization concept into financial accounting could encourage corporate managers to artificially boost current year profit (Freedman, 2004).

Another important distinction between the purpose of financial accounts and the goals of the tax system is that tax rules need to maximize the ability of government administrators to collect revenue efficiently while encouraging taxpayer compliance. These goals do not necessarily coincide with the goals of financial accounting, which has less concerns about investors who need administrative efficiency in their access to information and who, as a general rule, prefer more information rather than less even if more work is required to make sense of it.

Commentators on the 2019 OECD proposals raised similar concerns around the fact that because tax and accounting rules have different goals, it is not necessarily consistent with the purpose of either system to use one to serve the other. Financial reporting is intended to provide useful information to existing and potential investors and lenders, and so financial accounts need to help investors assess a company's ability to generate returns, as well as the timing and certainty of such returns.[11] In order to reflect the overall economic substance of the business, financial statements often use fair value measurement, which is generally considered to provide more relevant information than historic cost. To meet the objective of presenting information about a company's true economic picture, financial statements — in contrast to tax accounts — focus on the overall economic position, rather than providing information about discrete transactions between different legal entities. For similar reasons, they also account for some items that may or may not be relevant in calculating the tax base, such as acquisition accounting, impairments, and intercompany transactions (PwC Comments Pillar Two, 2019).

Because differences in financial accounts and tax accounts reflect differences in the goals of financial reporting and the tax system, full conformity between the two sets of rules will inevitably compromise to some extent the objectives of one or both systems.

B. Economic Performance/Manager Discretion

Among the most frequently raised concerns over the use of accounting profits as a substitute tax base is that asking accounting profits to serve a function aside from their main purpose of providing information to investors could dilute their usefulness in accomplishing their primary goal. Financial accounting deliberately allows managers discretion in reporting earnings in order to maximize their relevance (Manzon and

[11] Collected comments on pillar 2 can be found at http://www.oecd.org/tax/beps/public-comments-received-on-the-global-anti-base-erosion-globe-proposal-under-pillar-two.htm.

Plesko, 2002). But substituting financial accounts for the tax base would necessarily mean replacing flexible principle-based rules with detailed technical regulations for determining profits, gains, and losses.

It is in the timing of recognition of gains and losses that there is the most significant difference between the discretion provided to corporate managers for the preparation of financial accounts and to preparers of tax returns. As a general principle, accounting rules require businesses to have more evidence and certainty in recognizing contingencies for gain, rather than losses, meaning that it can be easier to recognize losses than gains for accounting purposes. That is because, as noted above, investors are more concerned about the risks of overstatement of financial statement earnings than of losses. Tax writers, in contrast, are more concerned about taxpayers overstating losses than gains, and so the tax rules tilt more toward disallowing or deferring loss recognition while accelerating gain recognition. Substituting financial accounting calculation of earnings for the tax base would give taxpayers greater flexibility, acting within the rules, to reduce their taxable income, using the discretion permitted by flexible accounting rules for this purpose. In effect, the system would be trading the numerous rules designed to prevent the possibility of tax avoidance for the flexibility sanctioned by accounting standards.

The academic research bears out the intuitive conclusion that when financial accounts are required to conform to tax concepts, businesses are more likely to reduce their reported earnings. A number of research papers have looked at the effects of the changes made by the Tax Reform Act of 1986, in which some taxpayers were required to shift from the cash to the accrual method of accounting. Guenther, Maydew, and Nutter (1997) determined that the change resulted in a decline of book profit margins of taxpayers who changed methods of approximately 5 percent. While previously those companies could defer taxable income without affecting book income, their inability to do so going forward meant that they had greater incentives (in order to reduce their tax burden) to defer income (for both tax and accounting purposes). The paper concludes that increasing book-tax conformity causes firms to defer financial statement income. Other papers that support the conclusion that when the tax system relies on financial accounts, taxpayers manage reported earnings to get better tax results include Gramlich (1991), Dhaliwal and Wang (1992), Boynton, Dobbins, and Plesko (1992), Manzon (1992), and Wang (1994).

