STOPPING THE ENRON END-RUNS AND OTHER TRICK PLAYS: THE BOOK-TAX ACCOUNTING CONFORMITY DEFENSE

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I. INTRODUCTION

"When you come to a fork in the road, TAKE IT!"
-- Yogi Berra
(philosopher and three-time American League "MVP")[1]

Robert Frost must not have known many imaginative accountants or tax professionals. In his classic poem *The Road Not Taken*, Frost assumed that at the proverbial fork in the road the traveler must choose one path or the other. Had he sufficient exposure to the talents of creative accounting and tax advisors, the poet might have considered Yogi Berra's third alternative -- take *both* roads.

In accounting for business transactions in the United States, it has long been the case that keeping two different sets of books (one for financial reporting and one for income tax reporting) is permissible and "generally accepted."[2] A company can often effect a transaction that in economic substance begins at "point A" and ends at "point B," but account for the path taken in one manner in its financial

[1] YOGI BERRA & DAVID KAPLAN, WHEN YOU COME TO A FORK IN THE ROAD, TAKE IT! (2001).

[2] *See generally* Harold E. Arnett, *Taxable Income vs. Financial Income: How Much Uniformity Can We Stand?*, 44 ACCT. REV. 482 (1969); Alfred F. Falk, *Tax Accounting and Business Accounting: How to Maintain Two Sets of Books to the Satisfaction of the Treasury*, 28 INST. ON FED. TAX'N 19 (1970); Calvin H. Johnson, *Using GAAP Instead of Tax Accounting is a Bad Idea*, 83 TAX NOTES 425 (1999) (each of these sources discussing the differences between tax and financial accounting which have precluded the use of a single system of computing income for tax and financial statements purposes).

statements and in a markedly different manner in the company's income tax returns.

Three prominent examples of this accounting divergence that have recently become subject to public scrutiny (and head scratching) are: "synthetic leases" of real estate (where a company claims to "own" financed property for income tax purposes, but claims to be a mere "tenant" under an "operating lease" for financial accounting purposes);[3] "off-balance sheet" partnerships (one of Enron's financial accounting "end runs" under which, among other things, a company in effective control of a partnership may claim responsibility for all or part of the partnership's liabilities in its income tax reporting, but exclude such liabilities from its balance sheet for financial statement purposes);[4] and

[3] For detailed descriptions of typical synthetic lease transactions, see, e.g., Steven G. Frost & Paul Carman, *Federal and State Tax Consequences of Synthetic Leasing - Multiple Benefits, Minimal Risks*, 95 J. TAX'N 361 (2001); David Holmes, *The Use of Synthetic Leases to Finance Build-to-Suit Transactions*, REAL ESTATE FIN. J. 17 (Winter, 1996); John C. Murray, *Off-Balance Sheet Financing: Synthetic Leases*, 32 REAL PROP. PROB. & TRUST J. 193 (1997) (John C. Murray is also sometimes referred to in other sources cited herein as "Jack Murray"); H. Peter Nesvold, *What Are You Trying to Hide? Synthetic Leases, Financial Disclosure, and the Information Mosaic*, 4 STAN. J. L., BUS. & FIN. 83 (1999); Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445 (2000). *See also* SYNTHETIC LEASE FINANCING: KEEPING DEBT OFF THE BALANCE SHEET (Nancy R. Little ed., 2002) [hereinafter Little]. It should be noted that synthetic leases are used in other structured finance settings as well, such as in the airline industry, which will not be explored herein. *Id.* at 1 & chs. 9, 10. Synthetic leases of real estate are discussed in greater detail *infra*, Part II.A.

[4] Off-balance sheet partnerships are made possible for financial accounting purposes by "generally accepted accounting principles" established principally by the Financial Accounting Standards Board ("FASB"), pertaining to "equity method" accounting for certain investments in partnerships and avoidance of financial statements "consolidation" with certain "special purpose entities" ("SPEs"), as discussed, *infra*, Part II.B. For a description of Enron's pursuit of off-balance sheet financing and other benefits sought through the use of SPEs, see WILLIAM C. POWERS ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON

accounting for the grant and exercise of compensatory "nonqualified" employee stock options[5] at a bargain price (whereby a tax deduction is recognized for the compensation represented by the bargain element of the transaction, but financial accounting under U.S. "generally accepted accounting principles" ("GAAP") has failed to require that a charge be taken against the employer's income in its financial statements).[6]

CORPORATION 18-67 (Feb. 1, 2002), 2002 WL 198018 [hereinafter Powers Report], *available at* http://money.cnn.com/2002/02/02/companies/enron_report/index.htm. The Powers Report and other Enron-related source materials have been published on the Internet by the Houston Chronicle at http://www.chron.com/content/chronicle/special/01/enron/index.html (last visited Dec. 15, 2002).

[5] The term "nonqualified" is used here to distinguish the employee stock options analyzed herein from "incentive stock options" as defined in I.R.C. § 422 (2002) and options received in "employee stock purchase plans" as defined in I.R.C. § 423 (2002). Under those provisions, if certain statutory requirements are met, such options, sometimes called "statutory stock options," for federal income tax purposes result in no income recognition by the employee, and no associated compensation deduction by the employer, either at the time of grant or the time of exercise of the option. For a summary of the basic elements of nonqualified and statutory stock options, see STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION, REP. NO. JCX-29-02, at 40-45 (April 17, 2002), *available at* http://www.house.gov/jct/x-29-02.pdf (last visited Dec. 15, 2002).

[6] *See* I.R.C. § 83(h) (2002) and Treas. Reg. § 1.83-7 (1978) (providing for such tax result in instances in which the fair market value of the option itself is not "readily ascertainable" at the time the option is granted); ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, Opinion No. 25 (Accounting Principles Bd. 1972) [hereinafter APB Opinion No. 25]; ACCOUNTING FOR STOCK BASED COMPENSATION, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995) [hereinafter SFAS No. 123], *amended by* Statement of Financial Accounting Standards No. 148 (Financial Accounting Standards Bd. 2002) (under SFAS No. 123 companies are encouraged to account for stock option compensation awards based on the fair value as of the award date but can in many cases elect -- as it appears most large public companies have -- to forego applying such grant-based accounting method and to continue to apply the prior rules under APB Opinion No. 25); ACCOUNTING FOR CERTAIN TRANSACTIONS INVOLVING STOCK COMPENSATION, Interpretation No. 44, (Financial Accounting Standards Bd. 2000)

In each of those three cases, the company (or at least the company's management) may derive substantial benefits from such book-tax divergence, in terms of both tax savings and better looking financial statements than would be the case if the book reporting of the transactions more closely corresponded with the associated tax reporting.[7] Moreover,

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[hereinafter FASB Interpretation 44]. FASB Interpretation 44, effective generally as of July 1, 2000, clarified the application of APB Opinion No. 25, permitting accounting rules for stock option awards based on the "intrinsic value" on the option grant, which, depending on the particular facts, may often result in no charge against financial income, though footnote disclosure must be made to show what the effects on earnings would have been had the "fair value method" been used. *See, e.g.*, Anthony F. Cocco & Glenn Vent, *FASB Interpretation 44 Accounting for Certain Transactions Involving Stock Compensation,* 70 C.P.A. J. 22, 24 (July 2000) (explaining that "[s]ince most companies set the strike price equal to the market price on the grant date, no compensation expense is ever recorded"); Michelle Hanlon & Terry Shevlin, *Accounting for Tax Benefits of Employee Stock Options and Implications for Research*, 16 ACCT. HORIZONS 1, 2 (Mar. 2002) (stating that "[b]ecause almost all firms apply APB No. 25 accounting with note disclosure, the recognized [employee stock option] compensation is zero for most firms," (citing McConnell et al., *Employee Stock Option Expense: Pro Forma Impact on EPS and Operating Margins -- the S&P 500*, ACCOUNTING ISSUES, Bear, Stearns & Co., Inc., (Aug. 2000) (reporting that only two of the Fortune 500 companies, Winn-Dixie and Boeing, were then actually recognizing compensation expense on employee stock options))); *Corporate Governance and Executive Compensation Hearing Before the Senate Comm. on Finance*, 107th Cong. 2 (2002) (written testimony of John H. Biggs, Chairman, President and CEO of TIAA-CREF) (testifying to Congress that "[m]ost companies use stock options to pay employees. In the S&P 500, 99 percent of the companies provide stock options to employees, and only two of those companies show expense for stock options"), *available at* http://www.finance.senate.gov/~finance/hearings/testimony/041802jbtest.pdf (last visited Dec. 15, 2002). Accounting for nonqualified employee stock options is discussed in greater detail *infra*, Part II.C (discussing, *inter alia*, post-Enron revisiting of this long-debated accounting issue, recent decisions by some large public companies, reached in the midst of the negative publicity recently surrounding this issue, to change to the "fair value" method and expense the costs involved, and FASB re-engagement in review of this issue in view of such developments and recent action by the IASB in this area).

[7] For purposes of this article, the term "book" accounting refers to the accounting reflected in a U.S. public company's audited financial

these "take both roads" transactions are not recent innovations and are by no means unique to Enron. They have been around for many years, and despite some significant criticism,[8] have been utilized by many well-known companies with respect to transactions involving billions of dollars.[9] Long before Enron's December 2, 2001 bankruptcy

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statements and "tax" accounting refers to the reporting of transactions by such company in its federal income tax returns. Potential tax and financial statement "appearance" benefits of divergent book and tax accounting for given transactions are discussed *infra* note 25 and accompanying text.

[8] *See, e.g.*, Abraham J. Briloff, *Pooling and Fooling*, BARRON'S MAGAZINE, Oct. 23, 2000, at 26, 28-29 (questioning the propriety of companies claiming an income tax deduction for the compensatory element of exercises of employee stock options at a bargain, but not showing the same as a charge against earnings for financial statement purposes); Nesvold, *supra* note 3, at 110-13 (calling for reconsideration of the financial accounting rules and practices permitting off-balance sheet treatment of synthetic leases); Weidner, *supra* note 3, at 487 (similarly criticizing the financial accounting treatment of synthetic leases); Robert K. Herdman et al., *Proposals Regarding Industry Segment and Other Interim Financial Reporting Matters, Management's Discussion and Analysis, and Off Balance Sheet Financing Disclosure*, 29 SEC DOCKET NO. 1026, 1984 WL 53320 at *1-2 (SEC Release No. 6514, et al.) (Feb. 15, 1984) (noting increasing use of off-balance sheet arrangements and expressing concern that financial disclosures were inadequately presenting the substance of such arrangements) [hereinafter Herdman et al.].

[9] For recent revelations of major synthetic lease "off-balance sheet" transactions, for example, see the following reports published after the Enron bankruptcy filing: Seth Lubove & Elizabeth MacDonald, *Debt? Who, Me?*, FORBES, Feb. 18, 2002 at 56 (discussing synthetic leasing or similar practices by Krispy Kreme Donuts, Dollar General, Enron, and Cisco Systems); Sheila Muto, *Firms Use Synthetic Leases Despite Criticism*, WALL ST. J., Feb. 20. 2002, at B6 (billion dollar synthetic lease financing by AOL Time Warner); Jim Finkle, *U.S. Accounting Changes May End 'Synthetic Leases,'* BLOOMBERG NEWS, Feb. 21, 2002 (San Francisco) (noting other prominent users of synthetic leases, including Microsoft, Symantec, 3Com, Cisco Systems, Solectron, and Krispy Kreme Donuts); Angela Zimm, *Genentech Leases Kept $573 Million in Liability Off Books*, BLOOMBERG NEWS, Mar. 7, 2002 (Boston); Rob Urban, *Accounting Change May Add $100 Billion Debt to Companies' Books*, BLOOMBERG NEWS, Feb. 27, 2002 (New York) (reporting estimates that changes to synthetic lease accounting under consideration by FASB could result in U.S. companies

filing, the existence of transactions such as synthetic leases, with blatantly inconsistent book and tax accounting treatment, implied inadequate interaction among the institutions charged with shaping and regulating tax and accounting rules.[10]

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having to add over *$100 billion* in debt to their balance sheets); Steve Bergsman, *Serious Questions About Synthetic Leases*, NAT'L REAL ESTATE ADVISOR, May, 2002 (reporting on the post-Enron attention to off-balance sheet financing, and noting the involvement in synthetic leasing of Kmart, Charles Schwab, Krispy Kreme Donuts, and AOL Time Warner); Steve Bergsman, *Scrutinizing Synthetic Leases*, SHOPPING CENTER WORLD, July 2002 (describing PETsMART's efforts to use sale-leasebacks to get out of synthetic leases, noting an estimate by a joint venture between CRIC and Prudential Real Estate Investors that the size of the synthetic lease market is six to eight billion dollars a year). *See also* Little, *supra* note 3, at xxv (indicating that the editor has been working on synthetic leases since 1991); Nesvold, *supra* note 3, at 85 n.7 (citing several sources in support of the observation that major corporations were, in 1999, increasingly looking to synthetic lease financing for various types of real estate facilities). As for the magnitude of the tax deductions being claimed by companies upon the exercise of employee stock options at a bargain without a corresponding charge against earnings for "book" purposes, see, e.g., the discussion of Cisco Systems, Inc., in Briloff, *supra* note 8, at 28-29 (estimating that Cisco claimed approximately *$2.5 billion* in tax deductions for its tax year ending July 31, 1999 for such compensation) and Hanlon & Shevlin, *supra* note 6, at 6-7 (discussing a report by Citizens for Tax Justice which estimated that a group of 233 out of 250 companies with positive pretax profits studied claimed an aggregate of $25.8 billion in employee stock option benefits over the 1996-1998 period).

[10] Representatives of the SEC's Office of Chief Accountant and Division of Corporation Finance acknowledged in telephone interviews in August and September 2001 that there had been no system of regular interaction between their offices and the Treasury Department to compare book and tax accounting for potentially abusive transactions. Telephone Interviews by Attorney Robert Coulthard (Aug. 10, Sept. 6, & Sept. 10, 2001) (summarized in memorandum on file with author). In addition, the FASB Emerging Issues Task Force ("EITF") had neither included representatives of nor formally interacted with the Treasury Department. E-mail Interview by Attorney Robert Coulthard with EITF representative at FASB (Aug. 6, 2001) (memorandum on file with author). Similarly, an Aug. 31, 2001, report prepared by accounting staff members at the SEC's Division of Corporation Finance identifying "current accounting disclosure issues" failed to target book-tax divergence as an area of significant concern. *See* SEC CORP. FIN. CURRENT ACCT. & DISCLOSURE ISSUES (Aug.

The Enron bankruptcy and subsequent revelations of questionable accounting practices by other major companies[11] have placed these divergent accounting transactions on the public radar, raising two pivotal questions. First, why were such large "blips" allowed to fly largely below the radar for so many years? Second, and more importantly, how can the administration of the tax and securities laws be improved to bring to these and other divergent accounting transactions the degree of "transparency" the markets are demanding, and regulators and other interested observers are professing to seek, in the aftermath of Enron?[12]

31, 2001), *available at* http://www.sec.gov/divisions/corpfin/acctdisc.htm (last visited Dec. 15, 2002).

[11] Among the more notable incidents, WorldCom announced in June 2002 that it would restate financial statements due to improper booking of some $3.8 billion in income over a five-quarter period and, also in June 2002, Xerox Corp. restated prior financial statements to reflect that it had improperly booked approximately $6.4 billion in revenue over the last five years. *See* Jake Ulick, *WorldCom's Financial Bomb*, CNNMONEY, June 26, 2002, *at* http://money.cnn.com/2002/06/25news/worldcom (reporting SEC statement that the WorldCom developments involved "accounting improprieties of unprecedented magnitude" and evidenced the need for reform in regulating corporate accounting); Steve Burkholder, *Xerox Reports Improperly Boosting Revenue by $6.4 Billion; Ex-Auditor KPMG Takes Issue*, 34 SEC. L. & REG. R. 27 at 1111-14 (July 2002) (reporting that the revenue recognition issues involved primarily changes in accounting for leases, and noting that KPMG, Xerox's former auditing firm, has announced disagreement with the restatement). *See also* Bill Brubaker, *Merck's Accounting Questioned; Co-Payments Were Booked as Revenue*, WASH. POST, July 8, 2002, § F, at E01 (reporting on Merck & Co.'s disclosure that it booked more than $12 billion for prescription drug co-payments which were actually retained by the pharmacy, not by Merck's Medco unit).

[12] *See, e.g.*, SEC Chairman Harvey Pitt, *Public Statement Regarding Regulation of the Accounting Profession* (Jan. 17, 2002), *at* http://www.sec.gov/news/speech/spch535.htm (last visited Dec. 15, 2002); Petition to U.S. Securities and Exchange Commission for Issuance of Interpretive Release, Dec. 31, 2001 submitted by the then "Big Five" accounting firms and the American Institute of Certified Public Accountants ("AICPA") [hereinafter Big Five Petition], *available at* http://www.sec.gov/rules/petitions/petndiscl-1232001.htm (last visited Dec.

A useful starting place is to acknowledge that this is not the first period of serious accounting crisis in the United States. For example, in the midst of accounting turmoil in the late 1970s, a partner in the accounting firm of Coopers & Lybrand observed:

> The accounting profession has been under intense scrutiny this past year. Not since the 1930s, when the congressional hearings that established the Securities and Exchange Commission were held, has there been such interest in accounting. Renewed congressional interest probably began with the highly publicized business failures that occurred over the past few years. The sudden failures of publicly owned companies, such as Equity Funding, Penn Central, Four Seasons Nursing Homes, and National Student Marketing, raised questions of why there was little or no prior warning from the auditors that anything was wrong.[13]

If the names Enron and WorldCom were substituted for the companies cited in that statement, it could easily be repeated today -- verbatim. This suggests that analysis of why questionable accounting practices exploiting book-tax differences have flourished and how reforms might be achieved must include an historical perspective. Accordingly, this article will focus its review on two aspects of the circumstances that facilitated the now-criticized opaque financial accounting for transactions with surprising book-tax divergence -- a general, and long-standing, consensus that the government should avoid legislating financial accounting standards, and a widespread and also long-standing fear of utilizing the tax law treatment or analysis of a transaction as a guide in determining the proper financial

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15, 2002) (requesting that the SEC issue an interpretive release regarding the application of disclosure requirements, under Regulation S-K Item 303, to certain categories of complex transactions to "improve the transparency of financial reporting"). *See also* 17 C.F.R. § 229.303 (2002).

[13] Roy D. Thylin, *Accounting Developments*, 1 J. ACCT., AUDITING & FIN. 264, 264 (1977-1978) (writing in an era of "major audit failures" and revelations of questionable payments made to governmental officials -- a practice that was eventually addressed by the enactment of the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213 §§ 102-104, 91 Stat. 1494 (codified as amended at 15 U.S.C. §§ 78a, 78dd-1, 78dd-2, 78f (1977)).

statement reporting of the same transaction. A review of the record of the book-tax conformity debate in the United States over the last half century reveals that these circumstances are grounded in generalizations and assumptions about the roles of the accounting profession and the tax law which merit serious reconsideration.

Most recently, the many legislative initiatives to improve the transparency of public-company financial disclosures, culminating in the enactment of the Sarbanes-Oxley Act of 2002,[14] have perpetuated the tradition of substantial delegation of the accounting standard-setting function to private sector bodies. The new law also failed to address the problem of unwarranted disconnect between the administration of the tax law and public company financial accounting. Although the Sarbanes-Oxley Act takes some major steps to improve public company auditing standards through a broad grant of authority to a new "Public Company Accounting Oversight Board" as a quasi-governmental overseer of the public company auditing process,[15] the Act continues the role of a private sector body as the primary setter of generally accepted accounting principles,[16] and, despite mandating various studies to

[14] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

[15] *Id.* at §§101-107, discussed *infra* notes 314-319 and accompanying text. For an overview of the pre-existing system of self-regulation of the auditing process by the accounting profession's AICPA and various related organizations, see U.S. GEN. ACCT. OFFICE, THE ACCOUNTING PROFESSION, STATUS OF PANEL ON AUDIT EFFECTIVENESS RECOMMENDATIONS TO ENHANCE THE SELF-REGULATORY SYSTEM, REP. NO. GAO-02-411, at 6-10 (May 2002) [hereinafter GAO 2002 ACCT. PROF. REPORT], *available at* http://www.gao.gov.

[16] Sarbanes-Oxley Act §108. The current system of establishing "generally accepted accounting principles" relies heavily on the work of the FASB, in interaction with the Securities and Exchange Commission and sections of the AICPA. *See* U.S. GEN. ACCT. OFFICE, SECURITIES AND EXCHANGE COMM., REVIEWS OF ACCOUNTING MATTERS RELATED TO PUBLIC FILINGS, REP. NO. GAO-01-718, at 4-7 (June 2001) [hereinafter GAO 2001 SEC REPORT], *available at* http://www.gao.gov/. *See also* S. REP. NO. 107-205, at 12-13 (2002), *available at* http://www.senate.gov/~banking/docs

improve accounting principles and practices, does not target book-tax divergence as a problem area.

At least some commentators, however, have now begun to embrace the notion of increased utilization of book-tax comparisons to improve both tax and financial accounting. For example, two prominent attorneys, following the enactment of the Sarbanes-Oxley Act, have urged "that Congress, the SEC, and the IRS consider adopting a single comprehensive requirement for the *public* disclosure of a detailed schedule reconciling public companies' book and tax income statements and balance sheets."[17] Interestingly, the

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/reports/reports.htm (last visited Dec. 15, 2002) ("Since 1973, the SEC has generally required companies operating in the United States to prepare their financial statements in accordance with 'principles, standards, and practices' promulgated by the Financial Accounting Standards Board . . . in the absence of specific SEC pronouncements on particular accounting questions.").

[17] Peter C. Canellos & Edward D. Kleinbard, *Disclosing Book-Tax Differences*, 96 TAX NOTES 999, 999 (Aug. 12, 2002) (emphasis added). This proposal, along with Senator Chuck Grassley's July 8, 2002 request that the Treasury and SEC consider the potential benefits of more public disclosure of corporate tax information are discussed at length, *infra* notes 368-371 and accompanying text. In terms of historical precedent for open disclosure of tax accounting information, one might consider the "Exchequer" procedures imposed in the 11th century by the Norman government in England. *See* M.T. CLANCHY, A HISTORY OF ENGLAND, EARLY MEDIEVAL ENGLAND 49-53 (Felipe Fernandez-Armesto ed., Folio Soc'y 5th ed. 2000) (1983). The Exchequer "was not a government department but an object"; to be precise, a rectangular table used as a "gigantic abacus" for an examination of a sheriff's accounts, with an accountant acting much like a "croupier" in moving around "counters" in lined columns showing what the sheriff owed and what had been paid thus far. *Id* at 49. Clanchy explains:

> At one end of the table sat the king's highest officials . . . and at the opposite end by himself, or at best with the support of a clerk, sat the sheriff whose accounts were being examined. The strange appearance of the table and the high rank of those around it should have been enough to impress upon most sheriffs the hazard of defrauding the king of his revenues. . . . As the accountant set out the counters he called out the numbers, so everyone could understand what was going on. . . . the Exchequer table

proponents of that public disclosure proposal noted that they had originally been arguing for more comprehensive disclosure of book-tax differences solely on corporate tax returns, to assist IRS audits. But in the aftermath of publicity regarding Enron, WorldCom, and other alleged large company accounting abuses it became clear that such disclosure in financial statements would increase the transparency of *financial* accounting as well.[18] It thus has taken some audit failures of gargantuan proportion to shine a bright light on the potential dual benefits of book-tax comparisons, in terms of improving both the administration of the tax law and the financial reporting which is critical to the regulation of dealings in securities. This is the case despite the fact that there has been considerable recent attention, largely from a tax perspective, on the growing gap between the book and taxable income of large companies and on suggestions that more attention to book-tax differences is in order to identify and eliminate abusive corporate tax shelters.[19]

> ensured that accounts were not only done but seen to be done, step by step, by all those who sat round the table.