The research also suggests that an increase in book-tax conformity leads to a decline in the informativeness of financial reporting (Hanlon, Maydew, and Shevlin, 2008). Studies based on cross-country comparisons have shown that there is a decline in the quality of reported earnings when there is greater book-tax conformity (Ali and Hwang, 2000). Atwood, Drake, and Myers (2010) examined whether the degree of required book-tax conformity across countries affects the association between earnings and future cash flows, and they concluded that earnings persistence and earnings quality are lower when book-tax conformity is higher, with current earnings having a lower predictive value of future earnings and future cash flows in countries with higher book-tax conformity (see also Hanlon, 2005). Hanlon, LaPlante, and Shevlin (2005) determined that if book and tax measures of income were conformed, the loss of information to investors would be "quite dramatic" — their results suggested an information loss on

the order of 50 percent. Hanlon, Maydew, and Shevlin (2008) found that increasing book-tax conformity tends to result in a degradation of the informativeness of financial reporting earnings. Hanlon and Shevlin (2005) concluded that when the tax rules look to financial statements for determining the tax base, there is a possible loss of information about performance in publicly disclosed earnings.

Looking to tax rules as the basis for financial accounting produces its own distortions (Freedman, 2004). For example, tax rules require all industries to depreciate the same asset at the same rate. But financial accounting provides for different rates of depreciation for different types of assets depending on the industry, and even for potentially the same asset depending on its real economic value in different industries. A requirement to conform financial accounts to taxable income could reduce managers' discretion to provide accurate information about true economic value. Similarly, the trend in financial accounting to reflect assets and liabilities at fair value (rather than historical cost accounting) undertaken to provide investors with more relevant information, is contrary to the goals of tax rules, which are intended to ensure uniformity among taxpayers and minimize taxpayer avoidance opportunities through the use of easily verifiable numbers.

Financial accounting standards (FASB Statements of Financial Accounting Concepts Nos. 1 and 2) require information reported on financial statements to be relevant (helpful in making decisions), reliable, comparable across firms, consistent across time, and material (large enough to affect decisions).[12] To accomplish those goals, financial standards specifically do not require businesses to apply the rules uniformly. If the goal is to provide investors the best holistic picture of a business's finances, allowing preparers the ability to exercise discretion when presenting that information should increase its quality for this purpose. In practical terms, this discretion means that managers have some flexibility in the recognition of revenues and expenses, depending on their company's unique circumstances. It also means that there can be significant differences in the treatment of items of income or loss in different industries. While financial accounting rules require managers to exercise judgment in providing their most accurate assessment of a firm's financial condition, tax laws instead look for an objective set of rules on which to base tax owed. As an example, GAAP require an assessment of numerous factors in determining a company's annual pension expense, factors that are subject to discretion, while tax rules require taxpayers to claim a deduction at the time when cash is contributed to a pension fund.

There is no reason why tax base calculations should be prepared with the same degree of discretion. To the contrary, collection of revenue is improved, and taxpayer compliance enhanced, when a standardized set of rules applies to all taxpayers, without permitting the exercise of taxpayer discretion. Partly because accounting standards are designed to provide useful information to creditors and investors who lack the authority to require companies to provide relevant information on financial performance and position (McLelland and Mills, 2007), financial statements do not attempt to derive a

[12] https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220132541&acceptedDisclaimer=true.

single true number for what constitutes profit (Freedman, 2004). Furthermore, financial statements are designed primarily to provide information to shareholders and other investors to enable them to make decisions about future profits, while tax accounts are designed to present a snapshot in time, necessarily backward looking.

The contrasting approaches in this area — one of which looks backward to verifiable and identifiable facts and the other of which, looking forward, relies on preparers' judgment — illustrate the differences in approach that makes it less useful — for both disciplines — to apply a single set of rules to accomplish different purposes.

C. Who Writes the Rules

While the concerns expressed above relate primarily to the pressure that book-tax conformity could impose on the usefulness of either financial accounts or tax rules, a separate set of concerns involves questions around the rule-writing process. In most countries, the organizations that write tax laws are not the same ones that set accounting standards. While elected legislatures generally pass tax laws, accounting rules are developed, in most cases, by private standard setting bodies.[13] It is unlikely that politicians would be willing to cede the power associated with the tax rule-writing process to a private rule-setting body.[14] Conforming book and tax income, therefore, probably means that eventually accounting standards would be prescribed, or at least overseen, by Congress rather than by private standard setting organizations not subject to political whims (Hanlon and Shevlin, 2005).

Introducing greater reliance on financial statement profits in the calculation of taxable income will inevitably result in governments' exerting additional influence over the accounting rulemaking process. There are already precedents for Congress acting to overturn accounting rules in response to corporate lobbying (Hanlon, 2020). In July 2004, in response to a rule change proposed by the Financial Accounting Standards Board (FASB) that would have generally required companies to expense stock options at the time of grant (albeit while still allowing some discretion in reporting), the House of Representatives passed the Stock Option Accounting Reform Act intended to prevent the FASB from requiring companies to expense all employee stock options (Farber, Johnson, and Petroni, 2007). As another, more recent example, Congress overturned (temporarily, and for some situations) FASB rules regarding reporting of credit losses (Accounting Standards Update (ASU) No. 2016-13) adopted in 2016 in response to the global financial crisis to require that currently expected credit losses on many financial assets be deducted against income when the assets are acquired and thereafter while holding them.[15] These types of measures contradict the purpose behind the independent

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[13] While the Securities and Exchange Commission has the statutory authority to prescribe accounting and other reporting standards for publicly traded companies, it has generally ceded this right to private groups. McClelland and Mills (2007).

[14] Freedman (2004, p. 98) notes that "neutrality of taxation may be a desideratum but governments will not wish to give up the ability to use tax as an economic tool, however ineffective a tool it may be."

[15] The Coronavirus Aid, Relief, and Economic Security (CARES) Act provided optional relief from adoption of current expected credit loss (CECL) rules in 2020. Pub. L. No: 116-136, 116th Cong. (2020). Also see OCC Bulletin 2020-30 (2020).

funding of the FASB as mandated by the Sarbanes–Oxley Act of 2002, specifically adopted to promote the organization's independence from political pressure.[16]

On the other side, relying on private organizations to write the rules on which the government's revenue depends removes the type of transparency and accountability from tax rule writing that has developed around the legislative process and regulatory processes. And questions about who gets to write the rules develop into questions of who gets to adjudicate them, an issue that has already been percolating in the EU. Freedman (2004, p. 98) has noted that how the European Court of Justice would interact with the IASB in the event of adoption of an EU common consolidated corporate tax base that relied on IFRS would be "dynamic and difficult to predict."

D. Risks to Revenues

The considerations above are focused mainly on the practical concerns for investors, taxpayers, and tax administrators related to the use of financial statement earnings as an alternative tax base. But there is another set of concerns that arises from the primary purpose for which the tax laws exist: the need for tax revenues in order to achieve the basic fiscal needs of governments. In this regard, the flexibility that financial accounting standards provide to preparers of financial accounts can operate in conflict with the government's needs. Because the primary objective of tax laws is the collection of revenue to meet the government's spending needs, it necessarily allows taxpayers less flexibility to choose between the application of the rules in calculating taxable income.

The distinction between the two systems in the timing of deductions provides one example of this difference — some losses are required to be estimated and reflected for accounting purposes prior to the time realized under the tax rules. In circumstances where financial accounting requires the deferral of some items of income, such as in the case of revenue from sales subject to customer returns, allowing taxpayers flexibility could well result in less taxes paid. The timing issues are magnified because tax rates are subject to change due to political whims, with the result that deferral could result in less (or more) total tax paid. It is partly in order to solidify the revenue stream and partly in order to have clear rules that taxpayers can comply with and revenue agents can audit that tax rules differ from financial accounting rules in the timing of recognition of items of income (gains) and losses (McClelland and Mills, 2007).

While fair value accounting reflects the volatility of market conditions, incorporating market volatility into a tax system might not be optimal for revenue collection (Freedman, 2004).[17] These concerns may be less relevant when the proposal is for a surtax or a backstop minimum tax, as in the Biden/Warren/OECD proposals. But the notion of an additional tax imposed on a different tax base raises other challenges and multiplies complexities.