Id. at 49-50 (also describing various other related paraphernalia, called "tallies" and "pipe rolls," used "to make the record on the spot" and provide the sheriff with a tangible receipt).

[18] Canellos & Kleinbard, *supra*, note 17, at 999 (emphasis added). As discussed *infra* notes 241, 251-254 and accompanying text, forms and regulations under both the federal tax and securities laws call for some limited book-tax reconciliation, but not the type of comprehensive disclosure of book-tax differences suggested by Canellos & Kleinbard.

[19] *See, e.g.*, Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax "GAAP,"* 2001 COLUM. BUS. L. REV. 539; Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175 (2002); Lillian Mills et al., *Trends in Book-Tax Income and Balance Sheet Differences*, 96 TAX NOTES 1109 (2002); Terry Shevlin, *Corporate Tax Shelters and Book-Tax Differences*, 55 TAX L. REV. 427 (2002); George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405 (2002); George K. Yin, *Getting Serious About Corporate Tax Shelters; Taking a Lesson from History*, 54 SMU L. REV. 209 (2001). As discussed in Part III *infra*, this growing body of literature suggesting improvements to the tax system by more "linkage" to "book" accounting constitutes a

One benefit from the otherwise tragic Enron experience may indeed be more widespread awareness that the quest for loopholes typically associated with tax shelters is an equally important concern in regulating financial accounting, thereby warranting a coordinated response to both problems.[20] Better disclosure of book-tax differences is only a first, though critical, step in more effective use of book-tax comparative analysis to identify and eliminate abusive tax *and* financial accounting practices. Regulatory actions in addition to the imposition of improved disclosure requirements -- such as book-tax consistency requirements imposed from *both* the tax and securities regulation perspective for potentially abusive transactions -- also merit consideration.

Evidencing recent manifestations of the need for enhanced governmental attention to book-tax conformity issues, Part II *infra* explores synthetic leases, off-balance sheet partnerships and nonqualified employee stock options as examples of transactions with dramatic financial statement/income tax reporting divergence. These accounting practices have been widely employed under

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revisiting of tax-oriented "conformity" concepts which caused significant debate in the past -- particularly in the 1950s and 1970s -- but, in keeping with old assumptions about the role of government in financial accounting explored herein, predominantly stops short of suggesting that financial accounting could in many cases benefit from adoption of tax law concepts.

[20] *See* Peter C. Canellos, *Enron and Tax Shelters: Similarities and Differences*, 94 TAX NOTES 923, 923 (2002) (suggesting that the complex accounting structures employed by Enron involve similarities to corporate tax shelter structures, including "apparent compliance with vague, inconsistent and confused rules" and "devices to conceal and confuse"); Alice G. Abreu, *Corporate Tax Shelters: The Slippery Slope to Enron?*, 94 TAX NOTES 1715, 1715 (2002) (positing a possible "causal connection" between the "pushing the literal limits of compliance" and "reporting-as-game mentality" which have characterized the recent proliferation of corporate tax shelters and the financial accounting practices engaged in by Enron). While both Canellos and Abreu are on firm ground in using the Enron debacle to point to the similarity in the underlying mindset which has yielded both tax and accounting gimmicks, discussion below will demonstrate that side-stepping rules in *both* tax and financial accounting, to reduce tax liability and "manage earnings," is not a recent phenomenon.

prevailing interpretations of accounting principles and federal income tax law, but are nevertheless questionable when viewed in the light of the underlying substance of the transactions.

Part III then summarizes the history of the book-tax accounting conformity debate in the United States, describing the political environment and institutional decisions that have allowed substantial divergence to exist. That history includes an abundance of thoughtful analysis justifying book-tax differences in many situations. It also reflects, however, a questionable degree of deference to non-governmental bodies, primarily the American Institute of Certified Public Accountants ("AICPA") and, since 1973, the Financial Accounting Standards Board ("FASB"), in the establishment of auditing and financial accounting standards;[21] unjustified dismissal of the possibility that financial accounting might learn some lessons from tax accounting for certain types of transactions; and, consequently, insufficient use of book-tax accounting comparisons and consistency requirements as part of the process of identifying and eliminating both tax and financial accounting abuses.

Finally, Part IV suggests ways for the appropriate regulatory bodies to more regularly employ book-tax comparisons to identify improper accounting practices and to cause the implementation of rules and standards which require book and tax accounting consistency in targeted situations in which such consistency comports with common goals of tax and financial reporting. Consistent with the spirit of the Sarbanes-Oxley Act, such coordinated efforts would facilitate the production of clear disclosure of the underlying economic substance of complex transactions -- thus facilitating the "transparency" generally viewed in the aftermath of Enron and other high-profile audit failures as the key to restoring confidence in both financial accounting and the tax system, at a time when such confidence is sorely needed.

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[21] *See supra* notes 15, 16.

II. SOME "TAKE BOTH ROADS" TRANSACTIONS

A. The "Synthetic" Lease of Real Estate

1. Overview: A Floor Wax AND A Dessert Topping?[22]

Labeling a real estate finance arrangement a "synthetic" lease should, in and of itself, raise suspicion about the nature of the underlying transaction. Yet, the multi-billion dollar synthetic lease industry has flourished under that nomenclature for several years, albeit not without some significant criticism.[23] While some analysts in recent years focused on the dubious accounting driving synthetic leases,[24] it took the Enron disaster to generate broad public awareness of the simple problem with this device -- the exploitation of overly-generous financial accounting rules to produce debt which is "off" balance sheet for book purposes, but is very much "on" balance sheet for income tax purposes. As a general proposition, for financial accounting purposes, management often seeks to avoid balance sheet debt because various ratios used by analysts to value companies are

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[22] *Saturday Night Live: Shimmer* (NBC television broadcast, Jan. 10, 1976), *available at* http://snltranscripts.jt.org/75/75ishimmer.phtml.

[23] *See, e.g.*, Nesvold, *supra* note 3; Weidner, *supra* note 3.

[24] *See, e.g.*, Nesvold, *supra* note 3, at 108 (suggesting financial accounting reforms to SPE and other rules to bring disclosure of synthetic lease financing "on" balance sheet); Weidner, *supra* note 3, at 486-487 (discussing the need to improve the financial accounting standards to curtail the off-balance sheet "sleight-of-hand" involved in synthetic lease accounting). Speaking loudly to the attractiveness of off-balance sheet treatment from a financial accounting perspective, Little, *supra* note 3, cites (in a preface to the text) the following quotation attributed to Richard Greene: "The basic drives of man are few: to get enough food, to find shelter and to keep debt off of the balance sheet." Richard Greene, *The Joys of Leasing,* FORBES, Nov. 24, 1980, at 59. As an aside, one must wonder whether Greene's reference to "shelter" was intended to refer to a roof and walls or tax benefits (or perhaps both).

negatively affected by high debt.[25] For tax purposes, debt is often desired to support loss deductions, allow for nontaxable receipts of cash, and, in general, drive tax deferral.[26] Thus, a financing arrangement creating "debt" for tax purposes but not for book purposes may be particularly attractive, as the engineers of synthetic lease transactions clearly understood. There are indications that rating agencies have recognized the need to adjust ratings based on financial statement figures to take into account the true economic effects of synthetic leases,[27] but that is simply not the same as treating

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[25] Murray, *supra* note 3, at 195, 209; Nesvold, *supra* note 3, at 93-94; Weidner, *supra* note 3, at 450-51. *See also* Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 143 n. 6 (1997) (citing various sources on the potential benefits of managed earnings and keeping debt off balance sheets); A. Tom Nelson, *Capitalizing Leases - The Effect on Financial Ratios*, 116 J. ACCT. 49 (July 1963).

[26] Under general tax principles, the receipt of loan proceeds is not treated as an income recognition event because of the obligation to repay the borrowed proceeds; if the repayment obligation is cancelled then there may, subject to certain exceptions, be resulting income recognition. *See* I.R.C. § 108 (2002). Moreover, a taxpayer's basis in property, including depreciable property, may include costs funded through borrowings. *See, e.g.*, Comm'r v. Tufts, 461 U.S. 300 (1983); Crane v. Comm'r, 331 U.S. 1 (1947). There are various applicable limits on the ability of certain types of taxpayers to claim "leveraged" deductions (such as the "at risk" rules of I.R.C. § 465 (2002) and the passive activity loss limitation rules of I.R.C. § 469 (2002)), but these limitations would generally not preclude the claiming of deductions in respect of depreciable real estate by a publicly-held corporation. *See* I.R.C. §§ 465(a)(1), §469(a) (2002). In the partnership context, a partner is allocated a share of the partnership's liabilities under I.R.C. § 752 (2002), resulting in a deemed contribution of money by the partner to the partnership, thereby increasing the partner's basis in its partnership interest under I.R.C. §§ 705 and 722 (2002); increased basis, in turn, can result in the partner's ability to claim additional losses or receive tax-deferred distributions from the partnership. *See* I.R.C. §§ 704(d), 731(a) (2002).

[27] *See* E-mail from Jack Murray to the editor of "Dirt," Professor Patrick A. Randolph, Jr., of the University of Missouri at Kansas City School of Law; re: Jack Murray on Synthetic Leases and Enron Fallout in General forwarded to DIRT@LISTSERV.umkc.edu on Aug. 6, 2002 (on file with author) (arguing that synthetic leases are distinguishable from "the

the obligations involved as debt on the balance sheet in the first instance.

In essence, a synthetic lease is an arrangement documented (mainly) as a "lease" with respect to which, under prevailing interpretations of tax and financial accounting rules, a company can simultaneously treat itself as the "owner" of a building for income tax purposes, but merely a "tenant" under a so-called "operating lease" for financial accounting purposes.[28] Jack Murray, a noted authority on the multi-billion dollar synthetic lease structured financing industry which has emerged over the

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Enron off-balance-sheet shenanigans" and observing that "credit-rating agencies such as Standard & Poor's, Moody's, and Fitch already take synthetic-lease obligations into account when assessing a corporation's creditworthiness"). Murray quoted a March 7, 2002 Fitch Ratings report which stated:

> When rating companies that use synthetic leases, Fitch Ratings will effectively add the financing back to the balance sheet and income statement by adjusting leverage and other key credit ratios. In addition, Fitch may assign rating to the lease debt, based on the credit rating of the lessee and/or the value of the underlying asset(s).

FitchRatings, *Synthetic Leasing*, Mar. 7, 2002, at 1 (on file with author), *available at* http://www.fitchratings.com. *See also* Marian Lavelle & Leonard Weiner, *Lots of Leasing Trouble*, U.S. NEWS & WORLD REP., Feb. 18, 2002, at 32 (arguing that the term "synthetic" unjustifiably raises a "big red flag" that "[i]t's not real" and that "such leases are considered 'on the books' when lenders and credit agencies evaluate firms' financial strengths"). Of course, relying on rating company reports to disseminate information on the effects of synthetic leases has its limits, especially compared to actual inclusion of the underlying debt on the balance sheet. The analysts who are doing the rating still have to be given sufficient disclosure to understand the transactions. Investors or their representatives have to obtain the rating companies' reports and work through the differences from the companies' financial statement figures. Moreover, there is obviously a time lag involved when lenders and rating agencies (not to mention less sophisticated investors) have to learn to convert the financial figures actually used in a company's financial statements to reflect the true nature of a complex transaction.

[28] *See* Little, *supra* note 3, at 1, 25-38; Weidner, *supra* note 3, at 454-58.

last decade or so, described the potential utility of such an arrangement to a "corporate user of real estate" as follows:

> [I]f properly structured as a true "synthetic" leasing transaction, the lessee/corporate user will be able to expense the rental payments it makes to the lessor under the synthetic lease, and its balance sheet will not be *marred by the appearance* of real estate ownership or by the existence of mortgage debt. However, the lessee/corporate user will retain all the tax benefits and burdens of ownership, including the ability to depreciate the real estate assets and obtain any appreciation upon a subsequent purchase of the real property from the lessor or upon resale to a third party.[29]

This have your cake and eat it too proposition is reminiscent of the late-seventies *Saturday Night Live* sketch, set in a suburban kitchen, in which the spokesman for a new product convinces a couple that the foamy substance he is pitching does double duty -- as a floor wax *and* a dessert topping -- concluding: "New Shimmer, for the greatest shine you've ever tasted!"[30] Well, it is possible Shimmer could legitimately serve the dual functions of floor wax and dessert topping, but the prudent consumer would investigate further before mopping or ingesting. The same can be said of synthetic lease arrangements. They sound too good to be true, and accordingly warrant special scrutiny by the various institutions charged with setting accounting standards,

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[29] Murray, *supra* note 3, at 194-195 (emphasis added). Murray has more recently stated that synthetic leases "are based on the strange fiction -- which I have never fully comprehended -- that the transaction is an operating lease for financial accounting purposes and a capital lease for all other purposes" and that "[a]ccurate and complete disclosure is the key, and it is certainly true reforms are necessary in this area," though stressing that synthetic leases have been legally used for legitimate purposes despite the book-tax accounting divergence. E-mail from Jack Murray to the editor of Dirt, Professor Randolph; re: New Accounting Rules and Synthetic Leases forwarded to DIRTLISTSERVE@umkc.edu on Feb. 15, 2002 (on file with author); *see also* Dirt *at* http://www.umkc.edu/dirt.

[30] *Saturday Night Live: Shimmer*, *supra* note 22.

regulating full and fair disclosure of the financial condition of public companies, and administering the income tax system.

2. The Central Components of the Arrangement

A synthetic lease transaction involves a substantial amount of paperwork and numerous complexities.[31] Specifics can certainly deviate quite a bit from deal to deal. The central components of a typical synthetic lease arrangement can, however, be summarized as follows:

(i) a "special purpose entity" ("SPE")[32] is formed to be (on paper) the owner and lessor of a facility (often a real estate project to be occupied by only the corporate user);

(ii) the SPE enters into contracts for the acquisition and/or construction of the facility and is (again, on paper) the borrower of associated mortgage financing, though the corporate user/lessee may be designated as the SPE's agent with respect to certain construction supervision matters;[33]

(iii) the SPE enters into a relatively short-term lease (usually not exceeding ten years) with the high credit rating corporate user, which calls for lessee payment obligations set in amounts and timing that provide comfort to the mortgage lender that the principal and interest on the mortgage loan will be timely paid, and allocates to the corporate user/lessee the responsibility to pay virtually all material expenses and bear various risks associated with the property;[34] and

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[31] For a recent, comprehensive explanation of various details of the issues, techniques and documents involved in synthetic leasing, see Little, *supra* note 3.

[32] *See generally* John C. Murray, *Use of Special Purpose Entities in Synthetic Leasing Transactions* (2000) *at* http://www.firstam.com/faf/html/cust/jm-entities-outline.html; Murray, *supra* note 3, at 200-209; Weidner, *supra* note 3, at 459-462; Little, *supra* note 3, at 7-15. *See also* Nesvold, *supra* note 3, at 90 nn.32-38 and accompanying text (citing various sources in support of the proposition that many SPE-lessors are subsidiaries of lenders providing financing to the transaction).

[33] *See* Little, *supra* note 3, at 4-5.

[34] *See id.* at 2-6, 18-19; Murray, *supra* note 3, at 194-99.

(iv) the documents involved include a variety of agreements and "options" which serve to provide the mortgage lender assurance that its debt is secure and provide the corporate user with essentially all of the material benefits and burdens of ownership of the real estate including, importantly, the ability to capture the benefit of appreciation in the value of the property.[35]

The "end of term options" are particularly intriguing. As explained in the recent book on synthetic leasing published by the ABA's Section of Real Property, Probate and Trust Law:

> Because of the accounting rules . . . the purchase of the property by the lessee must be optional, and the lessee also must have the option to return the property to the lessor at the end of the lease term. If the lessee exercises this option, it pays the lessor contingent rent or a guaranteed payment equal to approximately 85 percent of the lease balance. If there is no amortization in the transaction, this amount equals about 85 percent of the cost of the property financed by the debt and the equity under the synthetic lease arrangement.
>
> If the lessee exercises the return option . . . it attempts to sell the property to a third party on behalf of the lessor. . . . Any sales proceeds in excess of the lease balance are paid to the lessee. The lessor may reject a proposed sale if the sales proceeds are insufficient to repay in full the outstanding lease balance. If the lessor does not reject the proposed

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[35] *See* Little, *supra* note 3, at 3-4. Little notes:

> Many synthetic leases permit the lessee to purchase the property on any rent payment date and at the end of the lease term by prepaying the debt and the equity. The purchase or prepayment during the lease term is often without any premium or penalty. Therefore, to the extent that the property value exceeds the outstanding amount of the debt and equity at the time the lessee purchases the property, the lessee keeps the appreciation in the property.

Id.

> sale, the lessee may be required to pay any deficiency; however, the lessee's maximum liability under the sale option is the amount of the contingent rent or guaranteed payment. This payment is often referred to as the "recourse" portion of the loan because it is the maximum amount that the accounting rules permit the lessee to pay.[36]

This description of the "end of term options" leaves little doubt that, in economic substance, the lessee is the party obligated to see that the debt gets repaid. Nonetheless, the "accounting rules" referred to in the above-quoted passage have been construed to permit the treatment of such debt sought by the corporate user -- off-balance sheet financing. Assuming the desired "book" reporting of the transaction is respected, the corporate user does not show the real estate as an asset on its balance sheet and, more importantly from its perspective, does not show the mortgage loan as a liability on its balance sheet. If the desired tax reporting is also respected, the corporate user also captures the income tax advantages associated with being treated as the owner of the property for tax purposes. The combination of resulting depreciation and interest expense deductions on its income tax returns can, at least during the early years of the "lease," provide more tax savings than would the "rent" deductions if the corporate user were treated as a "tenant" for tax purposes.[37] This "win-win" result is accomplished in a manner that allows the corporate user to effectively control the property and ultimately reap the benefits of any substantial increase in its value. In addition, there has been a perception among synthetic leasing industry analysts that in many instances more favorable interest rates and other

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[36] Little, *supra* note 3, at 6. The discussion in Little goes on to state that "[a]lthough the accounting rules require as a general rule that the lessee have a sale option, as a practical matter the parties do not anticipate that the lessee will exercise the option," and the discussion explains that the contingent rent or guaranteed payment and other lessee obligations under the documents provide economic disincentives for the lessee to exercise this sale option. *Id.*

[37] *See* Weidner, *supra* note 3, at 448.

financing terms could be obtained by the tenant/corporate user than would have been the case with traditional real estate mortgage financing.[38]

3. Tax Accounting for the Synthetic Lease

The parties are often candid about the fact that the synthetic lease transaction will be reported inconsistently to various potentially interested audiences. This book-tax divergence exploitation may involve some self-consciousness, if not trepidation. Murray explains that the principal document, the "lease," commonly includes:

> [A] statement that the transaction is between unrelated parties and that the parties intend that the lease be treated as an operating lease for financial accounting purposes, but as a financing arrangement, or loan, for tax, bankruptcy, and commercial purposes (*although corporate auditors may have concerns about such an explicit recitation*).[39]

Leaving aside for the moment the salient point -- that corporate auditors *ought to have concerns* about this divergence whether or not such divergence is explicitly recited in the documents -- this description of the intent of the parties highlights the underlying tax law and accounting rules at work in the synthetic lease context.

From a tax perspective, identification of the "corporate user" as the "owner" of the property (and thus the "borrower" of the mortgage loan) is clearly the proper treatment. Under

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[38] *See* Murray, *supra* note 3, at 198, 210; Nesvold, *supra* note 3, at 94-95, 95 n.63 (citing various sources in support of the proposition that there are potential financing advantages to be had in synthetic leasing, including favorable borrowing rates, but also acknowledging the view of at least one commentator that the interest rates involved did not really differ from the rates available for "straightforward debt financing" based on the lessee's credit).

[39] Murray, *supra* note 3, at 214 (emphasis added). *See also* Little, *supra* note 3, at 19. "There is usually express language in the lease to the effect that the parties intend that it will be a lease for financial accounting purposes and a loan for tax purposes." *Id.*

well-established "substance over form" principles, many notable tax shelter cases have addressed the issue of whether a putative tenant should be treated as the owner of purportedly "leased" property because it has, through purchase options and other aspects of the pertinent agreements, most of the typical benefits and burdens of ownership.[40] These precedents often involved a difficult multi-factored analysis because at least colorable arguments existed that the purported "owner-lessor" had some significant indicia of ownership. In a customary synthetic lease transaction, however, the fact that the deck is so severely stacked toward the corporate user/lessee (in terms of control and possession of economic rights and obligations indicative of ownership) makes the decision easy -- the corporate user/lessee should be recognized as the "tax owner" of the property. The IRS has privately ruled to that effect in at least one situation involving a synthetic lease,[41] and

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[40] *See* Weidner, *supra* note 3, at 465-85 for an excellent exposition of the principal case law and its support of the conclusion that the "lessee" in a customary synthetic lease arrangement should be deemed the owner of the "leased" property for income tax purposes.

[41] I.R.S. F.S.A. 199920003 (Jan. 12, 1999). Some commentators, although agreeing with the result, have found the reasoning in this Field Service Advice (which on its face termed the tax ownership determination in the subject transaction a "close call") somewhat questionable, noting that the transaction under review lacked some of the residual risk/reward indicia of ownership (such as guarantees of residual value or clear rights to capture "appreciation" in the value of the leased property) of great significance in the case law, and that the Service's ruling may have in large measure turned not only on the many indicia of risk and control the lessee possessed, but also on the parties' expression of intent and consistent treatment of the lessee as the "tax owner" of the subject property. *See* Frost & Carman, *supra* note 3, at 368; Little, *supra* note 3, at 54 (suggesting that the IRS did not thoroughly analyze and/or weigh the consequences of "end-of-term" options, which appear to have effectively shifted "most of the benefits and risks of residual value" to the lessee, and suggesting that the ruling should not have been such a close call); Weidner, *supra* note 3, at 485 (arguing that the ruling reaches the correct result based on considerations in key case law which stress taking a practical approach to the parties' actions and their implications as to the probable effects of options and other provisions in determining the lessee's relationship to the property, as well as the concept of also looking at the

commentators have noted that the substance over form tax law analysis clearly makes the "tenant" in typical synthetic lease arrangements the *owner* of the subject property for tax purposes.[42]

4. Financial Accounting for the Synthetic Lease

With the tax law overwhelmingly friendly to the corporate user in a synthetic lease transaction desirous of "owner" status for tax purposes, one might expect financial accounting standards to have been commensurately hostile to the corporate user seeking mere "tenant" status for "book" purposes in these transactions. As noted *supra*,[43] and discussed in more detail *infra*,[44] the SEC has, in effect, delegated to the FASB the primary responsibility for establishing and regulating the "generally accepted accounting principles" that are the cornerstone of financial disclosure by reporting companies.[45] The FASB standards and interpretations on accounting for leases are extremely complex. The following discussion is designed to provide an overview of the key rules.[46]

The GAAP approach to accounting for the economic effects of a purported lease is to determine whether the lease should be characterized as an "operating lease" (a "true" lease in which the party named as "lessee" will indeed be treated as a mere rent-paying tenant for GAAP purposes) or a "capital lease" (in which case the named "lessee" will be

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transaction from the SPE's perspective to determine if, in substance, it should be treated as the tax owner where it possesses few benefits or burdens of ownership).