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[16] S. Rep. No. 205, 107th Cong., 2d Sess. 13 (2002).

[17] The pressure put on government revenues when budget collections depend on financial accounting is also inherent in recent proposals to tax income on a mark-to-market basis. See Senator Wyden's proposal for mark-to-market taxation of publicly traded assets of wealthy individuals at https://www.finance.senate.gov/ranking-members-news/wyden-unveils-proposal-to-fix-broken-tax-code-equalize-treatment-of-wages-and-wealth-protect-security-.

E. Critiques of OECD Proposals

Academic accountants have been mostly silent so far about the OECD's proposals, in part because of their lack of specificity. The lack of clarity, and the challenge it presents in terms of making meaningful comments on the proposal, was noted in a number of the practitioner comments to the 2019 consultation drafts, with some saying that "[d]esigning a detailed mechanism to implement a solution is impractical when the problem is not clearly identified." (ACCA Comments to Pillar Two, 2019, p. 2). Others cautioned about the challenges involved in allocating global consolidated financial statement income to local subsidiary entities, to the extent this might be required in computing a global minimum tax, given that preparation of consolidated financial statements involves many adjustments made on a global basis for which there is no mechanism for subsequently pushing them down to local subsidiary financial accounts (EY Comments Pillar Two, 2019). In short, adjustments to either local books or consolidated financials are problematic, albeit for different reasons. Nonetheless, the OECD did receive comments from taxpayers and their advisors about the challenges involved with starting with accounting books in calculating a tax base, and many of these comments echoed (without citing) those of the academic accountants expressed above.

1. Purpose of the Project

A number of the comments on the OECD consultation document revolved around a theme similar to one emphasized in the academic critiques of prior proposals, namely, that using financial statements as a substitute tax base is problematic given that the two sets of accounts are prepared for different purposes. Some of these comments reflected that in situations in which the purpose of financial reporting does not align with the objectives of the GloBE proposal, their use may not provide an appropriate foundation for calculating a GloBE tax base or an effective tax rate (PwC Comments Pillar Two, 2019). But, as noted by the academic papers generally, the purposes of financial reporting are simply not consistent with those of computing a tax base. It follows then that financial statements may not provide an appropriate foundation for calculating a global minimum tax base.

Echoing other types of concerns expressed above, the Chartered Institute of Accountants noted that because accounting rules are necessarily somewhat subjective and require greater exercise of judgment than does the calculation of taxable income and loss, tax administrators could be expected to have a more difficult time monitoring compliance if financial accounts serve as the global minimum tax base (Chartered Institute of Accountants Comments Pillar Two, 2019). The Corporate Taxpayers Group (representing New Zealand's largest businesses) warned that the use of accounting profits for purposes of computing a global minimum tax would give rise to arbitrary outcomes, in part because financial accounts always involve estimates and judgments rather than exact depictions of the financial position of any entity and in part because there are material differences between taxable income and financial reporting income.[18]

[18] Corporate Taxpayer Group Comments (December 2, 2019), available at 2020 TNTI 35-33.

However, at least some of the comments minimized the concerns over the possibility that financial statement earnings would be manipulated if they formed the basis for an alternative tax base, at least in the context of the pillar one proposal. The Chartered Institute of Accountants said any that such fears were overblown and based on an inflated perception of the importance of tax within companies' overall management and financial reporting.[19]

2. Adjustments

In explaining why its draft proposal suggested using financial statements as a starting point, the OECD said that consolidated financials could establish a consistent tax base across jurisdictions (OECD, 2019b). But some have pointed out that they could at the same time result in other types of distortions because different jurisdictions rely on different local accounting standards (Chartered Institute of Accountants Comments to Pillar Two, 2019). This presents a problem for the GLoBE proposal whether the starting point is global consolidated financial statements or local country books.

The GLoBE proposal recognizes that if the calculation of the global minimum tax threshold and ultimately the tax base starts from financial statements, these accounts would then need to be adjusted and reconciled to reflect the permanent and temporary differences that result from the fact that tax rules and financial accounting rules differ in their requirements for the timing of some items of income, gain, loss, and deduction and depreciation. The Chartered Institute of Taxation noted in that regard that the decision as to which, if any, adjustments would be needed ultimately would be a political one, taking into account the policy goals of the proposal.

Other comments highlighted the challenges of making adjustments for permanent and temporary differences in light of the policy goals for the GLoBE proposal. For example, effective tax rate reconciliation for permanent differences included in consolidated financial statements usually only identifies such differences at a level relevant for reporting to investors, which means that there are no standards for how companies should make such adjustments for purposes of calculating a global minimum tax base (PwC Comments Pillar Two, 2019). And, while deferred tax accounting rules may require reconciliation of temporary differences, the details and specificity of how any such reconciliations are tracked may vary according to jurisdiction. Practically speaking, this means that to the extent a global minimum tax proposal seeks to use accounting standards to make adjustments for permanent and temporary differences in order to arrive at a global minimum tax base, the OECD would need to develop a standardized set of rules for this purpose.

The adjustments proposed by the OECD for temporary differences between book and tax profits would be required at multiple points in the calculation of any additional minimum tax due. First, they would be needed in determining whether the appropriate (minimum) tax had been paid. Second, they would be required in order to identify which

[19] Chartered Institute of Accountants Comments to Pillar One (November 11, 2019), available at https://www.tax.org.uk/sites/default/files/191111%20OECD%20Secretariat%20Proposal%20for%20a%20%27Unified%20Approach%27%20under%20Pillar%20One%20-%20CIOT%20response.pdf.

businesses owed additional taxes. This would necessarily require the organization to make decisions about whether and how to impose time limitations on the reversal of any such adjustments.

Other types of adjustments required relate to the timing of taxes paid in local jurisdictions. For example, for purposes of calculating the global minimum tax base in the current year, it likely would be necessary to create an account for excess taxes paid in a local jurisdiction that a taxpayer could get credit for in a subsequent year; if no subsequent year adjustment was made, accounting timing differences could end up having permanent effects, undermining the policy objectives of the foreign minimum tax (PwC Comments Pillar Two, 2019). Similar issues arise with respect to items that the tax law allows to be carried forward from one year to the next (such as losses) not reflected in financial accounts. One solution proposed was rather than adopting an annual period for purposes of the minimum tax base calculation, the global tax base could rely on a rolling period average, which would smooth out fluctuations in the effective tax rate resulting from timing differences. But even a rolling period for calculating the minimum tax base could result in distortions if it is not long enough to take into account the effect of long-reversing temporary differences with long-lived assets (PwC Comments Pillar Two, 2019).

In short, if starting from financial statements and making adjustments thereto to arrive at a tax base for purposes of a global minimum tax, one would need to create a separate set of books that would track the (temporary) adjustments required to get from one set of books to another. This means that the calculation required for the OECD tax base would essentially require an entirely new set of tax accounts to be created at the global level, with rules determined by the OECD.

3. Determining the Effective Tax Rate

The GLoBE proposal requires an evaluation of a multinational's effective tax rate in order to determine whether the minimum tax has been paid or additional tax needs to be assessed. This requires a determination of the global effective tax rate for this purpose, which in turn necessarily requires a reconciliation between the effective tax rate as calculated for financial accounting purposes and the cash taxes paid. The deferred tax account in financial statements reflects those differences. But not all such differences are reflected in the income statement; in some cases, they are recorded through equity. And the deferred tax account also reflects judgment on the part of preparers that is not available in the computation of tax accounts, such as when and how much of a valuation allowance may be recorded for financial statement purposes for deferred tax assets, how to record UTPs, accounting for deferred taxes from a business combination, effects from changes in tax law, and other exceptions to recognition of a deferred tax asset (PwC Comments Pillar Two, 2019).