[42] *See* Little, *supra* note 3, at 53-55; Weidner, *supra* note 3, at 485-486.

[43] *See supra* note 16.

[44] *See infra* notes 272, 320-322 and accompanying text.

[45] *Id. See also* U.S. GEN. ACCT. OFFICE, THE ACCOUNTING PROFESSION, MAJOR ISSUES: PROGRESS AND CONCERNS, REP. NO. GAO/AIMD-96-98, at 3 (Sept. 1996) [hereinafter GAO 1996 ACCT. PROF. REPORT], *available at* http://www.gao.gov; Nesvold, *supra* note 3, at 88-89.

[46] For a recent detailed examination of the many accounting rules potentially implicated in synthetic lease arrangements, see Little, *supra* note 3, at 8-15, 25-43.

treated as the owner of the property and, in the leveraged lease setting, as the borrower of the associated financing).[47] The corporate user in a synthetic lease transaction is seeking "operating lease" treatment for financial accounting purposes.

The primary FASB guidance on the "operating lease" versus "capital lease" determination is Statement of Financial Accounting Standards No. 13 ("SFAS No. 13").[48] Under SFAS No. 13, a lease is treated as a "capital" rather than an "operating" lease if any of the following four circumstances exists under the lease arrangements, determined as of the time the lease is entered into: (1) ownership of the "leased" property is to transfer to the purported lessee by the end of the lease term; (2) the lessee has a bargain purchase option on the leased property; (3) the term of the lease covers 75 percent or more of the estimated economic useful life of the leased property; or (4) the present value of the minimum rental payments amounts to 90 percent or more of the excess of the fair market value of the leased property over the amount of any investment tax credit retained by the "lessor" in respect of the leased property.[49] If the lessee is not able to avoid each of these four

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[47] *See* Little, *supra* note 3, at 26; Weidner, *supra* note 3, at 454-458.

[48] ACCOUNTING FOR LEASES, Statement of Financial Accounting Standards No. 13 (Financial Accounting Standards Bd. 1976) [hereinafter SFAS No. 13]. FASB materials are available through http://www.fasb.org.

[49] *Id.* ¶ 7. Of particular importance in many synthetic leasing transactions, SFAS No. 13 contains some additional rules for leases of real estate, including rules calling for separate or combined consideration of land and buildings in specified circumstances. *Id.* ¶¶ 24-28. *See also* Weidner, *supra* note 3, at 3; Little, *supra* note 3, at 28-38. It should be noted that the focus in SFAS No. 13 on the time at which the lease is entered into permits the numbers crunching, and coordinated shaping of the lease provisions, necessary to demonstrate that any purchase option is not at a "bargain" and that the other numerical hurdles are not crossed. For example, for purposes of SFAS No. 13, "bargain purchase option" is defined as "[a] provision allowing the lessee, at his option, to purchase the lease property for a price sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that the exercise of the option appears, *at the inception of the lease*, to be reasonably assured." SFAS No. 13, *supra* note 48, ¶ 5.d (emphasis added).

circumstances, it will have to apply capital lease treatment, which includes treating the present value of the rental payments as a debt obligation (and balance sheet liability, as opposed to merely a "footnoted" long-term rental obligation[50]), recording the leased property as an asset owned (and amortizing the imputed cost to the extent the leased property is of a type subject to depreciation for GAAP purposes), and reflecting the rental payments as in part

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[50] *See* SFAS No. 13, *supra* note 48, ¶ 16, for the disclosures required if capital lease treatment is avoided. Paragraph 16 states in pertinent part:

> 16. The following information with respect to leases shall be disclosed in the lessee's financial statements or the footnotes thereto . . .
>
> b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:
>
> i. Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.
>
> ii. The total of minimum rentals to be received in the future under noncancelable subleases of the date as of the latest balance sheet presented.
>
> c. For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.
>
> d. A general description of the lessee's leasing arrangements, including, but not limited to, the following:
>
> i. The basis on which contingent rental payments are determined.
>
> ii. The existence and terms of renewal or purchase options and escalation clauses.
>
> iii. Restrictions imposed by lease arrangements, such as those concerning dividends, additional rent, and further leasing.

See also Weidner, *supra* note 3, at 456 n.55.

payments of principal and in part payments of interest on the imputed debt obligation (in contrast to the full expensing of the payments as "rent" which would occur if the lease constituted an "operating" lease).[51]

Some commentators have argued that the "footnoting" for synthetic leases treated as "operating leases" provides sufficient information to alert the reader (at least if the reader is a lender or credit rating agency) that capital lease treatment may be more appropriate.[52] That argument is unpersuasive, for at least three reasons. First, the strength of the proposition that the footnotes are adequate depends on how a company seeking off-balance sheet treatment deals with SFAS No. 13's requirement to provide a "general description" of the lease arrangement (beyond specific disclosures of rent and other payment obligations).[53] The public reaction to revelations of the scope of the public company debt involved in synthetic leasing (not to mention the efforts announced by some companies to abandon their synthetic lease arrangements) strongly suggests that many companies failed to adequately disclose the bottom line on their synthetic leases.[54] Second, not all potential investors are well-positioned to convert the actual figures in the balance sheet by extrapolation from footnoted information. And, third, if there is no material difference in the quality of disclosure, why have companies fought so hard to achieve "off" balance sheet treatment, doing documentation handstands with "end of term options," in an attempt to avoid placing the lease obligations in the liabilities column on the balance sheet?

There is a substantial body of commentary on SFAS No. 13 and its application to leveraged lease transactions in

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[51] *See* SFAS No. 13, *supra* note 48, ¶ 16.a; Weidner, *supra* note 3, at 456.

[52] *See supra* note 27.

[53] *See supra* note 50.

[54] *See supra* note 9.

general, and, recently, synthetic leases in particular.[55] In his probing article on synthetic leases, Professor Donald Weidner notes that the drafters of SFAS No. 13 intended to force a lessee to adopt capital lease treatment where "substantially all of the benefits and risks incident to the ownership of [the leased property]" are transferred to the lessee, characterizing this "benefits and risks" analysis as the "core concept" behind SFAS No. 13.[56] Yet, as Professor Weidner points out, despite the similarity of this concept to the "benefits and burdens" analysis employed by the IRS and the courts in determining ownership for federal income tax purposes, the FASB has consciously declined to completely harmonize the capital lease determination for financial accounting purposes with the reporting of ownership for income tax purposes.[57] For some 25 years, the failure to mandate book-tax consistency has left the door open for transactions such as synthetic leases that rely on mechanical avoidance of the four-part test of SFAS No. 13 to support operating lease treatment for book purposes, while simultaneously utilizing the more comprehensive facts and circumstances approach adopted by the tax law to claim the existence of sufficient benefits and burdens to allow the lessee to treat itself as the owner of the leased property and obligor of the associated debt for tax purposes.

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[55] *See, e.g.*, Nesvold, *supra* note 3, at 104-05 (and sources cited therein); Weidner, *supra* note 3, at 454-58, 486-87 (and sources cited therein).

[56] Weidner, *supra* note 3, at 456-57.

[57] *Id.* at 457-58 (noting that the FASB expressly stated in its SFAS No. 13 that the "possible need for conformity" between the financial and tax reporting in this regard was "beyond the scope" of SFAS No. 13); *see also* Lee Sheppard, *Enron's Basis-Shifting Synthetic Leases*, 95 Tax Notes 1423 (2002) (focusing on the tax aspects of a complex synthetic lease/partnership transaction involving the Enron headquarters building and Enron affiliates); J. Brent Vasconcellos, *Enron's Teresa Transaction: It's the Financial Disclosure, Stupid*, 95 Tax Notes 1829 (2002) (criticizing Lee Sheppard's analysis and suggesting that GAAP could benefit from utilization of the tax law's "business purpose" and "substance over form" doctrines).

SFAS No. 13 is not the only potential obstacle to operating lease treatment by a synthetic real estate lessee in its financial reporting. Even if a lease passes the SFAS No. 13 tests, operating lease characterization may be unavailable under the special "sale-leaseback" rules of the FASB's Statement of Financial Accounting Standards No. 98 ("SFAS No. 98"),[58] which imposes stringent criteria that can deny the lessee the desired operating lease result if the lessee transferred ownership of the lease property to the purported lessor but then retained "continuing involvement" in the ownership.[59] Passing muster under the continuing involvement tests of SFAS No. 98 can be a much more difficult proposition for the lessee than avoiding the four factors in SFAS No. 13, but in typical synthetic lease transactions the SFAS No. 98 obstacles are avoided simply by making sure the ostensible lessor does not acquire the asset from the lessee.[60]

A further, more common problem may exist, however, if the lessor and lessee are determined to be one and the same. As mentioned *supra*, modern synthetic lease arrangements usually involve a lessor which is a SPE whose job is to essentially act as the middleman in the transaction between the sources of financing (banks or other lending institutions) and the high-credit source of repayment of the financing (the corporate lessee/user of the leased property).[61] The issue is whether the SPE is a bona fide third party acting independently of the corporate user/lessee or in essence a "straw party" to be treated as an alter ego or agent of the putative lessee, thus treating its assets and obligations as those of the lessee. This "consolidation" issue has been a hot topic in GAAP accounting (both before and after the Enron revelations) well within the sights of the FASB's "Emerging

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[58] ACCOUNTING FOR LEASES, Statement of Financial Accounting Standards No. 98 (Financial Accounting Statements Bd. 1988) [hereinafter SFAS No. 98].

[59] *See id.*; Little, *supra* note 3, at 9-10, 28-30; Weidner, *supra* note 3, at 454-55 (each discussing key elements of SFAS No. 98).

[60] *See* Little, *supra* note 3, at 10; Weidner, *supra* note 3, at 455.

[61] *See supra* notes 32-36 and accompanying text.

Issues Task Force" ("EITF"), and addressed, for example, in EITF Issue No. 90-15 ("EITF 90-15").[62] The EITF pronouncements in theory adopted a principled substance over form approach. EITF 90-15 set forth a three-part test, to be applied by reference to all of the facts and circumstances of the subject transaction, under which consolidation would be required where substantially all of the SPE/lessor's business involved leasing assets to the corporate lessee, the lessee had substantially all of the residual risks and rewards relating to the leased property *and* the lessor did not maintain a substantive investment that was at risk throughout the lease term.[63] Much like

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[62] EMERGING ISSUES TASK FORCE, ISSUE NO. 90-15, IMPACT OF NONSUBSTANTIVE LESSORS, RESIDUAL VALUE GUARANTEES, AND OTHER PROVISIONS IN LEASING TRANSACTIONS (July 1990) [hereinafter EITF 90-15].

[63] *See* EITF 90-15; Little, *supra* note 3, at 10-11 (summarizing EITF 90-15). EITF 90-15 was largely precipitated by SEC requests. *See* EITF Topic D-14, *Transactions Involving Special-Purpose Entities*, indicating that the SEC in effect precipitated the EITF 90-15 when it was announced by the SEC Observer that

> the SEC staff believes that nonconsolidation and sales recognition are not appropriate . . . when the majority owner of the SPE makes only a nominal capital investment, the activities of the SPE are virtually all on the sponsor's or transferor's behalf, and the substantive risks and rewards of the asset or the debt of the SPE rest directly or indirectly with the sponsor or transferor

and that, with respect to leasing in particular,

> the SEC staff *is not attempting to change generally accepted accounting principles in this area* but believes that the application of such principles should result in accounting that is not misleading and . . . literature in addition to FASB Statement No. 13 Accounting for Leases, including that related to consolidation, should be considered.

(emphasis added). *See also* EMERGING ISSUES TASK FORCE, ISSUE NO. 96-21, IMPLEMENTATION ISSUES IN ACCOUNTING FOR LEASING TRANSACTIONS INVOLVING SPECIAL PURPOSE ENTITIES (amplifying the application of certain aspects of EITF 90-15, as well as SFAS 13, including, *inter alia*, prohibitions on the use of nonrecourse financing or other risk limiting

SFAS No. 13, the spirit of the EITF 90-15 approach reflected the type of benefits and burdens examination utilized in the tax law, but with the same deficiency as SFAS No. 13 -- mechanical rules that can be circumvented rather easily. An arrangement could have the characteristics described in the first two parts of the test but avoid consolidation simply by meeting the "substantive investment" requirement. The practitioners of synthetic leases came to rely heavily on the ability to demonstrate a rather minimal equity investment and risk of loss on the part of the "unrelated" owners of the SPE-lessor, typically relying on authority in EITF Issue No. 90-15 requiring a *minimum* investment of 3 percent of the entity's total capital by owners unrelated to the party with whom possible consolidation is being tested.[64] As discussed more fully *infra* in the context of "off-balance sheet partnerships,"[65] the 3 percent minimum was not intended (at least in the view of the SEC) to be a "safe harbor" for all transactions, has, with good reason, raised Congressional

arrangements in attempts to escape consolidation under 90-15 by establishing "substantive investment" by the lessor); EMERGING ISSUES TASK FORCE, ISSUE NO. 97-1, IMPLEMENTATION ISSUES IN ACCOUNTING FOR LEASE TRANSACTIONS, INCLUDING THOSE INVOLVING SPECIAL PURPOSE ENTITIES (dealing with the extent to which lessee indemnification for pre-existing environmental conditions may be present before creating "sale-leaseback" characterization for purposes of SFAS No. 98, and whether certain types of default provisions unrelated to the lessee's use of the property affect the characterization of the lease for financial statement purposes); EMERGING ISSUES TASK FORCE, ISSUE NO. 97-10, THE EFFECT OF LESSEE INVOLVEMENT IN ASSET CONSTRUCTION (setting forth guidance on the impact of various construction-related involvement by the lessee on the potential application of SFAS No. 98), *available at* http://www.fasb.org/eitf. For recent detailed discussion of these EITF Issues, see Little, *supra* note 3, at 30-37. As discussed *infra* at note 113 and accompanying text, FASB has recently nullified the three-part test of EITF 90-15 in its January 17, 2003 Interpretation No. 46. *See* CONSOLIDATION OF VARIABLE INTEREST ENTITIES, Interpretation No. 46, app. D, ¶ D.1.a (Financial Accounting Standards Bd. 2003) [hereinafter FASB'S 2003 CONSOLIDATION INTERPRETATION].

[64] *See* Little, *supra* note 3, at 10-11; Nesvold, *supra* note 3, at 105-106; Weidner, *supra* note 3, at 458-462.

[65] *See infra* notes 94-107 and accompanying text.

eyebrows since the Enron bankruptcy filing,[66] and has recently been explicitly rejected by the FASB.[67] During its heyday the "3 percent outside party" requirement became an accounting loophole, leading to a proliferation of accommodation parties acting, under the prevailing practices, as non-consolidated SPEs, allowing corporate users to finance facilities and claim the divergent book-tax ownership at the heart of synthetic leasing.[68]

Synthetic leases are but one example of off-balance sheet financing. The SPE accounting issues, discussed in more detail in Subpart B *infra*, are complex. In some cases, "consolidation" may be a difficult judgment call, especially under the new standards issued by FASB in January 2003 and discussed *infra*.[69] But it is not at all clear that one need resort to those subtleties in sizing up synthetic lease transactions. The question presented, and addressed in Part IV *infra*, is whether a straightforward prohibition on the inconsistent book and tax reporting on the fundamental issue of "ownership" of the "leased" property might have allowed investors to more readily discern the reality of these transactions -- that the lessee *is* the owner of the property

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[66] *See, e.g.*, EITF 90-15, *supra* note 62, at Question No. 3 ("The SEC staff understands from discussions with the Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property."); *The Enron Collapse: Impact on Investors and Financial Markets: Joint Hearing Before the Subcomm. on Capital Markets, Ins., and Gov't Sponsored Enterprises and the Subcomm of the Comm. on Fin. Services*, H.R. DOC. NO. 107-51, pt. 1, 17, 33-34, 43-45 (2001) (questions addressed to Robert K. Herdman, then SEC Chief Accountant) *available at* http://financialservices.house.gov (Hearings, Dec. 12, 2001).

[67] *See* discussion of 2002 and 2003 developments, *infra* notes 99-109 and accompanying text.

[68] *See* Weidner, *supra* note 3, at 461-62 (referring to third parties involved in synthetic lease financing as "Professional Test Flunkers").

[69] *See* discussion of FASB's 2003 CONSOLIDATION INTERPRETATION, *infra* notes 105-109 and accompanying text.

and *is* the obligor of its mortgage financing despite the veil provided by the purported lease from the accommodation SPE/lessor.

B. Off-Balance Sheet Partnerships

1. The Enron End-Runs

Enron was no stranger to the benefits of book-tax divergence, especially when it involved keeping debt off its books. For example, it profited from the issuance of instruments known as "Monthly Income Preferred Securities" ("MIPS") by treating them as "debt" for tax purposes (generating interest deductions) even though characterizing the same instruments as "equity" for book purposes.[70] It also financed its Houston headquarters through a synthetic lease arrangement.[71] As summarized in the February 2002 Powers Report commissioned by the Enron Board of Directors, beginning in the early 1990s Enron management came to fancy off-balance sheet financing "because it would enable Enron to present itself more attractively as measured by the ratios favored by Wall Street analysts and rating agencies," and caused the company to engage in "numerous" transactions using joint ventures and/or SPEs in an effort to obtain the use of borrowed capital without including the corresponding debt in its balance sheet liabilities.[72]

Some of the more infamous Enron escapades involved off-balance sheet partnerships, the history of many of which is

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[70] *See* I.R.S. Tech. Adv. Mem. 199910046 (Nov. 16, 1998). *See also* Victor Fleischer, *Enron's Dirty Tax Secret: Waiting for the Other Shoe to Drop*, 94 TAX NOTES 1045 (2002); Sheryl Stratton, *Enron May Receive Financial Products Proposals*, 94 TAX NOTES 411 (2002) (each discussing MIPS and supporting the I.R.S. conclusion that such instruments should be treated as "debt" for federal income tax purposes).

[71] Powers Report, *supra* note 4, at 19; *see also* Sheppard, *supra* note 57.

[72] Powers Report, *supra* note 4, at 19.

chronicled in the Powers Report.[73] For purposes of this article, one now notorious example -- Chewco Investments, L.P ("Chewco") and its role in the Joint Energy Development Investment Limited Partnership ("JEDI I") -- will serve to illustrate the questionable nature of the accounting rules with which Enron was playing and the need to seriously

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[73] The Powers Report characterizes many of these transactions as "extraordinarily complex" and endeavors to summarize their main elements in an understandable fashion. Powers Report, *supra* note 4, at 18 n.6. Apart from the "Chewco" arrangements described *infra* in text accompanying notes 74-84, other Enron "SPE" transactions of particular note and notoriety include several series of arrangements conducted through partnerships commonly known as "LJM1" and "LJM2" and structures commonly known as the "Rhythms hedge" and "Raptor I through IV" transactions. *See id.* at 32-62. The details of the LJM1 and LJM2 transactions are beyond the scope of this presentation. However, in terms of their common themes of using the then-existing non-consolidation rules to achieve desired accounting results, grounded largely in form over substance, and apparently not achievable in the absence of the intricate SPE structures, it is useful to note the conclusions of the Powers Report as to the intent of these financial labyrinths. *See* Powers Report, *supra* note 4, at 39-40 (commenting on the so-called Rhythms hedge that "[t]here are substantial accounting questions raised by using an SPE as a counterparty to a hedge price risk when the primary source of payment by the SPE is an entity's own stock. . . "); *id.* at 58-60 (summarizing the various Raptor series transactions as follows: "The Raptors were an effort to use gains in Enron's stock price and restriction discounts to avoid reflecting losses on Enron's income statement. Were this permissible, a company with access to its outstanding stock could place itself in an ascending spiral; an increasing stock price would enable it to keep losses in its investments from public view; which, in turn, would spur further increases in its stock price; which in turn, would increase its capacity to keep losses in its investments from public view"). In terms of financial statement "footnote disclosure" of such off-balance sheet partnerships, the Powers Report suggests that although there were some detailed disclosures, "they glossed over issues concerning the potential risks and returns of the transactions, their business purpose, accounting policies they implicated, and contingencies involved" and that "the volume of the details that Enron provided did not compensate for the obtuseness of the overall disclosure." *Id.* at 91. *See also* William Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tulane L. Rev. 1275 (2002) (examining several Enron transactions and practices in the context of their implications on a self-regulatory system of corporate governance).

consider the extent to which GAAP might borrow some basic tax law concepts in setting the standards for financial accounting for partnership arrangements.

The Chewco saga is described in vivid detail in the Powers Report[74] and noted in numerous commentaries, including a colorful *Newsweek* article which characterized the tale as an "accounting trip . . . made more lively by some Enron financial techie's fondness for 'Star Wars'."[75] The essential elements of the story for present purposes are as follows: [76]

In 1993 Enron and the California Public Employees' Retirement System ("CALPERS") formed JEDI I as an investment partnership, with Enron contributing $250 million worth of Enron stock and CALPERS contributing $250 million in cash. Enron intended that the ownership and management arrangements would ensure that Enron would not have to include the assets and liabilities of JEDI I on Enron's consolidated balance sheet. JEDI I prospered in its business of trading in energy stocks, power plants and other investments, and in 1997 an even bigger ($1 billion) partnership with CALPERS (JEDI II, of course) was proposed. Enron suggested a buy-out of CALPERS' interest in JEDI I to facilitate CALPERS's investment in JEDI II. Though Enron itself was apparently negotiating the buy-out price for CALPERS's interest in JEDI I, it realized that continued non-consolidation in its financial statements would require that a buyer other than Enron purchase the CALPERS position. This realization led to the proposed formation of Chewco as the designated buyer.

With input from in-house and outside counsel, Chewco was quickly formed in November 1997 and restructured before the end of 1997, resulting in its status as a limited partnership. Chewco was to be managed by a general

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[74] *Id.* at 20-33.

[75] Alan Sloan, *Who Killed Enron*, NEWSWEEK, Jan. 21, 2002, at 21.

[76] For a more detailed discussion of these events and their chronology, see *id.* at 21-23; Powers Report, *supra* note 4, at 20-33. *See also* Bratton, *supra* note 73, at 1305-09.

partner entity owned and managed by an Enron employee named Michael Kopper (who at Enron reported to the Chief Financial Officer)[77] and with a limited partner indirectly owned by Kopper's domestic partner.[78] The Powers Commission investigation "found no evidence that [Enron's] Board of Directors (other than [then CEO Jeffrey] Skilling) was aware that an Enron employee was an investor in or manager of Chewco."[79]

The planning for Chewco contemplated that it would have approximately $11.5 million of invested equity (a little more than 3 percent of the cost of the CALPERS interest in JEDI I). The 3 percent was ultimately funded with $115,000 cash from Kopper and the balance borrowed from Barclays Bank under some relatively complicated arrangements which included reserve accounts representing cash collateral for repayment of the Barclays financing.[80] Chewco then

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[77] On August 21, 2002 Kopper pled guilty to federal conspiracy charges related to his involvement in Chewco and other partnerships. *See* Kurt Eichenwald, *Enron's Many Strands: The Overview; Ex-Enron Official Admits Payments to Finance Chief*, N.Y. TIMES, Aug. 22, 2002, § A, at 1.

[78] The Powers Report explains that prior to changes made by year end in 1997, Chewco was originally proposed to be controlled by Andrew Fastow, Enron's then-CFO (an idea ultimately rejected on advice of counsel), and that Chewco, when originally formed as a limited liability company wholly-owned (through various entities) by Kopper, still failed to satisfy the accounting standards for non-consolidation. Apparently the belief held at the time was that satisfying the requirements by year end would suffice.

[79] Powers Report, *supra* note 4, at 68.

[80] Looking through "tiered" ownership arrangements, it appears from the description of these transactions in the Powers Report that the only two beneficial owners of Chewco were Kopper (who owned Chewco's general partner entity) and Kopper's domestic partner Dodson (who, by virtue of a transfer of ownership interest to him by Kopper, owned Chewco's limited partner entity). Barclays Bank made what the Powers Report indicates were called "equity loans" aggregating $11.4 million to Chewco's general and limited partner entities, enabling them to make corresponding amounts of "equity" contributions to Chewco under paperwork seemingly designed to allow "loan" characterization by Barclays ("for regulatory and business reasons") but "equity characterization" by Enron and Chewco ("for accounting reasons"). The Powers Report states that "[d]uring this time period, that was not an

purchased the CALPERS interest in JEDI I in November 1997 for approximately $383 million, the funding of which included, in addition to the $11.5 million of so-called "equity," a $240 million loan to Chewco from Barclays guaranteed by Enron and a $132 million advance by JEDI I to Chewco under a revolving credit agreement.[81]

During early 2000 a plan developed to unwind this particular off-balance sheet arrangement by Enron buying out Chewco's interest in JEDI I. The unwinding ultimately occurred in March 2001, on terms which, according to the Powers Report, appear to have netted Kopper and his domestic partner millions of dollars on their aggregate $125,000 investment.[82]

In late October 2001, Enron and its accountants, Arthur Andersen LLP, determined that Chewco did not satisfy the SPE non-consolidation requirements and that it, and in turn JEDI I, should have been included in Enron's consolidated financial statements when CALPERS was bought out of JEDI I in November 1997. This resulted in a restatement of Enron's financial statements for 1997 through 2000, showing hundreds of millions of dollars of decreases to its net income and increases to its balance sheet liabilities for those years.[83]

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unusual practice for SPE financing." *See* Powers Report, *supra* note 4, at 25-27. Unfortunately for Enron, the bank required that these "equity loans" be secured with cash collateral from JEDI I distributions, ultimately precluding satisfaction of the 3 percent minimum "outside" equity target for SPE non-consolidation. *Id.* at 25.

[81] Powers Report, *supra* note 4, at 25.

[82] *See* Powers Report, *supra* note 4, at 30-33 (describing a series of arrangements involving cash distributions and payments, as well as relief of responsibility for indebtedness, and concluding that Kopper and Dodson received as a result of their approximately four-year involvement in the JEDI I arrangements some $10 million for a $125,000 investment). News reports of Kopper's August, 2002 plea agreement suggest that return of all or substantial amounts of such profits is contemplated. *See Prosecutors Move Up the Enron Food Chain*, WASH. POST, Aug. 25, 2002, § F, at H02 ("as part of a separate civil agreement with the SEC, Kopper has agreed to turn over $12 million in illegal profits").

[83] *See* Powers Report, *supra* note 4, at 32-33. The Powers Report summarizes the consequences of the restatement on the Enron financials as follows: "It decreased Enron's reported net income by $28 million (out of

In addition to identifying the egregious error on the non-consolidation issue, the Powers Report is replete with suggestions of other possible improprieties relating to Chewco and JEDI I. These items include questionable fee and tax indemnity payments; arguably unauthorized corporate actions; unusual accelerations and/or creations of income; possibly improper reporting of gains and losses relating to changes in the value of Enron stock held by JEDI I; and potential relationships between the buyout of Chewco's interest in March 2001 and other off-balance sheet transactions occurring at approximately the same time.[84] Many of those issues have been[85] and will undoubtedly continue to be the subject of much litigation and exploration in various forums. The focus in this article is on the "non-consolidation" issue, and, in particular, on not merely the circumstances and temptations that may have lead Enron management to break some accounting rules, but, more importantly, why the applicable rules were themselves inadequate.

$105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron's reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000." *Id.* at 21.

[84] *See* Powers Report, *supra* note 4, at 24-32 (describing several such transactions and raising several issues as to potentially questionable accounting practices and possibly improper self-dealing by Enron officers and employees).

[85] *See, e.g., In re* Enron Corp. Securities, Derivative & "Erisa" Litigation, 196 F. Supp. 2d 1375 (Jud. Pan. Mult. Lit., 2002) (describing consolidation and transfer of numerous actions); Eichenwald, *supra* note 77; *Prosecutors Move Up the Enron Food Chain*, *supra* note 82. Indeed, the scope of Enron civil litigation has spawned such publications as the Andrews Publications "Enron Litigation Reporter." *See* ANDREWS PUBLICATIONS, CATALOG, *at* http://www.andrewspub.com/rptr_desc.asp?pub=ENR.

2. Basic Standards of GAAP Accounting for Investments in Partnerships

Under GAAP, a corporation such as Enron making an investment in a partnership such as JEDI I in 1997 had to determine which of the following three methods was most appropriate in accounting for such investment:[86]

> (i) The "cost" method, typically applied to ownership of less than 20 percent of an entity's voting equity securities, under which the investment is initially booked at cost and changes in fair value (if readily determinable) are reflected periodically (with only realized gains and losses included in computing income and unrealized gains and losses reported as a component of stockholders' equity); if the fair value of the investment is not readily determinable, then it is carried at "cost";
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> (ii) The "equity" method, typically applied to ownership of between 20 percent and 50 percent of the entity's voting equity securities, under which (a) the investment is initially recorded at cost, and subsequently increased by the investing company's allocable share of the entity's earnings and decreased by its share of the entity's losses, as well as by dividend distributions to the investing entity and (b) various other adjustments (such as elimination of intercompany gains and losses and amortization of the excess of the cost of the investment over the investing company's interest in the underlying equity in the "investee" entity's net assets) are made in a manner similar to those required in consolidated financial statements; or
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> (iii) The "consolidation" method, typically applied to ownership of over 50 percent of the entity's voting equity securities, under which the income, loss,

[86] *See* DAVID R. FRAZIER ET AL., GUIDE TO GAAP, 8.100-8.202, 19.200, 34.100 (2d ed. 1997) [hereinafter GUIDE TO GAAP].

> assets and liabilities of the entity are included in the investing company's financial statements.[87]

Selection of the appropriate method might often be made by reference to the above-described percentages of ownership of voting equity securities, but those percentages did not represent hard and fast rules. Thus, the equity method, rather than the cost method, could have been in order even if the investing company's ownership in the purported off-balance sheet partnership (the "investee") were less than 20 percent in cases where the investing company had "the ability to significantly influence the investee's financial and operating policies."[88] Similarly, even if the reporting/investing company's ownership of voting equity in the investee was not more than 50 percent, "consolidation" may have been in order if the investing company otherwise owned a "controlling financial interest" in the voting equity of the investee entity. Conversely, it was possible for consolidation to be avoided despite majority ownership of voting equity in special circumstances under which such ownership did not in actuality represent a "controlling" financial interest.[89] Nevertheless, once outside the simplistic realm of clear majority voting control in a corporate setting, the waters were quite murky, leaving room for varied interpretations and ultimately abuse.[90]

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[87] *Id.* at 19.100. The "equity method" has been called "one-line consolidation." This is because an investment accounted for under the equity method is shown on the investing company's balance sheet as a single amount, earnings and losses from the investment are shown as a single amount in the investing company's net income, and the investing company's net income and equity at the end of a reporting period are generally the same as would be the case under the "consolidation" method. *Id.*

[88] *Id.*

[89] *Id.* at 8.200, 8.201 (based on principles from ARB No. 51, *infra* note 93, which states, *inter alia*, that "the usual condition for a controlling financial interest is ownership of a majority voting interest").

[90] In commenting in June 2002 on the then state of GAAP in this area, FASB observed:

Enron applied the "equity method" of accounting for its investment in JEDI I as a 50 percent owner from its inception in 1993, and, prior to the 2001 "restatement," continued that accounting method after Chewco's acquisition of the CALPERS interest in 1997.[91] Although the equity method has elements of "consolidation," one key difference between the two approaches is that the equity method would, unlike consolidation, keep JEDI I's large amounts of debt off Enron's balance sheet. The history described in the Powers Report of the apparent gaffes which led to the 2001 restatement to report Chewco and JEDI I on a "consolidated" basis certainly makes good reading. If accurate, it leaves no doubt that consolidation was appropriate, at least after Chewco's purchase of the CALPERS position. The compelling question, however, is whether, with a little more care, Enron could have, with relative ease, crafted a supportable position for non-consolidation under prevailing interpretations of the accounting standards on consolidation of SPEs in effect at the time.

> Some relationships between enterprises and SPEs are similar to a relationship established by a majority voting interest, but the SPEs often are arranged without a governing board or with a governing board that has limited ability to make decisions that control the SPE's activities. The activities of SPEs often are limited or predetermined by the articles of incorporation, bylaws, partnership agreements, trust agreements, other establishing documents, or contractual agreements between the parties involved with the SPE. In those circumstances, the SPE can be made to serve the purposes of another enterprise by means other than voting interests. Prior to [the proposed 2002 Interpretation] there were no effective accounting principles for determining when and if that type of relationship between an enterprise and an SPE exists.

PROPOSED INTERPRETATION CONSOLIDATION OF CERTAIN SPECIAL-PURPOSE ENTITIES, Exposure Draft, 13, app. B (Financial Accounting Standards Bd. June 28, 2002) [hereinafter FASB'S 2002 SPE PROPOSED INTERPRETATION], *available at* http://www.fasb.org/draft.

[91] Powers Report, *supra* note 4, at 29.

By FASB's own admission, the accounting literature on SPEs had been "fragmented and incomplete."[92] Prevailing interpretations were derived from a somewhat odd combination of general rules on consolidated financial statements and consolidation of majority owned subsidiaries and special rules relating to leasing transactions and to transfers of bundles of financial assets in financial arrangements commonly known as "securitizations."[93] In a situation such as the Chewco/JEDI I structure, it appears the trend was to draw on this somewhat haphazard body of accounting authority to support non-consolidation of an SPE where (i) one or more "independent" owners made a substantive capital investment in the SPE (at least 3 percent of the SPE's total capital), with attendant risks and rewards of ownership throughout the term of the deal and (ii) such independent owner(s) had "control" over the SPE based on not just a voting percentage test, but on subjective factors evidencing control.[94] Despite FASB guidance and SEC commentary indicating that the 3 percent equity investment was a "minimum" and that a higher percentage might be required in a given transaction, it appears numerous transactions were effected based a 3 percent (or only slightly higher) outside equity investment.[95] As for independent

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[92] *See* FASB's 2002 SPE PROPOSED INTERPRETATION, *supra* note 90, at ii. *Accord*, FASB's 2003 CONSOLIDATION INTERPRETATION, *supra* note 63, Summary.

[93] *See* CONSOLIDATED FINANCIAL STATEMENTS, Accounting Research Bulletin No. 51 (Accounting Principles Bd. 1959) [hereinafter ARB No. 51]; CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Bd. 1987); ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000); FASB'S 2002 SPE PROPOSED INTERPRETATION, *supra* note 90, at ii.

[94] *See* Powers Report, *supra* note 4, at 20.

[95] *See The Enron Collapse* (questions addressed to Robert K. Herdman), *supra* note 66, at 29-35 (discussing typical SPE structures and addressing concerns about rules of accounting for SPEs); FASB'S 2002 SPE PROPOSED INTERPRETATION, *supra* note 90, app. C, ¶ C.1.a (noting the SEC staff's position, described in Question 3 of EITF 90-15, that "a greater

control, it is not particularly difficult to provide the outside investors with control "on paper," particularly if not very many management decisions must be made and where the financial realities of the arrangements make it extremely unlikely the outside investors will refuse to abide by the will of the primary investor.[96] For example, through tiered arrangements, Kopper could hold a relatively small economic ownership interest, in percentage terms, in the overall JEDI I structure, but by controlling the general partner of Chewco, he presumably had the legal right to cause Chewco to veto decisions at the JEDI I level. But would Kopper exercise that right contrary to the wishes of Enron?

Had Enron not committed a clear error (breaking a numerical "rule" for minimum "outside" equity investment) by allowing the alleged 3 percent "outside" equity to be secured from within the deal,[97] it might still have had some problems with the Chewco/JEDI I structure in terms of the independence of Kopper and his domestic partner under a subjective analysis -- though it appears that Arthur Andersen was focused only on the 3 percent requirement when it recommended the restatement.[98] One might suspect

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[than 3 percent] investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property").

[96] Concern over the potential for manipulation through the use of friendly parties (or parties in a position subject to coercion) is evident in the "Background Information and Basis for Conclusions" discussion in FASB'S 2002 SPE PROPOSED INTERPRETATION, *supra* note 90, app. B, ¶ B27 and in FASB'S 2003 CONSOLIDATION INTERPRETATION, *supra* note 63, app. C, ¶ C38 (in each case explaining the proposal to expand the scope of an applicable list of related parties by describing economic and contractual circumstances that could be brought to bear on such parties and expressing the desire to prevent a company from avoiding consolidation of an entity "by arranging to protect its interest or directly expand its holdings through other parties").

[97] *See* Powers Report, *supra* note 4, at 26, 32.

[98] *Id.* at 32. *See also* Allan B. Afterman, *The Enron Debate: Casting A Shadow Over U.S. Accounting and Auditing Standards*, CORP. FIN. REV. 13, 16 (Mar. - Apr. 2002); *but cf.* Bratton, *supra* note 73, at 1348 (arguing that the "central problem" with many of the Enron accounting violations "lay not with the rules themselves but Enron's failure to follow them").

that under the then-prevailing GAAP interpretations and accounting practices, had Enron located some more "distant" outsiders and had them more cleanly invest the 3 percent, the company and its accountants would likely have been comfortable with the non-consolidation of the Chewco SPE, and thus of JEDI I, and continued the off-balance sheet handling of the underlying liabilities. Fortunately, Congress, the SEC and FASB have now been able to look beyond Enron's particular excesses and errors to question and ultimately revise the SPE accounting rules in general.

3. 2002 and 2003 GAAP Reforms

On June 28, 2002, in the midst of the pre-Sarbanes-Oxley Act fervor over accounting abuses, the FASB issued for comment a "Proposed Interpretation" regarding the consolidation of certain SPEs.[99] In taking this action, the Board noted the "increasingly common" use of SPEs and observed that: "Some enterprises appear to have used SPEs to avoid reporting assets and liabilities for which they are responsible, to defer the reporting of losses that have already been incurred, or to report gains that are illusory."[100] Providing background information for the principles proposed in the 2002 SPE Proposed Interpretation, FASB pointed to, among other things, some particularly abusive practices which had come to its attention, including use of chains of SPEs in an attempt to use one equity investment to capitalize multiple SPEs and efforts to disguise the identity of the source of "real financial support" for an SPE.[101] The substance of the Proposed Interpretation generally reflects confirmation by FASB that the pre-existing guidance on financial accounting for SPEs failed to adequately

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[99] *See* FASB'S 2002 SPE PROPOSED INTERPRETATION, *supra* note 90. FASB'S 2002 SPE PROPOSED INTERPRETATION takes the form of an interpretation of ARB No. 51, *supra* note 93, the primary source of GAAP guidance on consolidated financial statements since 1959.

[100] FASB'S 2002 SPE PROPOSED INTERPRETATION, *supra* note 90, app. B, ¶ B2.

[101] *Id.* app. B, ¶¶ B8-B9.

distinguish between different types and uses of SPEs,[102] left room for undue reliance on seemingly "bright line" rules (such as majority voting ownership and the 3 percent outside equity benchmark),[103] and inadequately addressed potential abuses through the use of related parties to disguise effective influence by the company principally benefited by the SPE arrangement.[104]

Addressing prior deficiencies in the accounting principles governing the consolidation analysis and taking into consideration the large number of comments received on its 2002 SPE Proposed Interpretation, the FASB subsequently issued in January 2003 its Interpretation No. 46, CONSOLIDATION OF VARIABLE INTEREST ENTITIES, substituting the term "Variable Interest Equity" ("VIE") for "SPE" in an effort to broaden the coverage of the Interpretation.[105] Using the term "VIE" to describe "a

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[102] For example, the FASB stated: "SPEs engaged in activities other than leasing and securitizations generally are not addressed by existing accounting literature. The Board has been told that existing practices related to those SPEs have been developed by analogy to requirements for SPE lessors even though their characteristics may be very different." *See* FASB'S 2002 SPE PROPOSED INTERPRETATION, *supra* note 90, at ii.

[103] *See id.* app. B, ¶¶ B3-B4 (citing lack of "effective accounting principles" for dealing with arrangements that amount to parent-subsidiary relationships other than through "majority voting interest"); *id.* app. B, ¶ B9 (explaining its rejection of the 3 percent guideline in EITF 90-15 and stressing that a percentage for presumed sufficiency of outside equity investment, raised to 10 percent in the Proposed Interpretation, is intended to apply only in the direction of presumed insufficiency if the subject equity investment is not at or greater than the specified percentage, *without* presumed sufficiency merely because such investment is at or greater than such percentage).

[104] *See id.* app. B, ¶¶ B26-B27.

[105] *See supra* note 63. FASB'S 2003 CONSOLIDATION INTERPRETATION indicated that it had received over 140 letters of comment on the 2002 Proposed Interpretation. *See* FASB'S 2003 CONSOLIDATION INTERPRETATION, *supra* note 63, app. C, ¶ C3. In its News Release accompanying Interpretation No. 46, the FASB explains that "[m]any variable interest entities have commonly been referred to as special purpose entities or off-balance sheet structures, but the guidance applies to a larger population of entities." *See* Financial Accounting Standards Bd., FASB Issues Guidance to Improve Financial Reporting for SPEs, Off-

corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities,[106] FASB's 2003 Consolidation Interpretation adheres to the spirit of its 2002 SPE Proposed Interpretation in adopting an essentially substance over form approach to the determination of when such a VIE should be consolidated with another business enterprise. Under the new rules, the "primary beneficiary" of an applicable VIE arrangement would generally have to consolidate the VIE's assets, liabilities and financial results with its own if such primary beneficiary "absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual, or

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Balance Sheet Structures and Similar Entities (news release dated January 17, 2003), *available at* http://www.fasb.org. The consolidation requirements of FASB'S 2003 CONSOLIDATION INTERPRETATION generally apply to VIEs created after January 31, 2003 and to entities created before that date as of the first fiscal year or interim period beginning after June 15, 2003 (although certain disclosure requirements may apply to post-January 31, 2003 financial statements regardless of when the VIE was created). *See* FASB'S 2003 CONSOLIDATION INTERPRETATION, *supra* note 63, ¶¶ 26-29. Expressly excluded from possible consolidation under Interpretation No. 46 are (a) certain "qualifying SPEs" associated with transfers of financial assets and meeting descriptions in SFAS No. 140, (b) certain types of employee benefit plans, (c) certain not-for-profit organizations, and (d) a limited number of other arrangements of types subject to special regulatory constraints (such as certain types of regulated investment companies and separate accounts of life insurance entities). *Id.* ¶ 4. It should be noted that the FASB has also recently issued new guidance on accounting for guarantees which may also affect financial statements reporting of various types of off-balance sheet arrangements (such as synthetic leases and off-balance sheet entities). *See* GUARANTOR'S ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR GUARANTEES, INCLUDING INDIRECT GUARANTEES OF INDEBTEDNESS OF OTHERS, Interpretation No. 45 (Financial Accounting Standards Bd. 2002).

[106] *See* Financial Accounting Standards Bd., FASB Issues Guidance to Improve Financial Reporting for SPEs, Off-Balance Sheet Structures and Similar Entities (news release dated January 17, 2003).

other pecuniary interests in an entity."[107] The tests employed in FASB's 2003 Consolidation Interpretation with respect to an arrangement within its coverage (which would include off-balance sheet partnerships such as the one effected through the Chewco/JEDI I structure) involve a number of judgments to determine the underlying apportionment of risk and rewards of the venture. Since the SEC has expressed concerns about off-balance sheet financing and SPEs for some time,[108] and, as discussed *infra*, is required

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[107] FASB'S 2003 CONSOLIDATION INTERPRETATION, *supra* note 63, Summary. Citing ARB No. 51's "usual condition" that consolidation due to an entity having a "controlling financial interest" in another entity be "majority voting ownership," the new Interpretation expressly targets arrangements where a controlling financial interest is manifested other than by majority voting control. *Id.* ¶ 1. Interpretation No. 46 requires a detailed examination of the dispersal of risks and rewards associated with the subject arrangements. Tests for independent outside investment as part of the requirements to avoid consolidation include demonstrating that purported "equity" is in fact subordinate to other interests in a manner typical for equity and a presumption that less than ten percent of the SPE's total capital is insufficient. *Id.* ¶¶ 9, 10, 21. Anticipating the basic approach FASB would take in the 2002 SPE PROPOSED INTERPRETATION, one commentator, in commentary equally applicable to the successor 2003 CONSOLIDATION INTERPRETATION, astutely observed:

> While the Interpretation is not intended to limit the use of SPEs, the elimination of off-balance sheet treatment will occur in many situations.
>
> The interpretation is generally qualitative in analysis. Preparers of financial statements will be required to use judgments when deriving conclusions concerning when consolidation of an SPE is appropriate, and which entity should in fact consolidate the operational results of the SPE.

Steven J. Adloff, *Special Purpose Entities*, K & L Alert, May 7, 2002, *at* http://www.kl.com.

[108] *See* Herdman et al., *supra* note 8, at 10 (proposing better disclosure of off-balance sheet financing arrangements, noting that "both the identification and analysis of the aggregate impact of the various types of arrangements may be difficult"); SEC Chief Accountant Lynn E. Turner, Remarks at AICPA National Conference on Banks and Savings Institutions (Nov. 9, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch318.htm (citing experiences with lack of compliance with existing accounting rules on SPEs and noting that the

under the Sarbanes-Oxley Act to report on the adequacy of associated disclosure requirements,[109] it is reasonable to expect that the types of principles incorporated in FASB's 2003 Consolidation Interpretation will be reflected in other guidance on off-balance sheet arrangements in the future.

4. Comparison to Tax Law

Tax lawyers will undoubtedly find familiar the "facts and circumstances" and "substance over form" themes of many aspects of FASB's 2003 Consolidation Interpretation. The federal income tax law is replete with precedents establishing that literal compliance with the provisions of the Internal Revenue Code ("I.R.C.") does not necessarily mean that the desired tax results will be obtained.[110] In

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SEC had asked FASB to "address the consolidation of SPEs in its consolidation project").

[109] *See infra* notes 308-312 and accompanying text.

[110] The seminal case in the federal income tax law in this regard is *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd* 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935), in which the taxpayer was denied her desired tax results despite apparent literal compliance with the detailed "corporate reorganization" provisions of the I.R.C. under lack of business purpose and substance over form analysis. There is a wealth of tax law literature regarding judicially-crafted doctrines of "substance over form" and "business purpose" which have often been used to deny tax benefits to transactions seemingly in literal compliance with I.R.C. provisions but ultimately deemed to be too good to be true. For a sampling of thoughtful, recent assessments of these doctrines in the federal income tax law, see SMU Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters*, 54 SMU L. REV. 3-240 (2001); NYU Symposia, *Symposium on Corporate Tax Shelters Part I & Part II*, 55 Tax L. Rev. 125 (Winter, Summer 2002); *see also* David Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999); Robert Thornton Smith, *Business Purpose: The Assault Upon the Citadel*, 53 TAX LAW. 1 (1999). In recent discussions of the possibility of "codifying" such common law doctrines as part of the war on corporate tax shelters, however, at least some commentators have noted the potential for such subjective tests to be "over-inclusive" and urged that careful analysis of the justifications for such steps be undertaken. *See, e.g.*, Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001) (discussing "Schauer's Theory of Rules" and an analytical approach to the

determining the relative responsibility for liabilities of a partnership (and associated tax benefits), the applicable Treasury Regulations are particularly in tune with "the games people play" and require a thorough analysis of the underlying economic arrangements among the principals and related parties.[111]

Just as tax professionals must make substance over form judgments, preparers of financial statements and auditors will be required to do the same under the revised principles governing SPE (and other VIE) consolidation issues for

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question of the extent to which codification of tax law doctrines such as "business purpose" is desirable).