Many of the comments on the OECD's draft GLoBE proposals expressed concern over how the minimum tax base might be adjusted to take into account tax incentives offered by various jurisdictions, with concerns expressed that a global minimum tax

that failed to respect these tax incentives would disadvantage countries (developing countries in particular) that offer them. Because using an effective tax rate as derived from financial accounts (without adjustment) is likely to produce a number that could vary from year to year, financial statements may not be a good basis for determining effective tax rates. Meanwhile, the effect of acquisitions, dispositions, and the accounting for not-wholly-owned investments could create a need for adjustments that could result in a second set of taxable income calculations to be determined by the OECD.

4. Special Types of Entities

Finally, while tax rules apply mostly uniformly across industries, different accounting rules apply to different industries. Any proposal that requires calculation of a tax base starting from consolidated financials would need to address such special rules for different entities (EY Comments Pillar Two, 2019). Some entities, such as pension funds or real estate investment trusts, are specifically granted tax-free status by domestic legislatures. As is the case with tax incentives, it is not clear how a system that looks to consolidated financial systems for a tax base would address those types of preferences afforded by political bodies.

To sum up, many of the comments made on the OECD proposals introduced in 2019 raise concerns about the use of financial statements as an alternative tax base similar to those raised about previous similar proposals. While the OECD has proposed making adjustments to financial accounts to arrive at a more workable tax base, the adjustments would end up creating an alternative tax base — one based on OECD rules rather than domestic legislative rules.

V. CONCLUSION

In reviewing the idea of taxing book income in 2007, McClelland and Mills concluded that proposals for book-tax conformity should receive further attention only when the long-term effects of then-recent changes in financial reporting and auditing standards, tax enforcement, and book-tax gap reporting were better understood. The past decade has not seen a lot of additional research in these areas, yet proposals to incorporate reliance on financial statement earnings rather than tax profits continue to gain attention domestically and globally.

U.S. Democratic candidates' proposals for an excess tax on corporate profits remain at a high level, while the OECD's proposals remain subject to revision before finalization (to the extent they are ever finalized). These most recent proposals address some of commentators' concerns as expressed over prior proposals, but in many other respects, they fail to do so. Most importantly, these proposals either hand over additional power to accounting standard setters or to the international organizations that will make the rules determining what adjustments are required to financial statement earnings to better reflect the needs of calculating taxable profits. In both cases, additional power is given to bureaucracies not directly subject to the oversight of elected legislatures.

The U.S. candidate proposals mitigate some of the concerns expressed over prior proposals for book-tax conformity, because they would not attempt to substitute financial statement earnings for the tax base but merely look to financial statements as a supplement for refining (or adding to) the normal tax base. This necessarily minimizes the concerns over manipulation of financial statement earnings. However, it does not eliminate them. To the extent that book earnings are being used to calculate any amount of tax owed to the government, the system will be creating an incentive for companies to lower those earnings, perhaps to the detriment of financial statement users. Arguably, any use of financial statements to determine the tax liability (even as a supplement) may potentially induce earnings management. In addition, Biden's proposal, which would help smooth over some of the differences in purpose between financial and tax earnings by allowing for credits and carryovers of losses in computing the excess tax, in effect substitutes an additional computation on top of the normal tax base (computed according to the rules of the Internal Revenue Code) and financial statement earnings (computed in accordance with GAAP). Additional complexity gives rise to additional opportunity for manipulation and avoidance on both the accounting and tax sides.

The OECD 2019 proposals, in contrast, appear to contemplate extensive adjustments to financial statement earnings to better reflect tax realities. Like the U.S. candidate proposals, the concerns are somewhat mitigated because the OECD proposals only apply to a portion of corporate earnings (the residual amount of Amount A in the Pillar One proposal) or in calculating a global minimum tax (the mechanism for which remains unclear). But the fact that the OECD proposals contemplate such extensive adjustments raises a separate set of concerns related to questions about the amount of power granted to the rule-setting body. If the OECD is responsible for developing adjustments to financial statement earnings for the calculation of a global consolidated tax base, it necessarily will need to write rules for a global tax base that are separate and apart from any that have been enacted by a state legislature. In effect, then, the OECD's global minimum tax proposal would require that legislatures hand over their power to tax their multinationals twice over — first to private standard setting accounting bodies and second to the OECD.

A robust discussion of the consequences of such abdication of sovereignty over a key function of government would appear to be needed before it occurs.

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