The IRS has administratively embraced such doctrines and in recent years has endeavored to identify in "anti-abuse" regulations facts and circumstances which support their invocation. *See, e.g.*, Treas. Reg. § 1.701-2 (as amended in 1995) (listing factors which might support the Commissioner of the IRS in disregarding the existence of purported partnerships or partners where such existence is deemed inconsistent with the intent of the partnership provisions of Subchapter K of the I.R.C.); Treas. Reg. § 1.707-3 (1992) (describing facts and circumstances which might support characterization of a purported partnership distribution as, instead, part of a payment in respect of a "disguised sale" of property to the partnership).

[111] Treas. Reg. § 1.752-2 (1991) generally provides that partnership liabilities for which any partner or related party to a partner bears the "economic risk of loss" are allocated among the partners based on the manner in which such economic risk of loss is shared, taking into account all pertinent agreements and other facts and circumstances. This regulation contains special anti-abuse rules designed to avoid circumvention of the economic substance spirit of the liability allocation rules through straw parties, obligations based on unrealistic contingencies, indirect pledges or assigning labels to arrangements which may not appear to be in the nature of repayment guarantees but are in substance "tantamount" to guarantees. *See* Treas. Reg. § 1.752-2(j). Partnership liabilities for which no partner or related party to a partner bears the "economic risk of loss" are allocated as "nonrecourse" liabilities under Treas. Reg. § 1.752-3 (as amended in 2000), which, in conjunction with profit and loss allocation rules in Treas. Reg. § 1.704-1 (as amended in 1997) and § 1.704-2 (1991), generally tracks the sharing of corresponding tax benefits and profits, but affords some flexibility to allocate such nonrecourse liabilities among the partners in ranges corresponding to the economic substance of the business deal among the partners.

financial statement purposes. Having to apply subjective standards in making accounting determinations is certainly not a new concept for accountants, but the complexity of modern SPE arrangements, and the rejection in the 2003 Consolidation Interpretation of simplistic concepts of majority voting as the sole determinant of control[112] and of a specified percentage of outside equity investment as a "safe harbor" proposition,[113] may bring substantial new anxiety to financial accounting professionals who customarily would strongly prefer "rules" to "standards."[114]

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[112] *See supra* note 107.

[113] *See supra* notes 66, 107. At the same time, FASB has nullified the three-part test of EITF 90-15 in general, stating, in the context of leases, that "[i]f a lessor entity is a variable interest entity as described in this Interpretation, it is subject to consolidation based on the provisions of this Interpretation." FASB'S 2003 CONSOLIDATION INTERPRETATION, *supra* note 63, app. D, ¶ D1.a. Similarly, the new Interpretation nullifies previous SPE Consolidation guidance in EITF Topic No. D-14. *Id.* app. D, ¶ D1.b.

[114] In explaining its view of the differences between tax accounting and financial accounting, the Supreme Court, in *Thor Power Tool Co. v. Comm'r* (discussed in detail in Part III *infra*), noted that accountants are called upon to make various estimates and judgments in attempting to present full and fair disclosure. 439 U.S. 522, 543-44 (1979). However, there is a clear perception that accountants are more comfortable with "rules" than with "standards." *See* Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149, 152 (2001). Addressing what he terms "an absolute chasm between lawyers and accountants," Professor Bankman observes:

> Accountants, like lawyers, are everywhere confronted with close questions. And there are instances aplenty in which the accounting profession has argued for standards over rules, particularly in cases in which the rules are thought draconian. . . . In general, though, the impulse in accounting is to resolve difficulties with rules rather than standards. Indeed, where standards are supported over rules, it is generally not because standards are thought superior, but because the particular rules proposed are thought wrongheaded. The broad, standards-based jurisprudence incorporated in the business purpose doctrine jibes awkwardly with the rule-leaning accounting profession.

Notwithstanding the similarities between the substance over form concepts adopted in FASB's 2003 Consolidation Interpretation and those utilized in the tax law to match tax consequences with the underlying economics of multi-party transactions, the Interpretation made no express reference to the relevance of tax return treatment of the SPE arrangements and transactions. To some extent, the absence of explicit references to tax accounting is understandable, given the differing meanings and consequences of "consolidation" under the tax law and GAAP.[115] However, should it not be appropriate to at least consider as a key factor in the financial reporting standards whether or not a "lessee" is claiming for tax purposes ownership of the leased property and responsibility for mortgage liability under a

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Id. *See also* Weidner, *supra* note 3, at 487 ("By their very nature, the financial accounting standards try to draw clear lines."). And, interestingly, the then "Big Five" accounting firms were certainly quick to ask the SEC for more rules to guide the accountants in preparing more "transparent" financial statements in the immediate wake of the Enron bankruptcy. *See* Big Five Petition, *supra* note 12. Of course, accountants would not be alone in choosing easy to follow rules over uncertain standards. *See* Aprill, *supra* note 110, at 9 ("Tax lawyers usually favor precise rules and criticize the courts' application of broad standards").

[115] Sections 1501 et seq. of the I.R.C. expressly deal with the consolidation of tax reporting for groups of affiliated corporations, but these sections are limited to rather objective ownership tests and are subject to very specialized technical tax reporting rules. *See* Mills, Newberry & Trautman, *supra* note 19, at 15-16 (discussing the differences between GAAP and tax "consolidation" concepts and rules and noting challenges in identifying book-tax consolidation differences, particularly where both corporations and pass-through entities are involved). However, the tax law does contain ample authority on questions such as whether a purported party to a transaction is merely "transitory" or an agent for another party and therefore subject to reallocation of its activities to an underlying principal. *See, e.g.*, the factors to be considered in determining whether a partnership and its partners are to be respected as bona fide parties under the "Partnership Anti-Abuse Rule" in Treas. Reg. § 1.701-2 (as amended in 1995) and the substance over form case law discussed in the sources cited *supra* note 110. *See also* I.R.C. § 482 (2002) (empowering Secretary of the Treasury to "distribute, apportion, or allocate gross income, deductions, credit, or allowances" among organizations under common ownership or control).

synthetic lease from a SPE-lessor?[116] Or, in the partnership context, should tax law allocation of a liability to a particular partner because of guarantees or collateral provided by such partner or a related party be relevant in determining whether such liability should appear on the partner's balance sheet for book purposes?[117] These and similar questions regarding the potential benefits and limits of book-tax comparisons and conformity requirements in this context will be addressed in Part IV *infra*.

C. Accounting for Nonqualified Employee Stock Options

1. Identifying the Compensation Issue

The obvious trick with synthetic leases and off-balance sheet partnerships is for the company structuring the arrangement to avoid balance sheet debt for book purposes, even if some or all of the financing involved is treated as the company's debt for tax purposes. With respect to nonqualified employee stock options, the treatment historically adopted by most large public companies has been to deduct as compensation for tax purposes the "bargain element" of the option arrangement (the excess of the fair market value of the stock purchased under the option over the exercise price), but refrain from "expensing" as

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[116] *See* Weidner, *supra* note 3, at 446, 487 ("FASB should require full disclosure by the lessee when the lessor and lessee have agreed that, for federal income tax purposes, the lessee will claim that it owns the encumbered asset").

[117] It should be noted that the basic concept of GAAP's "equity method" of accounting for investments in partnerships bears strong similarities to the "look-through" approach of I.R.C. § 702 (2002), which requires the partners to individually report for tax purposes their allocable "distributive shares" of partnership profits, losses, credits and items thereof. A question to consider is whether the "look-through" approach which the federal income tax law applies in assigning deemed responsibility for partnership liabilities has potential application to sound financial accounting, as discussed further in Part IV *infra*.

compensation in financial statements the cost of making such bargain available to employees.[118]

Assume, for example, that at a time when its common stock is trading at $100 per share, a publicly-traded company grants an employee, as a bonus for her work for the company, a "nonqualified" option[119] to purchase up to 1000 shares at $100 per share, exercisable at any time within the following ten years. Further assume that the employee exercises the option in full two years later, at a time when the stock is trading at $200 per share. The employee has thus received $100,000 in value by acquiring stock with a fair market value of $200,000 for a cost of only $100,000. Her ability to exercise the option and reap this benefit was directly related to her performance of services for the company. Accordingly, any value transferred to the employee by the company in the form of the option right must be in the nature of compensation, even though the employee was not paid in cash. In arguing for mandatory expensing of stock options costs in financial statements, Warren Buffet recently explained the fundamental economics of these arrangements:

> [T]here is a hidden, but very real, cash cost to a company when it issues options. If my company, Berkshire, were to give me a 10-year option on 1,000 shares of [Class A Berkshire stock] at today's market price, it would be compensating me with an asset that has a cash value of at least $20 million -- an amount the company would receive today if it sold a similar option in the marketplace. Giving an employee something that alternatively could be sold for hard cash has the same consequences for a company as giving him cash.
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> . . . The logic behind [the thinking of FASB members who advocated employee option cost expensing in the mid-90s] is simple:

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[118] *See supra* note 6.

[119] For a discussion of the difference between "statutory" and "nonqualified" compensatory stock options, see *supra* note 5.

> 1) If options aren't a form of compensation, what are they?
>
> 2) If compensation isn't an expense, what is it?
>
> 3) And if expenses shouldn't go into the calculation of earnings, where in the world should they go?[120]

Not everyone agrees with Buffet's seemingly inescapable logic regarding stock option compensation. For example, Harvey Golub, retired chairman and CEO of American Express, acknowledged that employee stock options have obvious value to the employee, but argued that "they cost the corporation nothing."[121] In taking this position, Golub disregards Buffet's rationale that the company has incurred an opportunity cost (i.e., the same option could have been issued to non-employees for cash that would go in the company coffers). Rather, he concludes, such cost was "entirely borne by the company's shareholders" (in the form of dilution of the value of the rights in the company's earnings and assets inherent in their shares, due to the rights of the employees holding the options), and he asserts that it is "beside the point" that if not for the option the company would have had to pay the compensation in cash.[122] One wonders how Golub would suggest handling the accounting if existing shareholders contributed cash to a company which was then used to pay a cash bonus to an executive. Would there be no charge against the company's earnings because the shareholders bore the cost? As the owners of a company, don't the shareholders always, in effect, bear the costs it incurs? Similarly, in recent

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[120] Warren Buffett, *Stock Options and Common Sense*, WASH. POST, April 9, 2002, § E, at A19 (noting also that grants of restricted stock are routinely expensed despite the absence of an actual cash outlay, and that "the day an employee receives an option, he can engage in various market maneuvers that will deliver him immediate cash, even if the market price of his company's stock is below the option's exercise price").

[121] Harvey Golub, *The Real Value of Options*, WALL ST. J., Aug. 8, 2002, § A, at 12, col. 3.

[122] *See id.*

Congressional testimony the chairman of TIAA-CREF used the example of a company issuing options for cash, and then paying the cash to employees as compensation -- clearly resulting in the recording of *both* a company cost and a dilution effect on shares outstanding.[123] It is doubtful proponents of Golub's position would argue that the company does not have a charge against earnings in this case, even though the net out-of-pocket cash cost to the company was zero. In reality, when employee stock options with value are granted there is both a compensation cost and a dilution of the outstanding shares.[124] The logic in the arguments of Buffet and Biggs is indeed inescapable. The key questions should therefore be (i) when will such cost be recognized for tax and book accounting purposes?, and (ii) how will the amount of such cost be determined? The answers under prevailing rules are not as theoretically pure as the logic underlying these questions.

2. Federal Income Tax Consequences

Under applicable Treasury Regulations, and assuming the option itself did not have a "readily ascertainable fair market value" at the time it was granted, when the employee exercises the option in our example, she recognizes $100,000 of ordinary (compensation) income and the company receives a $100,000 compensation deduction in computing its federal income tax liability.[125] The income tax approach acknowledges a compensatory element to the transaction

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[123] *See Corporate Governance and Executive Compensation* (written testimony of John H. Biggs), *supra* note 6, at 6 (concluding "[w]hen diluted earnings per share is proposed as a solution for stock option accounting, it simply is a smokescreen").

[124] As Biggs observes, "[b]oth are important measures to investors." *Id.*

[125] Treas. Reg. § 1.83-7 (1978). For these purposes, the Treasury regulations severely limit the circumstances in which the option will be deemed to be property received with a "readily ascertainable fair market value" (essentially requiring that the *option itself* be actively traded on an established market or have other unusual characteristics permitting ready valuation).

and avoids thorny valuation issues by generally postponing the day of reckoning until the option is exercised and the "bargain element" can be clearly measured.[126] This regime may comport nicely with the certainty sought in the

[126] This postponement helps to, among other things, skirt the difficult issues which would be encountered in trying to take into account guesses as to the volatility of the stock and other relevant factors which might apply in valuing a particular option prior to its exercise. *See infra*, note 129 (discussing such factors). However, the wait and see approach adopted by Treas. Reg. § 1.83-7 is a deviation from the general rule in the federal income tax law that upon the receipt of property as compensation for the performance of services the service provider immediately recognizes income in the amount of the fair market value of the property received. *See* Treas. Reg. § 1.61-2(d) (as amended in 1995). It is not, however, an unprecedented deviation from that basic rule in the face of difficult valuation problems. For example, in a particularly troublesome area of the tax law, the taxation of the receipt of a "profits" interest in a partnership in exchange for services is generally not an immediate recognition event if the profits interest is of speculative (or at least not readily ascertainable) value. *See* Rev. Proc. 93-27, 1993-2 C.B. 343, as amplified by Rev. Proc. 2001-43, 2001-34 I.R.B. 191; WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ch. 5 (3d ed. 1997). Moreover, I.R.C. Section 83, in general, deviates from the basic rule by postponing the recognition of income (and the employer's deduction) where the property received for services is "non-transferable and subject to a substantial risk of forfeiture." I.R.C. §§ 83(a), (h) (2002). An exception to the general rules on the valuation and income and deduction recognition aspects of nonqualified employee stock options can occur in the context of "golden parachute payments" addressed by I.R.C. § 280G (2002). *See* Rev. Proc. 2002-13, 2002-8 I.R.B. 549, *as modified by* Rev. Proc. 2002-45, 2002-27 I.R.B. 40 (containing valuation guidance in the context of recognition events upon certain arrangements in corporate change in control contexts). And, apart from income tax aspects, the federal gift and estate tax law may require valuation of nonqualified compensatory stock options upon certain completed gifts of such options. *See* Rev. Rul. 98-21, 1998-1 C.B. 975 (holding that "the transfer, to a family member, for no consideration, of a nonstatutory stock option, is a completed gift . . . on the later of (i) the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor"); Rev. Proc. 98-34, 1998-1 C.B. 983 (necessitating valuation under multi-factored fair value principles in certain transfer tax situations).

administration of the income tax system,[127] but its simplicity may create an artificial and unrealistic picture of the amount and timing of the compensation involved. The approach taken to most of these options under the Treasury Regulations effectively allows the measurement of the compensation income to be based on changes to the market value of the underlying stock occurring after the grant of the option, rather than on the value of the services performed as determined at the time the compensation (in the form of the *option)* is paid. The resulting enormous tax deductions for the bargain element of nonqualified employee stock options exercises claimed by publicly-reporting companies in recent years have been cited as a leading factor in the avoidance of income tax liability by many large companies.[128]

3. Current Financial Accounting Treatment

The current FASB standards governing financial accounting for stock-based compensation are both complex and controversial.[129] The complexity is evidenced by the

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[127] *See, e.g.*, ELLIE KEHMEIER ET AL., INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA, UNDERSTANDING TAX VS. ACCOUNTING TREATMENT OF STOCK OPTIONS: WHY THE LEVIN-MCCAIN PROPOSAL IS BAD PUBLIC POLICY 2 (2002) [hereinafter ITAA WHITE PAPER] (discussing the differences between tax and book accounting enunciated by the Supreme Court in *Thor Power Tool Co v. Comm'r* and discussed in detail in Part III *infra*), *available at* http://www.itaa.org/taxfinance/docs/itaa.sto.opt.pdf.

[128] *See* David Cay Johnston, *Study Finds that Many Large Companies Pay No Taxes*, N.Y. TIMES, Oct. 10, 2000, § C, at 2; Briloff, *supra* note 8, at 28 (estimating that for 1999 alone, Cisco Systems claimed approximately $2.5 *billion* in such deductions, reducing its income tax liability by approximately $837 million). *See also* Engler, *supra* note 19, at n.51 (noting that limiting the deduction to the "fair market value of the option at grant" would be the "theoretically correct result").

[129] There is a voluminous and expanding body of literature on accounting for employee stock options, reflecting substantial empirical data and detailed valuation analysis. The focus in this article is on the principal arguments of the debate as to if and when the costs of employee stock options should be required to be expensed by the employer company, in the context of comparing the book and tax treatment of such costs. For sources on the valuation of options, see, e.g., Damian Laurey, *Untangling*

maze of guidance on optional methods of accounting for employee stock options embodied in the FASB's long-standing Accounting Principles Board Opinion No. 25,[130] Statement of Financial Accounting Standards No. 123[131] and Interpretation No. 44,[132] and reflected in the work of the accounting industry's "Emerging Issues Task Force" over the

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the Stock Option Cost Sharing Loophole, 55 TAX LAW. 761, 773, 773 n. 83 (2002). Speaking to the complexity of the valuation challenge involved apart from the "intrinsic value" (i.e., the difference, if any, between the market value of the company's stock at the time the option is granted and the "exercise price" at which the option entitles the employee to buy company stock), Laurey recently described the factors relevant in determining the real "time value" of an option grant as follows:

> The time value (or speculative premium) is the excess of an option's fair value over its intrinsic value. Time value depends on: (1) the current stock price, (2) the exercise price, (3) the option's term, (4) the price volatility of the underlying stock, (5) the expected dividends on the underlying stock, and (6) the current risk-free interest rate for the expected life of the option. While the exercise date valuation involves a simple calculation of the excess of the current stock price over the exercise price, grant date valuation (or valuation at any date before exercise) requires a complex mathematical model such as the Black-Scholes model that incorporates the six factors listed above.

Id. at 773. Laurey's reference to the "Black-Scholes method" refers to widely-respected landmark work in the area of valuing employee stock options published in the early 1970s. *See* Fisher Black & Myron Scholes, *The Valuation of Option Contracts and a Test of Market Efficiency*, 27 J. FIN. 399 (1972); Fisher Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973); *see also* Dale Martin & Jonathan Duchac, *A Vested Present Value Approach to Valuing Employee Stock Options,* 1 ACAD. ACCT. & FIN. STUD. J. 38 (1997); Stuart Gillan, *Option Based Compensation: Panacea or Pandora's Box?*, TIAA-CREF INST. (2001) *at* http://www. tiaa-crefinstitute.org/Publications/wkpapers /wp_pdfs/wp04-05-01.pdf; ITAA WHITE PAPER, *supra* note 127, at 1 (describing the application of the "Black-Scholes" method to arrive at the "fair value").

[130] APB Opinion No. 25, *supra* note 6.

[131] SFAS No. 123, *supra* note 6.

[132] INTERPRETATION NO. 44, ACCOUNTING FOR CERTAIN TRANSACTIONS INVOLVING STOCK COMPENSATION, *supra* note 6.

last few years in issuing guidance on the application of the FASB standards to various types of arrangements involving stock-based compensation.[133] The controversial nature of the issue was manifest in the heated debate which raged from 1993 through 1995 over proposed changes to FASB's accounting standards in this area,[134] and the current stir over the decision of the International Accounting Standards Board ("IASB") to require by 2005 expensing of the cost of employee stock options by European Union and other companies following IASB standards.[135]

A general, though nevertheless technical description of the basic financial accounting options available to a company for an arrangement such as a compensatory nonqualified employee stock option is set forth in the following excerpt

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[133] EMERGING ISSUES TASK FORCE, ISSUE NO. 00-23, ISSUES RELATED TO THE ACCOUNTING FOR STOCK COMPENSATION UNDER APB OPINION NO. 25 (Dec. 27, 2001, revised Mar. 7, 2002 and Aug. 2, 2002).

[134] See discussion *infra* at notes 141-143 and accompanying text. The debate was recently described by current FASB Chairman Edmund Jacobs as "the most controversial project in the board's history." Steve Burkholder, *Accounting: FASB May Revisit Its Stock Option Rules If IASB Wants Stock Compensation Expensing*, 87 DAILY TAX REP. (BNA) G-5 (May 6, 2002).

[135] For samples of the heated nature of the current debate, see, e.g., ITAA WHITE PAPER, *supra* note 127; Steve Burkholder, *International Accounting: Volcker Defends IASB Stock Options Effort; Board Vice Chairman Cautions Opponents*, 33 SEC. REG. & L. REP. 1655 (Nov. 19, 2001). The IASB decided unanimously on July 16, 2002 to require the expensing. *See* Int'l Acct. Standards Bd., *Board Decisions on International Accounting Standards*, IASB UPDATE, July 2002, at 5-6 [hereinafter *IASB July 2002 Board Decision*], *available at* http://www.iasc.org.uk/docs/update/upd0207.pdf; *see also* IASB World Wide Web server *at* http://www.iasc.org.uk. On November 7, 2002, the IASB issued an Exposure Draft on Share-Based Payment which included rules on mandatory expensing. ED 2 SHARE-BASED PAYMENT (Int'l Acct. Standards Bd. 2002), *available at* http://www.iasc.org.uk/docs/ed02/ed02.pdf. Shortly thereafter, the FASB issued an invitation for comments on the topic of stock-based compensation. *See* Steve Burkholder, *Comment Sought on IASB Proposal, US Accounting for Stock Compensation*, 34 SEC. REG. & L. REP. 1924 (2002) (reporting on statement issued by FASB Chairman Robert Herz on November 18, 2002).

from FASB's summary of its Statement No. 123, the principal authority on the subject:

> This Statement defines a *fair value based method* of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. However, it also allows an entity to continue to measure compensation cost for those plans using the *intrinsic value based method* of accounting prescribed by APB Opinion No. 25 . . . Entities electing to remain with the accounting in Opinion 25 must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair value based method of accounting defined in this statement had been applied.
>
> Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at the grant date or other measurement date over the amount the employee must pay to acquire the stock. Most fixed stock option plans -- the most common type of stock compensation plan -- have no intrinsic value at grant date, and under Opinion 25 no compensation cost is recognized for them.
>
> The pro forma amounts required to be disclosed by an employer that continues to apply the accounting provisions of Opinion 25 will reflect the difference between compensation cost, if any, included in net income and the related cost measured by the fair value based method defined in this Statement, including tax effects, if any, that would have been recognized in the income statement if the fair value based method had been used. The required pro forma amounts will not reflect any other adjustments

> to reported net income or, if presented, earnings per share.[136]

In the example set forth *supra*, use of the "intrinsic value based method" would, as the FASB summary suggests commonly occurs, result in no cost recognition in the company's income statement, since the exercise price equaled the value of the stock on the date of grant (which is the measuring date in this situation).[137] However, there is obvious value to the employee in having the right to follow increases in the stock's value and to buy when a significant gap between the exercise price and trading value occurs -- even opponents of mandatory expensing do not seriously question that proposition, as the point of these options is to provide *compensation* to the employee.[138] As the Buffet and Biggs reasoning demonstrates, a corresponding cost attaches to the employer company in terms of the likelihood it will have to sell the employee its stock at a discount as compared

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[136] FINANCIAL ACCOUNTING STANDARDS BD., SUMMARY OF FASB STATEMENT NO. 123, *at* http://www.fasb.org/st/summary/stsum123.shtml (last visited Jan. 13, 2002).

[137] *See also Corporate Governance and Executive Compensation* (written testimony of John H. Biggs), *supra* note 6, at 4 ("Although a few options are granted above or below current market prices, the vast majority of options are granted 'at-the-money,' resulting in a zero expense.").

[138] *See, e.g.*, *supra* note 121 and accompanying text (comments attributed to Harvey Golub); Burkholder, *International Accounting: Volcker Defends IASB*, *supra* note 135 (quoting Thomas Jones, Vice-Chairman of the IASB, as remarking "that he does not hear many reasonable people saying that stock compensation does not represent an expense"). Indeed the fact that employee stock options have significant value is self-evident given the ferocity with which executives have been fighting proposed expensing of the compensation involved -- a point well-emphasized by the Executive Director of the Council of Institutional Investors, who observed in testimony before the Senate Finance Committee on the topic of "charging options" in financial accounting: "Options don't have value? Right. Then why are CEOs lobbying you like desperate cocaine addicts fearing withdrawal?" *Corporate Governance and Executive Compensation Hearing Before the S. Comm. on Fin.*, 107th Cong. (2002) (testimony of Sarah Teslik, Exec. Dir., Council of Inst. Investors), *at* http://finance.senate.gov/sitepages/hearings041802.htm.

to market value at some point during the option period. Such cost is evidenced by the fact that an investor not receiving compensation for services would have had to pay the company for such a valuable right. The "fair value based method" assigns a value to that cost by taking into account various factors, including the volatility of the stock, dividend expectations, prevailing interest rates and other considerations.[139] The "fair value" method is a rigorous and telling measurement of the likely effects of stock-based compensation. Corporate America has nonetheless overwhelmingly preferred the "intrinsic value based method" and its inherent lack of transparency.[140]

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[139] *See supra* note 129.

[140] *See supra* note 6. However, there have been recent reports, issued in the midst of growing public awareness of the problems with "managed earnings" and lack of accounting transparency, of several large companies deciding to alter their practices and begin expensing the cost of employee stock options. *See, e.g.*, Justin Bachman, *Coke Changes Accounting Options*, AP Business Writer, July 15, 2002, *available at* http://www.coca-cola.com (reporting Coca-Cola's decision to move to expensing on a prospective basis beginning in the fourth quarter, and noting that "many observers -- including Coke's largest individual shareholder, billionaire Warren Buffet -- argued that options have induced executives to doctor financial reports as a way to fuel their share prices"); Kathleen Day & Renae Merle, *Bank One to Count Options as Expense*, WASH. POST, July 8, 2002, § F at E01 (identifying Bank One as the first "major banking firm" to go to employee stock option expensing and observing: "Responding to investor calls for clear and complete financial statements, Bank One joins a handful of firms that have broken ranks with most of corporate America, which has relied heavily on options to compensate executives over the past decade but has not deducted them as expenses."); Andrew Hill, *GE Moves to Clarify Executive Options*, FIN. TIMES (London), Aug 1, 2002, at 22 (reporting General Electric's decisions to expense stock option costs and to require that senior officers hold shares for at least one year after exercising their options). The FASB has issued amendments to SFAS No. 123, *supra* note 6, providing special transition rules for companies making the switch to the fair value method. *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 148 (Financial Accounting Standards Bd. 2002).

4. Recent Debates Over Mandatory Expensing of Employee Stock Option Costs

In the early 1990s the FASB proposed to *require* the expensing of stock-based compensation in income statements.[141] A period of intense lobbying of the FASB and Congress by U.S. companies and various business groups (such as high-tech industry and executives associations) ensued, and led to proposed legislation which the FASB's chairman claimed would have "eviscerated" the Board.[142] Ultimately the FASB backed down and issued its Statement 123 as a compromise position. The then-chairman of the SEC, Arthur Levitt, has been quoted as saying that at the time he counseled the FASB to reverse its position on

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[141] In June of 1993, FASB circulated its Exposure Draft E-124, *Accounting for Stock-Based Compensation*, which, among other things, proposed mandatory expensing of the compensation costs of granting certain employee stock options. For a discussion of that proposal and the nearly ten years of study and debate leading up to it, see Joyce Strawser, *Accounting for Stock-Based Compensation: The FASB's Proposal*, 63 C.P.A. J. 44 (Oct. 1993).

[142] *See* Burkholder, *Accounting: FASB May Revisit its Stock Option Rules*, *supra* note 134. Specifically, legislation was introduced that would have overridden a FASB standard for expensing stock options costs. See Stock Options-Equity Expansion Act of 1993, S. 1175, 103d Cong. (1993), which is consistent with a Sense of the Congress Concurrent Resolution regarding the accounting standards proposed by the FASB, H.R. Con. Res. 98, S. Con. Res. 34, 103d Cong. (1993). Legislative history indicates that proponents of such legislation feared that the FASB rule would undermine employee stock options as a "vital tool for economic growth and job creation" for the sake of an accounting principle which had only theoretical justification. 139 CONG. REC. S15, 950-51 (1993) (statement of Sen. Lieberman); *see also* 140 CONG. REC. S2772 (1994) (statement of Sen. John Kerry) (arguing that the FASB proposal threatened to undo great accomplishments in the use of stock options "as a fundamental means of financing the start-up of new companies" and characterizing the FASB proposal as being "all in the name of a standard of accounting purity that FASB has great difficulty explaining in simple English"); *cf.* Robert W. Rouse & Douglas N. Barton, *Final Reporting: Stock Option Accounting, Employee Stock Option's Might be Today's Most Controversial Issue*, 173 J. ACCT. 67 (1993) (quoting Senator Carl Levin's description of employee stock options as "stealth compensation").

mandatory expensing of stock based compensation, but he later greatly regretted that action.[143] In contrast, in the spring of 2002, Harvey Pitt, the then-chairman of the SEC, advised a congressional committee against reopening public debate over accounting for stock options.[144]

Notwithstanding Chairman Pitt's recommendation, a flurry of post-Enron congressional activity on the stock options issue ensued, including the introduction of several bills under names which speak to the controversial nature of the debate, such as: the "Ending the Double Standards for Stock Options Act" introduced by Senators Carl Levin and John McCain on February 13, 2002;[145] the "Stock Option Accounting Reform Act" introduced by several members of the House of Representatives on July 17, 2002;[146] the "Prevention of Stock Option Abuse Act" introduced by Senator Ron Wyden on July 30, 2002;[147] and the "Rank and File Stock Option Act of 2002" introduced by Senators

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[143] *See* Burkholder, *Accounting: FASB May Revisit its Stock Option Rules*, *supra*, note 134.

[144] *See Stock Options: Council of Institutional Investors Backs Expensing of Stock Options*, 34 SEC. REG. & L. REP. 538 (2002).

[145] S. 1940, 107th Cong. (2002), reintroduced Jan. 16, 2003 as S. 182, 108th Cong. (2003) [hereinafter Levin-McCain Bill], *available at* http://thomas.loc.gov. The Levin-McCain Bill was substantially similar to a bill introduced by Senators Levin and McCain in 1997 under the same title, "Ending the Double Standards for Stock Options Act," S. 576, 105th Cong. (1997), *available at* http://thomas.loc.gov.

[146] H.R. 5147, 107th Cong. (2002) (which would direct the FASB to develop additional standards "relating to the recording of the value of a stock option granted by a public corporation to an officer or employee as an expense in the corporation's financial statements").

[147] S. 2822, 107th Cong. (2002) (including, *inter alia,* a statement that "stock option grants in some instances may have created incentives for directors and officers to pump up the corporation's short term share price, without regard to the corporation's long term financial health" and proposing that the SEC be directed to issue rules requiring publicly-traded companies to obtain prior shareholder approval of stock option compensation plans, rules imposing new requirements on the exercise of options by directors or executive officers and on sales of company stock by such persons, and enhanced disclosure requirements regarding employee stock options arrangements).

Joseph Lieberman and Barbara Boxer on August 1, 2002.[148] None of these proposals was included in the Sarbanes-Oxley corporate responsibility legislation.[149] Strong opinions and reasonable arguments exist on both sides of this continuing debate, and the FASB may very well be stuck in the middle again -- as it was in 1994.[150]

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[148] S. 2827, 107th Cong. (2002) (which would reduce or deny the income tax deduction to public companies relating to exercises of nonqualified employee stock options at a bargain in specified situations in which highly compensated employees have in excess of 50 percent of the rights to acquire shares or where a given highly compensated employee has over 5 percent of such rights; and would also direct the SEC to issue new rules requiring informed shareholder approval of stock option and other equity compensation plans and undertake a study on the possible need to impose new holding period requirements for stock held by senior executives).

[149] *See* CONG. REC. S6,625-32 (daily ed. July 11, 2002) (containing Senate debate relating to a proposed amendment to the Senate version of what eventually became the Sarbanes-Oxley Act, which amendment would have called for the recording in a publicly-traded corporation's income statement of grants of stock options to officers or employees; the amendment, on procedural grounds was not put to a vote, prompting its sponsor, Senator McCain, to claim that the purpose of the procedural debate was "to not have a vote on anything that has to do with stock options").

[150] In view of the recent IASB action to require expensing of employee stock option costs, as well as the decisions of some major U.S. companies to move to expensing in the income statement, the FASB continues to revisit SFAS No. 123 in terms of both adding new transition rules for companies who switch from the "intrinsic value" method to the "fair value" method and amending the disclosure requirements for companies providing stock option costs information in footnotes to require quarterly reporting of pro forma effects of outstanding stock options and related information, and reconsidering the possibility of mandatory expensing. *See* Financial Accounting Standards Bd., Amendment of the Transition and Disclosure Provisions of Statement 123 (project update dated Jan. 3, 2003), *available at* http://www.fasb.org/project/amend_123.shtml (last visited Jan. 27, 2003); Steve Burkholder, FASB Votes to Start Major Project on Accounting for Stock Compensation, 35 SEC. REG. & L. REP. 463 (Mar. 17, 2003) (reporting on FASB's March 12, 2003 announcement to revisit the mandatory expensing question and noting the existence of conflicting views on such action by many members of Congress).

One might argue that proper resolution of the issue is "as simple as 1-2-3," since FASB 123 does state that if the intrinsic value based method is used the company must nevertheless include a comparison to the fair value method and detailed information about the company's accounting for stock-based employee compensation and that accounting's effects on reported financial results in pro forma footnote disclosures.[151] As in the case of similar arguments regarding "footnote disclosure" of synthetic lease obligations, one must again question why various industries continue to fight with such vehemence against proposals to *require* the expensing of stock-based compensation if the same degree of transparency is being provided by virtue of footnote disclosure. The obvious answer is that the footnotes simply do not carry as much weight as the actual numbers in a balance sheet or income statement -- the numbers on which various computations and ratios are often primarily based en route to an investor's valuation of a company. It turns out that "burying it in the footnotes" is, as a practical matter, a successful way to camouflage debts and costs, even though some might argue that the information needed to get a true picture of the probable financial effects of the compensation is discernible from the footnotes.[152] This circumstance was

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[151] *See Corporate Governance and Executive Compensation Hearing Before the S. Comm. on Fin.*, 107th Cong. (2002) (written testimony of Mark G. Heesen, President, National Venture Capital Association) (noting that at least extensive footnote disclosures are required and arguing that "regardless of whether a fair value expense is recorded, and regardless of whether the company or its investors see the grant of options as a cost to the company, anyone who wants to consider this information in analyzing the financial report of the company has it fully available on an annual basis"), *at* http://www.senate.gov/~finance/hearings/testimony /041802mhtest.pdf; SFAS No. 123, *supra* note 6.

[152] This realistic observation is arguably supported in FSAS No. 123 itself, which as recently noted in testimony before the Senate Finance Committee by John H. Biggs, the Chairman of TIAA-CREF, widely regarded as one of the nation's largest and most sophisticated institutional investors, states: "The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue -- not because it believes that solution is the best way to improve

undoubtedly recognized by the IASB, which in announcing its recent decision to require expensing under a fair value approach of "all types of employee share-based payment," explicitly declined to "follow the same approach as [United States] accounting requirements" and concluded: "In other words, entities should not be permitted a choice between a fair value measurement method and an intrinsic value measurement method, and should not be permitted a choice between recognition and disclosure of expenses arising from employee share-based payment transactions."[153] Notably, while the IASB was considering this accounting issue, that board's very existence was being threatened in much the same manner as was the continued viability of the FASB when it advocated the expensing of employee stock option costs in the early 1990s.[154]

What, then, would happen if mandatory *income statement expensing* of stock option compensation became the rule in the United States? One prominent industry group, arguing against mandatory expensing, posited that "the forced deduction of option fair values will decrease financial earnings, depressing stock prices, and hinder the ability of companies in the high-tech industry to attract new capital."[155] Another argument advanced by opponents of mandatory expensing of stock option compensation is that this form of compensation is good for employees and

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financial accounting and reporting." Mr. Biggs went on to conclude: "In other words, disclosure in footnotes is inappropriate reporting to shareholders of the costs of operations." *Corporate Governance and Executive Compensation* (written testimony of John H. Biggs), *supra* note 6.

[153] *IASB July 2002 Board Decision*, *supra* note 135.

[154] In commenting on the IASB's consideration of a rule to require expensing of stock options, Philip Ameen, the Chairman of the Committee on Corporate Reporting of Financial Executives International, has said, "This adverse outcome, if sustained, will portend a quick erosion of corporate participation and support [for IASB]." *See* Burkholder, *International Accounting: Volcker Defends IASB*, *supra* note 135.

[155] See ITAA WHITE PAPER, *supra* note 127, at 2. *See also Corporate Governance and Executive Compensation*, (written testimony of Mark Heesen), *supra* note 151, at 13-14.

companies as a policy matter, and mandatory expensing will lead to fewer issuances of stock options to employees, including both highly compensated executives and rank and file workers.[156] These doomsday arguments have created such fervor that one interested observer, Thomas Jones, the Vice-Chairman of the IASB, urged in the spring of 2002 that the dialogue not be encumbered by "cry wolf" arguments to the effect that expensing stock options would mean "the end of civilization."[157]

Opponents of mandatory expensing of employee stock option costs in financial statements have thus not argued against the disclosure merits of the fair value proposition, but have instead pointed to the magnitude of the potential effects on companies making prolific use of employee stock options under the current accounting standards.[158] The response, of course, is that if a rule promoting accounting transparency by requiring expensing of employee stock option costs hinders the ability to provide incentives to employees and raise capital, that may be an appropriate result, as compared to raising capital by providing information to potential investors which obscures such costs.[159]

The current stock options debate is obviously politically charged.[160] The controversy is not new. Determining the

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[156] ITAA WHITE PAPER, *supra* note 127, at 3-4; Burkholder, *Accounting: FASB May Revisit its Stock Option Rules*, *supra*, note 134.

[157] *See* Burkholder, *International Accounting: Volcker Defends IASB*, *supra* note 135.

[158] The same "effects" arguments were made when the FASB threatened to require expensing of these costs in 1993. *See supra* note 142.

[159] *See* Burkholder, *Accounting: FASB May Revisit its Stock Option Rules*, *supra* note 134 (citing David Tweedie's response to the argument "that the expensing of stock options will lead to fewer options being issued" and quoting Mr. Tweedie as saying "[t]hat's the best reason for showing them," alluding, in the reporter's view, to the result that companies "would have to bear what many accounting experts believe is the real economic cost of compensation").

[160] For example, moves toward revisiting the issue of mandatory expensing of the cost of employee stock options have recently been

proper accounting for employee stock options in financial statements of U.S. companies has been a problematic issue since the 1950s.[161] More recently, strong positions for and against expensing stock option compensation in income statements were staked out on this issue during the fierce debate precipitated by the 1993 FASB proposal to require charges against earnings for stock option costs.[162] Although the continuing debate over what degree of disclosure of the cost of employee stock options is appropriate from a strictly financial accounting perspective is an interesting saga of domestic and global politics, the lack of consistency in the book and tax accounting for such compensation raises the

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supported by Federal Reserve Chairman Alan Greenspan, former SEC Chairman Arthur Levitt and such organizations as the Council for Institutional Investors, but opposed by President Bush, SEC Chairman Harvey Pitt, and such groups as the Information Technology Association of America. *See* Burkholder, *Accounting: FASB May Revisit its Stock Option Rules*, *supra* note 134 (as to the Greenspan and President Bush positions); *Stock Options: Council of Institutional Investors Backs Expensing*, *supra* note 144 (as to the positions of the Council and SEC Chairman Pitt); ITAA WHITE PAPER, *supra* note 127; *see also* T.R. Reid, *Options Must Be Treated as Expenses, Global Panel Says*, WASH. POST, July 17, 2002, at E04 (quoting Kimberly Crook, an IASB staff accountant, as saying: "We know that FASB has concluded that expensing options would be the right thing to do . . . But it's not required, because the Americans have made this a political issue, not an accounting issue").

[161] *See* William W. Werntz, *Accounting for Stock Options Issued to Employees*, ACCT., AUDITING, TAXES 137 (1953) (commenting on the increasing use of employee stock options in the early 1950s and identifying the determination of whether the option agreement includes an element of compensation, and if so, how the grant of the stock option should be "evaluated" as "major" accounting questions). Werntz, a lawyer, accountant, and long-time partner in the accounting firm of Touche Ross & Co., with experience as a teacher of accounting, corporate finance and law at Yale University and Yale Law School, reviewed the then-prevailing accounting proposals and valuation challenges in the handling of stock options, as well as the SEC's emphasis on disclosure and commented that: "Perhaps no treatment of a problem of this complexity can be worked out that would be wholly uncontroversial, particularly since the use of stock options (which, of course, is *not* an accounting question) is considered by many to be undesirable." *Id.* at 143.

[162] *See supra* notes 141-143.

more compelling analytical issues. By proposing to attack the tax deductions claimed by companies that are not expensing the corresponding compensation element of employee stock option arrangements, the Levin-McCain Bill -- styled "The Ending Double Standards for Stock Options Act"[163] -- put book-tax divergence at center stage, as discussed in the following subsection.

5. Tax-Related Proposals

Much like the IASB resuscitation of the FASB's earlier financial accounting proposal, the Levin-McCain bill revisits a failed proposal attempted from the tax side several years ago.[164] The most recent Levin-McCain proposal provides that a company's tax deduction for the compensatory element of a nonqualified stock option arrangement would be limited to the *lesser* of the amount expensed for book purposes or the amount the employee recognizes as ordinary income from such stock option compensation.[165] The inclusion of the "ending double standards" language in the title of the bill obviously followed the perception that there is something fundamentally wrong with a system whereby, in many cases, an item identified as "compensation" is deducted in arriving at taxable income, but not in arriving at the earnings reported in the companies' financial income statements. And, indeed, this apparent inconsistency may, at least at first blush, seem unconscionable. It has certainly caused public outcries about the resulting combination of tax avoidance and inflated earnings.[166] The fact that Enron is reported to have eschewed expensing some $600 million of

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[163] *See* Levin-McCain Bill, *supra* note 145.

[164] *See supra* note 145; *see also* Kurt Ritterpusch, *Stock Options: Levin, McCain Bill Would Require Companies to Include Stock Option Costs in Bottom Line*, 31 DAILY TAX. REP. (BNA) at G-6 (Feb. 14, 2002).

[165] *See* Levin-McCain Bill, *supra* note 145, § 2.

[166] *See* Johnston, *supra* note 128; Matt Krantz, *Loophole Inflates Earnings*, USA TODAY, Apr. 8, 2002, at 1B; Briloff, *supra* note 8; *see also* 143 CONG. REC. S3203 (1997) (statement of Sen. Levin) (referring to employee stock option deductions as "an expensive tax loophole").

stock option compensation for book purposes over a recent five-year period has certainly fueled the fire.[167]

Determining whether the income tax and financial accounting treatment of stock option compensation should be harmonized is by no means a simple matter. Opponents of the Levin-McCain proposal have criticized it on many levels. The principal lines of attack are well-summarized in the April 17, 2002 white paper issued by the Information Technology Association of America, a trade association representing the interests of many members of the U.S. information technology industry.[168] Leaving aside the ITAA's familiar refrains from the 1993-1995 debate as to the likely effects on capital raising and employee compensation of the Levin-McCain approach,[169] the ITAA's arguments on the technical merits of the proposal are essentially as follows: though purporting to be "tax" legislation, the Levin-McCain bill is a thinly-veiled attempt to influence the financial accounting for stock options, which is a complex issue best left to accounting "experts" and, in this case, the FASB, and is in pretty good shape under the current reporting regime; there are legitimate reasons for divergent book-tax treatment of various items, including stock option compensation, based on the differing goals of income tax administration and financial accounting acknowledged by the Supreme Court;[170] and conforming book and tax

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[167] *See* 148 CONG. REC. S6626 (2002) (statement of Sen. McCain) (noting recent analysis of Enron's issuance of "nearly $600 million in stock options" and also referring to reports of over $1 billion in stock options having been issued to senior executives of WorldCom).

[168] *See* ITAA WHITE PAPER, *supra* note 127. The ITAA purports to be the only trade association representing the interests of the world-leading U.S. IT industry. *See* ITAA World Wide Web server *at* http://www.itaa.org.

[169] *See id.* (arguing, for example, that mandatory expensing for book purposes would result in less option issuances, hurting rank and file employees and inhibiting the raising of capital by developing companies).

[170] See the discussion of the Supreme Court's opinion in *Thor Power Tool Co. v. Comm'r,* 439 U.S. 522 (1979), *infra* notes 181-191 and accompanying text.

accounting for stock options would add unwarranted complexity to the tax system.[171]

The ITAA arguments reflect some common themes in the history of the book-tax conformity debate in the United States. Foremost among them are a widespread fear of entrusting financial accounting standard-setting to the government and the assumption that financial accounting can learn very little from tax accounting and should stand on its own. Even some vocal proponents of mandatory expensing of employee stock option costs in financial statements seem to share those fears.[172] Standing against

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[171] *See id.; see also Corporate Governance and Executive Compensation Hearing Before the S. Comm. on Fin.* (written testimony of Mark G. Heesen), *supra* note 151, at 12-13 (making many of the same points and emphasizing the information available to investors and analysts through footnote disclosures and accounting rules requiring that earnings per share be reported "as if all in-the-money options were exercised," and, with respect to the "tax" perspective of the proposed legislation, arguing that the Levin-McCain bill is "an attempt to force a change in corporate behavior in financial reporting" and is "bad tax policy" which "would undermine both the logic and symmetry of Section 83, the private sector accounting standards setting process and Congress' role in setting tax policy").

[172] *See Stock Options: Levin, McCain Bill Would Require Companies to Include Stock Option Costs in Bottom Line*, 31 DAILY TAX. REP. (BNA) G-6 (Feb. 14, 2002) (reporting that Senator Levin emphasized that the Levin-McCain bill would *not* force financial accounting treatment, but merely deal with the tax deduction); *Corporate Governance and Executive Compensation* (written testimony of John H. Biggs), *supra* note 6, at 3-11. Mr. Biggs indicated he is troubled by the obtuseness of trying to deal with the stock option accounting issue through Levin-McCain's proposed denial of the tax deduction and, though advocating accounting rules requiring a charge for stock option expense in computing net income, also tends to agree with the argument that the government should not itself impose such technical accounting rules. *Id.* Mr. Biggs observed: "Although the legislation has a certain appeal, resulting in symmetry between tax and book accounting for option expense, we would prefer to address the financial reporting deficiency directly." *Id.* Mr. Biggs argues rather persuasively that footnote disclosures and "diluted earnings per share" calculations for "in-the-money" stock options are insufficient to provide transparent accounting of the full costs of employee stock options, and calls on Congress to support more FASB action on the issue, stating his opinion that "Congress, through the political process, should not enter into

these themes is the realization, driven home by the Enron experience and other major accounting disasters in recent years, that self-regulation by the accounting industry and private sector standard-setting bodies has left substantial room for abuse. In order to properly assess the degree to which the government might successfully utilize enhanced book-tax conformity measures to improve both the tax system and financial accounting for employee stock options and other transactions currently subject to divergent reporting, it is thus necessary to approach from an historical perspective the tension between tax accounting and book accounting, as well as the reluctance to involve the government in setting accounting rules and standards.

III. HISTORY OF THE BOOK-TAX CONFORMITY DEBATE

A. The Tax Law Perspective

1. Statutory Treatment

Section 446(a) of the I.R.C. generally addresses the book-tax conformity issue from a federal income tax perspective by succinctly providing:

> 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.[173]

This seemingly straightforward rule is complicated (and ultimately severely undercut) by I.R.C. Section 446(b), which sets forth the following exceptions to the basic conformity requirement:

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not

technical issues of accounting rules, but it should oversee the system through the SEC and should demand a fair and open process." *Id.*

[173] I.R.C. § 446(a) (2002).

> clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.[174]

Enacted as part of the comprehensive overhaul of the federal tax law embodied in the I.R.C. of 1954, Sections 446(a) and 446(b) were not new in concept in 1954. In fact, the language of these provisions is quite consistent with prior federal income tax statutory provisions regarding the extent to which taxable income is determined by reference to the taxpayer's method of computing book income.[175] Financial accounting predated the 1913 enactment of the first federal income tax statutes, and it was logical for the tax law to embrace the method of accounting for "book" purposes as a starting place for the computation of taxable income.[176] Section 446 and its predecessor statutory provisions have not been interpreted to require an exact matching of book and tax accounting (a "one set of books" requirement). As

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[174] I.R.C. § 446(b) (2002).

[175] *See* Section 13(d) of the Revenue Act of 1916, c. 463, 39 Stat. 756, 771; Section 212(b) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1064; Section 41 of I.R.C. of 1939, 53 Stat. 24. Legislative history from the enactment of the I.R.C. of 1954 confirms that Sections 446(a) and 446(b) essentially carried over the approach of the 1939 I.R.C. as to the general rules on methods of accounting. *See* SENATE COMM. ON FIN. REPORT, S. REP. NO. 1622, 83 Cong. (1954), *reprinted in* LEGISLATIVE HISTORY OF THE INTERNAL REVENUE CODE OF 1954, at 299-300 (June 18, 1954) (providing a detailed discussion of the technical provisions of H.R. 8300 which revised the internal revenue laws of the United States in 1954). For interesting descriptions of the early history of the statutory approach to "tax following book," see AM. ACCT. ASS'N COMM. ON ACCT. CONCEPTS AND STANDARDS, ACCOUNTING PRINCIPLES AND TAXABLE INCOME, SUPPLEMENTARY STATEMENT NO. 4 (1952), *reprinted in* 27 ACCT. REV. 427 (1952) [hereinafter AAA'S ACCOUNTING PRINCIPLES AND TAXABLE INCOME, SUPPLEMENTARY STATEMENT NO. 4]; Arnett, *supra* note 2, at 482-83; Robert G. Skinner, *The Pressure for Tax Conformity*, 1 TAX ADVISOR 708, 709 (Dec. 1972).

[176] *See* Arnett, supra note 2, at 483 (describing the early history of the tax law attempting to follow "generally accepted accounting principles," and noting that the tax law started off on the wrong foot by focusing on "cash method" income, but rather quickly, starting in 1918, began to take suggestions, such as the "accrual" concept, from financial accounting).

discussed in detail *infra*, various statutory and regulatory rules, as well as case law under the "clear reflection of income" exception to the general conformity rule of I.R.C. Section 446(a), have over the years led to determinations of taxable income which often dramatically diverge from financial income as determined under GAAP.

At times when the gulf between taxable income and book income of large corporations is perceived as becoming too wide -- especially in terms of book income greatly exceeding taxable income -- Congress is predictably pressed to take action. Thus, for example, the perception that corporations were not paying their fair share of tax while simultaneously touting increasing "book" income to investors led to major changes to the "alternative minimum tax" applicable to corporations which were put into effect during 1987 through 1989 to ensure that at least a minimum level of corporate tax was paid on 50 percent of the difference between book and tax income.[177] Over the last few years the attention given to

[177] *See* I.R.C. §§ 55-57 (as in effect for taxable years beginning in 1987, 1988, and 1989). For an explanation of the background and operation of the provisions which were in effect for that three-year period, see, e.g., JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 448-57 (Joint Comm. Print, May 4, 1987) [hereinafter 1986 JCT REPORT]; Sandra G. Soneff Redmond, *The Book Income Adjustments in the 1986 Tax Reform Act Corporate Minimum Tax: Has Congress Added Needless Complexity in the Name of Fairness*, 40 SW. L.J. 1219 (1987). After 1989, this part of the corporate minimum tax was replaced with the so-called "ACE adjustment" which involves very specific adjustments to alternative minimum taxable income, including, *inter alia*, potential adjustment of depreciation to conform to financial statement treatment. 1986 JCT REPORT at 457-62. For a recent discussion of the rather "comprehensive" approach to coordinating corporate taxable income with corporate book income which was in place for 1987 through 1989, see Engler, *supra* note 19 at 547-48, n.24; Johnson, *supra* note 2 (in several places referring to these alternative minimum tax provisions as a "bragging tax"). For discussion of an earlier initiative calling for increased regulatory and legislative efforts "to achieve greater conformity," see John S. Nolan, *The Merit in Conformity of Tax to Financial Accounting*, 50 TAXES 761 (Dec. 1972) (discussing, *inter alia*, the September 1970 recommendations of the President's Task Force on Business Taxation). In its brief discussion of book-tax conformity, the 1970 Report of the

corporate tax shelters has also included a great deal of focus on differences between a corporation's book and tax income, and proposals that the federal income tax law be modified to mandate more disclosure of book-tax differences as an audit tool and perhaps require more substantive "linkage" of determinations of corporate taxable income and financial accounting income.[178] For the time being, however, the federal income tax law contains few express requirements that specific transactions or items be accounted for in computing taxable income in the same manner in which they are reported on financial statements.[179]

President's Task Force on Business Taxation focused primarily on the same timing differences (prepaid income and estimated liability deductions) which Congress had attempted to address in provisions added to the I.R.C. in 1954, but repealed, retroactively in 1955, as discussed *infra* notes 193-198 and accompanying text. *See* PRESIDENT'S TASK FORCE REPORT ON BUSINESS TAXATION 60 (1970) [hereinafter PRESIDENT'S BUSINESS TAXATION REP.] (on file with author). The Report suggested that the Treasury Department exercise its regulatory authority to implement the original intent of those provisions (to have the tax law more closely follow the GAAP treatment of such items) and also recommended consideration of "legislative changes dealing with specific items, such as advance payments for services and expense accruals for product warranties, guarantees, sales discounts, and vacation pay." *Id.*

[178] *See, e.g.*, Canellos & Kleinbard, *supra* note 17 (advocating enhanced disclosure of book-tax differences); Engler, *supra* note 19 (proposing some limited "linkage" requirements whereby taxable income would follow GAAP treatment of selected items); Yin, *supra* note 19 (suggesting consideration of a tax on "adjusted book income" of public corporations). *See also* Calvin Johnson, *supra* note 2; Calvin Johnson, *A Book Income Tax*, 91 ANNUAL CONFERENCE ON TAXATION, NATIONAL TAX ASS'N 319, 320 (1998) (criticizing proposals to impose a tax on corporate GAAP income and suggesting that a tax on changes in a publicly-traded company's stock price and dividend distributions would be a "better idea").

[179] Outside of the general "method" rule of Section 446(a) discussed further below, there is the long-standing rule that use of the "last-in first-out" ("LIFO") method of inventory accounting for federal income tax purposes is conditioned on use of such method in reports to owners and creditors. I.R.C. § 472(c) (2002). For a discussion of a few instances of book-tax linkage reflected in Treasury Regulations, see Engler, *supra* note 19, at 561-62, nn.69-70 (addressing regulations regarding trading stamps, advance payments for goods and certain aspects of absorption of expenses in inventory accounting). And the I.R.C. itself does contain some discrete

2. Judicial Interpretations

When book-tax conformity has been put at issue as a matter of substantive tax law by the IRS, the legal and accounting professions, and the courts, the result has been a well-documented roller coaster ride, producing significant uncertainty as to when such conformity is required (or permitted).[180] A useful starting place to draw on this body of tax law in assessing the pros and cons of proposals for increased book-tax conformity from a tax perspective is the Supreme Court's opinion in *Thor Power Tool Co. v.*

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accounting provisions that follow GAAP-like timing principles. *See, e.g.*, I.R.C. § 455 (2002) (prepaid subscription income); I.R.C. § 456 (2002) (prepaid dues income of certain membership organizations); I.R.C. § 458 (2002) (magazines, paperbacks, and records returned after the close of the taxable year); I.R.C. § 460 (2002) (special rules for long-term contracts); I.R.C. § 461(c) (2002) (accrual of real property taxes); I.R.C. § 467 (2002) (certain rental arrangements or deferred payments for services); I.R.C. §§ 471-473 (2002) (accounting for inventories). The I.R.C. also contains a number of special provisions regarding the tax treatment of certain regulated industries subject to regulatory accounting requirements, which are outside the focus of this paper. *See, e.g.*, I.R.C. §§ 581-597 (2002) (banking); I.R.C. §§ 801-848 (2002) (insurance).

[180] For sources focusing in detail on the substantial body of "clear reflection of income" case law results under the tax law on book-tax conformity issues, see generally Karl S. Coplan, *Protecting the Public FISC: Fighting Accrual Abuse with Section 446 Discretion*, 83 COLUM. L. REV. 378 (1983); H. Dubroff, M. Cahill & D. Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALBANY L. REV. 354 (1983); Falk, *supra* note 2; Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998); Jennifer C. Root, *The Commissioner's Clear Reflection of Income Power under § 446(b) and the Abuse of Discretion Standard of Review: Where has the Rule of Law Gone and Can we Get it Back?*, 15 AKRON TAX J. 69 (2000). *See also* Russell Osgood, *The Story of Schlude: The Origins of the Tax/Financial Accounting GA(A)P*, *in* TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES (Paul L. Caron ed., 2003) (discussing a trilogy of tax cases to which the author traces the authority of the tax law's acceptance of two sets of books, arguing that the rules governing permissible book-tax divergence remain unclear, and suggesting that such lack of clarity may have contributed to recent audit failures involving what he characterizes as a tax/financial accounting "two step").

Commissioner.[181] At issue in *Thor Power* were the disallowance by the IRS of an excess inventory write-down and a bad debt reserve deduction claimed by the taxpayer.[182] The Tax Court had upheld the Commissioner's position on both issues and the Seventh Circuit affirmed the Tax Court's decision.[183] The Supreme Court granted certiorari to consider what Justice Blackmun's opinion characterized as "important and recurring tax accounting issues."[184]

The inventory issue presented the Court with an opportunity to address the question of whether or not the GAAP treatment of an item is presumptively controlling for federal income tax purposes.[185] As a preliminary matter, the Court endorsed Treasury Regulations taking the position that the phrase "method of accounting" as used in IRC Section 446 includes "not only the overall method of accounting of the taxpayer but also the accounting treatment of any item."[186] Citing several of its prior decisions, the Court reaffirmed the broad discretion vested in the Commissioner to reject for tax purposes methods of accounting which the Commissioner determines do not clearly reflect income.[187] It

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[181] Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979).

[182] *Thor Power*, 439 U.S. at 524.

[183] Thor Power Tool Co. v. Comm'r, 64 T.C. 154 (1975), *aff'd*, 563 F.2d 861 (7th Cir. 1977).

[184] *Thor Power*, 439 U.S. at 525.

[185] The Court viewed the taxpayer's main argument to be that conformity to GAAP created a presumption that its inventory methodology was valid for tax purposes absent strong evidence from the Commissioner rebutting such presumption. *Thor Power*, 439 U.S. at 539-40.

[186] *Id.* at 531 n.10 (citing Treas. Reg. § 1.446-1(a)(1) (1964)). This interpretation was not a foregone conclusion as a matter of statutory interpretation, and some had argued that perhaps only the broad issue of the "cash" method versus the "accrual" method was within the scope of I.R.C. § 446 (2002). *See* William L. Raby & Robert F. Richter, *Conformity of Tax and Financial Accounting*, 139 J. ACCT. 42 (Mar. 1975).

[187] *Thor Power*, 439 U.S. at 532 (citing Comm'r v. Hansen, 360 U.S. 446, 467 (1959); Lucas v. American Code Co., 280 U.S. 445, 449 (1930); Schlude v. Comm'r, 372 U.S. 102, 114 (1966); American Automobile Ass'n v. United States, 367 U.S. 687, 697-98 (1961); Automobile Club of Michigan v. Comm'r, 353 U.S. 180, 189-90 (1963); Brown v. Helvering, 291

went on to hold that the taxpayer had failed to comply with regulations under IRC Section 446 and the inventory-specific IRC Section 471 that represented a reasonable exercise of that discretion.[188] Though it might have stopped there, the Blackmun opinion proceeded to address as a policy matter the argument that conformity with GAAP should create a presumption of validity for tax purposes, as follows:

> [T]he presumption petitioner postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. 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 fisc. 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

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U.S. 193, 203 (1934); Lucas v. Structural Steel Co., 281 U.S. 264, 271 (1930)).

[188] *Id.* The Court concluded that although the Treasury Regulations under Section 446 state that "[a] method of accounting which reflects the consistent application of generally accepted accounting principles . . . will ordinarily be regarded as clearly reflecting income," that statement does not create a presumption but rather a general observation that generally accepted accounting practices will "in most cases . . . pass muster for tax purposes," so that, "if the Commissioner, in the exercise of his discretion, determines that they do not, he may prescribe a different practice without having to rebut any presumption running against the Treasury." *Id.* at 539-40 (citing Treas. Reg. § 1.446-1(a)(2)). Nonetheless, the scope of the Commissioner's "clear reflection" authority under I.R.C. § 446 has continued to be a controversial area in the federal income tax law. For a thoughtful analysis of standards for review of the Commissioner's discretion in "clear reflection of income" cases in the context of "rule of law" analysis, see Edward A. Morse, *Reflections on the Rule of Law and "Clear Reflection of Income": What Constitutes Discretion?*, 8 CORNELL L.J. & PUB. POL'Y 445 (1999); Root, *supra* note 180.

> 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 contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.[189]

In addition to emphasizing its perception of the differing "objectives" of tax and book accounting, the Court pointed to accounting "treatments" reflecting such differing objectives. Focusing on characteristics commonly cited in accounting literature explaining problems with book-tax conformity proposals, the Court observed:

> Where the tax law requires that a deduction be deferred until "all events" have occurred that will make it fixed and certain, accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated. Conversely, where the tax law requires that income be recognized currently under "claim of right," "ability to pay," and "control" rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched. Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes.[190] . . . Finally, a presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants have long recognized that "generally accepted accounting

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[189] *Thor Power*, 439 U.S. at 542-43 (alteration in original) (citations omitted).

[190] *Id.* at 543 (citations omitted).

> 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. . . . 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.[191]

The Supreme Court certainly had ample reason to assign significant weight in its analysis to the tension between the Treasury's desire for certainty and maximization of "the fisc" and the conservatism and relative uncertainty of financial accounting, at least in the era in which *Thor Power* arose.[192] This tension is perhaps best illustrated by the brief history of Sections 452 and 462, enacted as part of the I.R.C. of 1954[193] and promptly repealed (retroactively).[194] Legislative history of the repealing legislation indicates that these two sections were enacted in response to a recommendation made by President Eisenhower during his 1954 budget message that

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[191] *Id.* at 544 (citations omitted).

[192] *See* Howard M. Weinman, *Conformity of Tax and Financial Accounting*, 59 TAXES 419, 431 (1981) (in which, writing only a few years after the Court's decision in *Thor Power*, and generally embracing the Court's reasoning concerning the differences between the two systems of accounting, the author argued that "the mere presence of a conformity doctrine inhibits the development of sound accounting principles to which tax accounting might be required to conform").

[193] *See* I.R.C. §§ 452, 462 (1954) (repealed 1955). Section 452 generally provided for elective recognition of prepaid income over a period not exceeding six years in certain qualifying circumstances. Section 462 contained a general rule that in the computation of taxable income, and again on an elective basis, "there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies," and then set forth various exceptions and limitations on the use of this provision to currently expense additions to reserves for future expenses.

[194] Section 452 of the I.R.C. of 1954 was repealed June 15, 1955, ch. 143, § 1(a), 69 Stat. 134; Section 462 of the I.R.C. of 1954 was repealed June 15, 1955, ch. 143, § 1(b), 69 Stat. 134.

"[t]ax accounting should be brought more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses."[195] Section 452 allowed some spreading out of the recognition of prepaid income and Section 462 allowed deductions for reasonable additions to reserves for estimated expenses. Unfortunately, it quickly became apparent to the Secretary of the Treasury that the original estimates of the revenue loss from the passage of the two provisions were grossly understated[196] and that it appeared that taxpayers, with the assistance of their accountants and other tax advisors, intended to take positions inconsistent with the intended limited application of the two provisions, likely leading to protracted tax litigation.[197] As a result, what accountants might view as the more theoretically "pure" accounting (in the sense of consistency with GAAP's "matching principle"),[198] for prepaid income and expense reserves attempted in the 1954 enactment of I.R.C. Sections 452 and 462, was retracted in 1955 to protect the Treasury's

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[195] As quoted in Donald Schapiro, *Tax Accounting for Prepaid Income and Reserves for Future Expenses, in* HOUSE WAYS & MEANS COMM., 86TH CONG., COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE, TAX REVISION COMPENDIUM, 1133 (Comm. Print 1969).

[196] The original estimates had been in the $45 million range, but less than one year after the enactment of the 1954 I.R.C. the American Institute of Accountants estimated a $500 million revenue loss and others suggested the loss might "run to several billion dollars." S. REP. NO. 372, at 518 (1955).

[197] *See* S. REP. NO. 372, at 519-520 (1955); *Prepaid Income and Reserves for Estimated Taxes: Hearings on H.R. 4725 Before the House Comm. on Ways and Means*, 84th Cong. 3 (1955) (statement of the Honorable George M. Humphrey, Secretary of the Treasury). *See also* Weinman, *supra* note 192, at 425 (positing that "[l]argely, the difficulties resulted from the imprecisions in generally accepted accounting principles as to what should, or should not, be included in reserves").

[198] As discussed *infra* note 201 and accompanying text, there is significant debate on the extent to which the tax law should strive to follow financial accounting's "matching principle" (i.e., matching expenses with revenues of the period to which they properly relate).

bottom line and avoid the uncertainties of anticipated tax litigation.

Given the Sections 452/462 debacle and the substantial body of commentary Justice Blackmun cited in highlighting differences in tax and book accounting, there was ample justification for the Supreme Court to rather summarily reject in 1979 the notion that tax should follow GAAP as a general proposition. Thus, the tax law is left with a handful of I.R.C. and Treasury Regulations provisions on isolated accounting issues relating primarily to the timing of income or loss recognition[199] and a large body of case law, also dealing primarily with such "timing" questions, from which it is difficult to discern clear guidance as to when GAAP treatment will control tax treatment of given items.[200] As a notable manifestation of the uncertainties involved, some

[199] *See supra* note 179.

[200] See the rigorous reviews of the "clear reflection of income" case law in the commentaries cited *supra* note 180. For a sampling of representative cases in this area, see, e.g., Ford Motor Company v. Comm'r, 71 F.3d 209 (6th Cir. 1995) (affirming Tax Court's decision upholding IRS Commissioner's authority to force Ford to use for tax purposes the method of accounting employed in its financial statements with respect to deduction of costs associated with structured settlements of tort claims for which the company had purchased an annuity for eventual funding; Ford had sought to deduct currently for tax purposes the full costs of the payments to be made, including future payments, and report the annuity income as it came in; but for financial purposes it had expensed the "present value" of the liabilities); Wal-Mart Stores, Inc. v. Comm'r, 153 F.3d 650 (8th Cir. 1998) (affirming the Tax Court's reversal of the Commissioner's denial of Wal-Mart's inventory method involving estimated "shrinkage" in physical inventory, based on such method being both in accordance with GAAP and consistent with clear reflection of income); American Express Co. v. United States, 262 F.3d 1376 (Fed. Cir. 2001) (affirming Fed. Ct. of Claims in upholding Commissioner's denial of the taxpayer's request for a change in accounting method, sought by the taxpayer based on its change for book purposes under a changed FASB standard, to recognize credit card fee income ratably over 12-month period for which billed rather than when originally billed; the court held that it was within Commissioner's discretion to conclude the fees did not qualify for ratable income recognition under special rules regarding payments for contingent services, because they represented payments for the extension of credit).

commentary asserts that the tax law on "clear reflection of income" has historically failed to sufficiently incorporate the logic of the fundamental "matching principle" of financial accounting, while other commentary argues that the courts have tried too hard to incorporate that principle, thereby sacrificing sound tax policy.[201] To the extent that courts do struggle with book-tax conformity issues, they may be merely reflecting the market and political pressures and the complexity of some of the analytical issues involved which

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[201] *Compare, e.g.,* Nolan, *supra* note 177, at 766, 770 (describing GAAP's attempt "to allocate to each period the expenses which will be incurred in earning the income allocated to that period" as "seeking a realistic statement of financial condition" and generally concluding that in the absence of "a conscious Congressional policy" mandating a book-tax difference or where specialized rate-related accounting methods are imposed on public utilities, the tax law would be well-served to follow GAAP), Dubroff, Cahill & Norris, *supra* note 180, at 362 n.31 and accompanying text (citing legislative history from the repeal of I.R.C. Sections 452 and 462 indicating that despite such repeal Congress remained interested in bringing tax accounting into greater conformity with generally accepted principles of business accounting "since the latter generally reflect more accurately the timing of receipt of income and of incurring of expenses"), at 400 (asserting that "the importance of matching has been largely ignored" in prepaid income and all events test contexts), and at 402 (questioning whether the IRS and the courts have given "due deference" to GAAP on "clear reflection of income" issues) *and* W. Eugene Seago, *A Modest Proposal Regarding the Matching Principle*, 90 TAX NOTES 1855 (2001) (critiquing Geier, *supra* note 180, and arguing that the matching principle has and should play a prominent role in income tax accounting), *with* Geier, *supra* note 180, at 164 (concluding that: "[T]ax law is not about financial accounting. It is time we made a more concerted effort toward spreading that message to the bench and bar by fully debunking the myth that 'matching' income and related deductions in the same accounting period is as much a value in the income tax as it is in financial accounting."), Erik. M. Jensen, *The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance*, 37 U. FLA. L. REV. 443, 475 (1985) (citing inconsistencies in its application and concluding that "the matching principle lacks a coherent theoretical basis for tax purposes"), *and* Calvin H. Johnson, *The Illegitimate "Earned" Requirement in Tax and Nontax Accounting*, 50 TAX L. REV. 373 (1995) (generally criticizing GAAP's "earned income" concept and concluding that its adoption would be inappropriate as a tax policy).

undoubtedly contributed to various positions taken by the accounting profession and the Treasury Department on the desirability of book-tax conformity over the years, as chronicled in the following subsections.

3. Accounting Profession Pronouncements on Conformity

The accounting profession, through pronouncements by its principal governing bodies, has had a somewhat inconsistent record in its views on efforts to conform tax accounting to book accounting. At the same time, accountants have been unwavering in their assertion that the tax law should not control the development of financial accounting standards. As one group of commentators observed in 1983, after a period of some thirty-five years of earnest book-tax conformity debate: "It is not to be doubted that the accounting profession would view with great disfavor its displacement as the appropriate body for determining GAAP."[202] Indeed, even in the face of highly publicized audit failures of the past and present, the notion that Congress and governmental agencies should stay out of the business of setting financial accounting standards sometimes seems to be itself a "generally accepted" proposition.[203] A survey of some of the key statements by accounting institutions over the last half century thus demonstrates that the focus has been on the degree to which the federal income tax law should follow GAAP.

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[202] Dubroff, Cahill & Norris, *supra* note 180, at 389. *See also* Arnett, *supra* note 2, at 482 ("In a word, accountants feel they should influence congressional action on tax matters, but that governmental agencies should not prescribe generally accepted accounting principles.").

[203] *See* discussion *infra* notes 272, 320-323 and accompanying text (citing, *inter alia,* provisions of the Sarbanes-Oxley Act of 2002 designed to strengthen the funding and independence of the FASB and related legislative history). *See also supra* the discussion and text accompanying note 172 (citing fear of government control of the setting of financial accounting standards from parties on both side of the stock option expensing debate).

In the years leading to the enactment of the I.R.C. of 1954, the American Accounting Association ("AAA") and committees of the AICPA issued several statements calling for tax legislation modifying the computation of taxable income to more closely follow the determination of net income under GAAP.[204] Explaining the motivation behind this call for increased conformity of tax to book, the AICPA's Committee on Federal Taxation offered the following:

> Ever increasing divergences between rules of accounting for tax purposes (as prescribed by regulations, rulings, and court decisions), on the one hand, and generally accepted accounting principles (as universally applied in determining net income for commercial management and investment purposes), on the other hand, has been and continues to be the despair of businessmen, accountants, and tax practitioners alike. Such divergences not infrequently result in taxing as income what is actually capital. They are a continuing source of irritating adjustments of tax returns which, in the long run, yield no revenue to the government, because they merely represent shifts of income between years. The advantages, in terms of simplicity, of maximum conformance of tax accounting with the accounting methods employed in the taxpayer's accounting records, and in the

[204] *See* AAA'S ACCOUNTING PRINCIPLES AND TAXABLE INCOME, SUPPLEMENTARY STATEMENT NO. 4, *supra* note 175; AM. INST. OF ACCT. COMM. ON FED. TAX'N, RECOMMENDATIONS FOR AMENDMENT OF FEDERAL TAX LAWS (1953) [hereinafter AICPA 1953 Federal Tax Committee's Recommendations]; AM. INST. OF ACCT. COMM. ON ACCT. PRINCIPLES FOR INCOME TAX PURPOSES, DIVERGENCES BETWEEN RULES OF TAX ACCOUNTING AND GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (Dec. 10, 1953) *reprinted in* 94 J. ACCT. 93 (1954) [hereinafter AICPA 1953 Committee on Accounting Principles for Tax Purposes]. *See also* Arnett, *supra* note 2, at 483-84 & nn.1-2 and accompanying text (recounting this period of accounting history).

> preparation of his financial and credit reports, are self-evident.[205]

It is doubtful that the Committee's complaint of "irritating adjustments of tax returns" was a persuasive element of its argument for enhanced use of GAAP practices in determining taxable income. After all, the point that such adjustments "merely represent shifts of income between tax years" is rather hollow, given that the goal of many tax deferral techniques is to reap time value of money benefits by delaying the recognition of income or accelerating the claiming of deductions to shelter current income with full knowledge that there will be a later day of reckoning.[206] The lure of the simplicity that would allegedly result from tax law adoption of GAAP standards was, on the other hand, rather powerful. The effort to eliminate book-tax divergence in key areas was expressed as an attempt to "go far to reduce the [then] present and long-standing confusion and controversy" and to "restore the essential confidence of taxpayers in the fairness of the system,"[207] although at least one noted commentator on accounting policy had suggested that the advantages of such attempted simplicity may be superficial and outweighed by considerations warranting that the two accounting systems be allowed to develop independently.[208] Ultimately, the 1954 tax reform legislation

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[205] AICPA 1953 Federal Tax Committee's Recommendations, *supra* note 204, at 19.

[206] It should be noted that AICPA's Committee on Accounting Principles for Income Tax Purposes did supplement the "mere timing" argument by observing that accelerating the recognition of taxable income by accelerating income recognition or delaying deduction is likely to reduce the government's revenue collection "in a period of rising tax rates." AICPA 1953 Committee on Accounting Principles for Tax Purposes, *supra* note 204, at 94.

[207] *Id.*

[208] *See* Arthur M. Cannon, *Tax Pressures on Accounting Principles and Accountants' Independence*, 27 ACCT. REV. 419, 419 (1952) (arguing, in response to calls in the early 1950s for more book-tax accounting conformity, that: "[t]he time has come to recognize by divorce the separation-in-fact between taxable and business income, permitting each to go its own way pursuant to the underlying purposes and nature of

did follow the predominant recommendations of the accounting profession, taking steps, particularly in the ill-fated addition of I.R.C. Sections 452 and 462, to more closely follow GAAP on some issues of the timing of income and loss recognition.[209] And, despite the repeal of Sections 452 and 462 in 1955, the underlying accounting principles they embodied did survive and have affected subsequent tax rules, which more closely conformed tax accounting to GAAP on at least some specific items.[210]

Throughout its lobbying for amendment of the tax law to embrace GAAP principles for tax purposes, the accounting profession was extremely clear in expressing its view that the government should not get too carried away and assume that the desirability of "conformity" meant that the government should actually have a hand in determining the application or formulation of the principles to which the tax law was being asked to conform. The AAA's Committee on Concepts and Standards Underlying Corporate Financial

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each."). This sentiment was echoed in later years by Raby & Richter, *supra* note 186, at 48 (observing that "[c]onformity, on the surface, can be appealing" but that "the undesirable consequences of across-the-board conformity of tax and financial accounting are nevertheless far more important").

[209] *See* AICPA 1953 Federal Tax Committee's Recommendations, *supra* note 204, at 22 (as to prepaid income); *id.* at 24 (as to estimated expenses and losses); *see also* AICPA 1953 Committee on Accounting Principles for Tax Purposes, *supra* note 204, at 95-96. In addition to reiteration by enactment of I.R.C. § 446 of the "general conformity" rule contained in prior tax statutes, and the prepaid income and estimated expenses provisions of §§ 452 and 462, the 1954 tax reform legislation's accounting provisions also brought tax accounting closer to book accounting in selected other areas, such as allowing 52-53 week tax years and providing for ratable accrual of real estate taxes by accrual basis taxpayers. *See* I.R.C. §§ 441(f), 461(c) (1954).

[210] *See* Sheldon S. Cohen, *Accounting for Taxes, Finance and Regulatory Purposes -- Are Variances Necessary?*, 44 TAXES 780, 788 (1966) (where the then Commissioner of Internal Revenue observed that post-repeal those two provisions continued to "have an impact on tax policy considerations," noting, as examples, the subsequent enactment of I.R.C. provisions on prepaid subscription income and prepaid dues income). *See also* PRESIDENT'S BUSINESS TAXATION REP., *supra* note 177, at 60.

Statements commented, for example, that "neither the Congress nor the administrative authorities nor the Courts should undertake to modify the application of generally accepted accounting principles, consistently used by the taxpayer for published statement purposes, solely to alter the recognition of income or expense for tax purposes," and that "[a]ccounting principles should not be formulated or public reporting methods prescribed by directives of the tax laws; the body of accounting principles and the methods of reporting should evolve from the need and uses of the broad public interest."[211] The same Committee characterized an I.R.C. provision conditioning the use of the last-in first-out ("LIFO") inventory method for tax purposes on consistent use of it in the taxpayer's financial statements as "an unwarranted and unnecessary encroachment."[212] The accounting profession was, as one commentator observed, pressing for conformity of tax to GAAP, but simultaneously arguing strenuously that its "harmony" recommendations "did not mean the passage of tax statutes which also legislated accounting treatment, but only that these statutes be based on principles of accounting developed in the market place."[213]

The tenacity with which the accounting profession has fought against suggestions that the tax law dictate the principles to be followed in preparing financial statements is perhaps best reflected in the debate over so-called "booking" requirements which flared up in the late 1960s and early 1970s. Sometimes referred to as a "financial eligibility test," a "booking" requirement simply means that the tax law would condition the use for tax purposes of GAAP treatment of an item on the taxpayer's demonstration that it actually used such treatment in its financial statements; or, as Sheldon Cohen, the then Commissioner of the Internal Revenue Service put it in 1966, "if the argument for a

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[211] AAA'S ACCOUNTING PRINCIPLES AND TAXABLE INCOME, SUPPLEMENTARY STATEMENT NO. 4, *supra* note 175, at 428.

[212] *Id.* at 430.

[213] Arnett, *supra* note 2, at 490.

particular tax treatment is that such treatment generally conforms to 'generally accepted accounting principles,' is it unreasonable to require that such treatment be used for financial statement purposes?"[214] The strength of that logic was tested in the early 1970s when the Treasury Department adopted or proposed several new accounting method eligibility requirements premised on consistent financial reporting.[215]

The AICPA's 1971 response to the Treasury's stepped-up focus on booking requirements was quite pointed, reading in part as follows:

> It is obvious . . . that complete conformity between tax accounting methods and financial accounting methods neither exists nor is feasible. A policy of complete conformity is therefore not in the public interest.
>
> Nevertheless, because of the advantages to all parties concerned of a consistent method of income determination, a policy which expresses a presumption that tax accounting methods should conform to financial accounting methods is desirable if it recognizes the existence of factors . . . which may operate to overcome that presumption.

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[214] Cohen, *supra* note 210, at 793. For the use of the term "financial eligibility test," see Skinner, *supra* note 175, at 708.

[215] Skinner, *supra* note 175, at 711-13 (stating that prior to August 7, 1970 the only "financial eligibility" requirement related to the use of the LIFO method of inventory valuation, but that the Treasury was acting to add booking requirements in seven other areas, some of which proposals were quickly withdrawn by the Treasury). The only such surviving "direct" booking requirement in the I.R.C. itself is the LIFO consistency rule of I.R.C. § 472(c) (2002). *See* Lillian F. Mills, *Book-Tax Differences and Internal Revenue Service Adjustments*, 36 J. ACCT. RES. 343, 345 (1998). Other isolated instances of specific booking "linkage" do appear, however, as a matter of Treasury Regulations. *See, e.g.*, Engler, *supra* note 19, at n.70 (discussing regulations on the tax effects of estimated redemptions on trading stamps and regulations on absorption of certain expenses into inventory).

> Therefore, the policy of the AICPA is to advocate conformance of tax accounting to generally accepted accounting principles, with certain exceptions which need to be continuously defined in a logical and cohesive manner *by the appropriate body within the AICPA.*
>
> A requirement that external reports for creditors, stockholders, etc. conform to income tax accounting as a prerequisite for the use of certain income tax methods has been applied by the Treasury Department and further applications are under consideration.
>
> This "booking requirement" may be applied inequitably among taxpayers, and may also serve as a deterrent to changes in accounting principles *considered desirable by the accounting profession.* Hence, the AICPA opposes imposition of booking requirements by the Treasury Department, or by Congress.[216]

Among other things, this rather harsh statement suggests a certain arrogance on the part of the accounting profession, rooted in the belief that only accountants can truly understand the intricacies of accounting for complex financial transactions. Therefore, they should be the ones to establish accounting principles that respond to the evolution of business transactions in a logical and cohesive manner. This territorial reasoning had a long history. The notion of the government preempting the accounting profession's role in the establishment and implementation of GAAP had long been the subject of notable hyperbole. For example, in 1952 one commentator posited that "no one is so well qualified as the independent accountant in assisting and advising in the determination of tax effect and tax liability," but that tax law

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[216] AICPA BOARD OF DIRECTORS, POSITION ON CONFORMITY OF TAX AND FIN. ACCT. (Oct. 8, 1971), *reprinted in* Robert G. Skinner, *The Pressure for Tax Conformity*, 1 TAX ADVISER 708, 710 (1972) (emphasis added).

pressures driving the determination of book income would represent "government assumption of the independent accountant's task with the evils of inflexibility and bureaucracy, and the challenge to our way of life which that brings."[217] Similarly, in an article published in *The Accounting Review* just a few years prior to the AICPA's 1971 proclamation on book-tax conformity, the likely consequences of potential congressional or regulatory actions in the nature of booking requirements were summarized, much in the manner of the "end of civilization" arguments more recently leveled against proposals for mandatory expensing of employee stock options,[218] as follows:

> We can all visualize the consequences if accounting principles were determined by legislative fiat. Progress would be slow or brought to a halt. The greatest asset of the [accounting] profession -- the critically needed judgment that professional accountants can bring to complex business situations would be eliminated.[219]

Despite the AICPA's claim to be the best source for determining how to establish and use GAAP in financial statements, the logic of Commissioner Cohen's suggestion of the hypocrisy involved in the accounting profession pushing for favorable tax results based on GAAP methodology, but at the same time objecting to conditioning such tax benefits on the use of consistent methodology in financial statements,

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[217] *See* Cannon, *supra* note 208, at 426 (concluding that: "Surely in recognition of the threat to orderly development of accounting principles and their usefulness to the public, and of the threat to their own essential attribute of independence, the public accounting profession will take the lead in the necessary separation of the concepts of taxable and business income.").

[218] *See* Burkholder, *supra* note 157 and accompanying text.

[219] Arnett, *supra* note 2, at 490. *See also* Terence F. Healy, *Narrowing the Gap Between Tax and Financial Accounting*, 22 TULANE TAX INST. 407, 433 (1973) (asserting that the "spirit of cooperation" among the legal and accounting professions and the Treasury Department would "break down if Treasury attempts to legislate by regulations -- especially in those areas that are unacceptable to the financial community").

was overpowering. One prominent accounting industry observer commented with respect to the Institute's 1971 statement: "Naturally, this rigid position proved to be a source of embarrassment to the AICPA. A policy of complete opposition to sound accounting being made a condition for tax treatment on the part of the organization responsible for development of accounting principles was certain to provide difficulties for the organization."[220] As a result of the predictably negative reaction to the 1971 position, the AICPA subsequently softened its stance by releasing in 1973 a revised statement on "Conformity of Tax to Financial Accounting" that deletes the language purporting to limit the authority of Congress and the Treasury Department and recognizes that "booking requirements" may be appropriate in "many circumstances."[221] The 1973 statement does, however, expressly state that "the AICPA will limit its concurrence with financial statement eligibility requirements to those instances where the appropriate bodies within the Institute conclude that such a proposed requirement will not have a material adverse effect on the improvement or application of generally accepted accounting principles."[222] This more reasoned approach to book-tax conformity issues, embracing a case-by-case analysis, rather than comprehensive attempts to intertwine tax and book reporting, has survived since the early 1970s, and manifests itself in the most recent dialogue on the extent to which tax accounting should follow GAAP.[223]

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[220] T. Milton Kupfer, *The Financial Accounting Disclosure of Tax Matters: Conflicts With Tax Accounting Technical Requirements,* 33 INST. ON FED. TAX'N. 1121, 1125 (1975).

[221] AICPA STATEMENT ADOPTED BY THE BOARD OF DIRECTORS ON CONFORMITY OF TAX AND FINANCIAL ACCOUNTING (Oct. 11, 1973), *reprinted in* 44 C.P.A.J. 15 (1974).

[222] *Id.*

[223] *See* Engler, *supra* note 19, at 548-58 (analyzing the principal reasons why "comprehensive linkage" is viewed as unfeasible, including the fact that the tax law often contains "tax preferences" designed to encourage certain behavior, and reviewing some of the key differences between the objectives of tax and financial accounting that have remained

Importantly, the AICPA's criticism of "booking requirements" was not grounded solely in skepticism concerning government usurpation of the accounting profession's role. There was also a strong sense, sometimes expressed as a foregone conclusion, that the integrity of GAAP would be compromised if it became advantageous to shape financial reporting to facilitate the securing of desired tax results.[224] The argument was essentially that companies

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a concern throughout the years since the Supreme Court's 1979 decision in *Thor Power*).

[224] *See, e.g.*, Arnett, *supra* note 2, at 484 ("Because of the tax advantages, accountants would be under extreme pressure by management to justify, as a generally accepted principle, the procedure allowing the greatest tax advantages; and accountants, if history is an accurate indicator, would succumb."); Cannon, *supra* note 208, at 425 ("[I]ntense pressures may be brought on the determination of accounting income when that is identified with taxable income . . . since the pressure of tax saving is to minimize not the fact of income but the reporting thereof, [the accountant] finds himself in some difficult positions where full and comparable reporting may be inconsistent with a tax position taken by management."); Herbert E. Miller, *How Much Income Tax Allocation,* 114 J. ACCT. 46, 49 (1962) ("[I]n some instances (important ones) accountants can get business to adopt an accounting procedure only if it has prospective income tax advantages" and "in some instances accountants are pressured to go along with bad accounting just because it is acceptable and sensible for income tax purposes."); Weinman, *supra* note 192, at 430 (stating that the commentators were in "near unanimity . . . that any requirement of conformity of financial to tax accounting would put tremendous pressure on [the FASB] . . . to permit whatever financial accounting led to the most favorable tax result"). *See also* Cohen, *supra* note 210, at 792 (citing this line of reasoning as cause to question "whether the main objective of those seeking reform of the tax accounting provisions is to eliminate differences between financial and income tax reporting"); C. Bryan Cloyd et al., *The Use of Financial Accounting Choice to Support Aggressive Tax Positions: Public and Private Firms*, 34 J. ACCT. RES. 23 (1996) (using empirical studies to support the proposition that "[i]f the appropriate financial accounting and tax treatments are ambiguous and the firm has chosen an aggressive tax treatment . . . management may choose a financial accounting method that conforms to the tax choice"); Mills, *supra* note 215, at 355 (pointing to data supporting the conclusions that "the more book income (or tax expense) exceeds taxable income (or tax paid), the greater are proposed IRS audit adjustments" and "firms cannot costlessly maximize financial reporting benefits and tax savings

would pressure their accountants into GAAP interpretations that yielded the best tax results, but not necessarily the most accurate picture of financial condition for creditors, shareholders, and other recipients of financial statements. In other words, if strict booking requirements were avoided, it might be possible to "take both roads" by claiming tax treatment predicated on an acceptable GAAP practice, but prepare financial statements under a different (yet permissible) GAAP interpretation that better suited the traditional objectives of financial reporting (or perhaps the company's objectives in its financial reporting).[225] Today, the enhanced pressures to "manage earnings" and cosmetically improve the appearance of balance sheets implicated in the Enron and other recent audit failures, coupled with the continuing desire to avoid taxes reflected in the recent proliferation of corporate tax shelters, strongly suggest a need to reassess the value of book-tax comparisons and, where appropriate, to impose conformity requirements as defenses against abuse from both a tax and securities regulation perspective. In the context of the history of the Treasury Department's views on "tax following book," the prospect of improper book-tax inconsistency, made possible by flexibility in the implementation of GAAP in financial

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independently," though noting that publicly-traded firms have "incentives that will make it optimal to bear some tax examination cost in order to trade off financial versus tax incentives"); Engler, *supra* note 19, at 582-85; Shevlin, *supra* note 19, at 436 (expressing the belief that increased alignment of tax and book income would substantially diminish the critical role played by financial accounting). *But see* Yin, *supra* note 19, 54 SMU L. REV. 209, 227 n.100 (2001) (noting a similar recent assertion by Calvin Johnson in his article cited herein at *supra,* note 2 and stating: "However, a recent study of the 1987-89 period, when corporate taxes were linked to reported book income through the application of the corporate minimum tax, questions the degree of earnings management undertaken by corporations in response to the law." (citing an unpublished paper by Won W. Choi et al. (2000) entitled *Potential Errors in Detection of Earnings Management; Reexamining Studies Investigating the AMT of 1986*)).

[225] *See* Arnett, *supra* note 2, at 490 (positing that such an approach might seem to a hypothetical Congressman "who has little knowledge about the intricacies of accounting" as an attempt by accountants to have "all the wheat but none of the chaff" or to "eat their cake and have it too").

statements, has undoubtedly driven much of that agency's approach to the conformity issue.

4. The Treasury Department and Book-Tax Conformity

Some commentators have criticized the Treasury Department and IRS for taking a "one way street" approach to book-tax conformity in regulations, audits, and tax litigation -- often citing a taxpayer's GAAP practice as "clearly reflecting income" when that will result in more (or accelerated) tax revenues, but rejecting GAAP treatment that would result in less (or deferred) tax revenues.[226] There is a wealth of literature dissecting the regulations and case law under the "clear reflection of income" standard that can be used to justify or reject the adoption of a book accounting method for tax purposes, from which some support for the "one way street" proposition may be derived.[227]

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[226] *See, e.g.*, Healy, *supra* note 219, at 409 ("in many instances the sacred principle of 'clearly reflecting income' gave way to the practicalities of protecting the revenue from the Treasury's point of view"); Raby & Richter, *supra* note 186, at 43 ("The history of court cases has demonstrated that the taxpayer's financial accounting treatment may control the tax treatment unless the IRS determines that a different result would be better. And the IRS often believes that income should be reported at an earlier point, and expenses deducted at a later point, than accountants would find proper for financial accounting purposes."); William L. Raby, *Ford Case May Destabilize Tax Accounting*, 62 TAX NOTES 1169, 1169 (1994) (explaining that taxpayer strategy utilizing GAAP "cannot overcome contrary provisions in the regulations. On the other hand . . . financial statement treatment that differs from tax may well persuade the court that the IRS is well within its power in concluding that the tax treatment is wrong."). *See also* William L. Raby & Burgess J. W. Raby, *Abuse of Discretion and Clearly Reflect Income*, 71 TAX NOTES 227, 229 (1996) (concluding that two 1996 judicial decisions indicated that the Tax Court and the Court of Federal Claims "may not . . . be willing to rubber stamp indiscriminate IRS attempts to switch all and sundry to methods of accounting that will maximize the Treasury's revenue" and characterizing the "IRS approach" as coming "close to asserting that the King can do no wrong").

[227] *See, e.g.*, the cases and commentaries cited *supra* notes 180 and 200.

On the other hand, there has been ample reason for the Treasury and IRS to fear damage to the tax revenues and the tax system from unjustified conformity to book treatment, and for this body of tax law to contain some seemingly inconsistent results. Many of the facts and issues involved are complex. Financial accounting standards have not been a model of clarity and the accounting profession itself has acknowledged that application of GAAP may be susceptible to manipulation motivated by the desire to reduce or defer taxes.[228] In approaching book-tax conformity issues, the Treasury Department is no doubt mindful of intended and legitimate differences between tax and book accounting -- for example a legislative tax policy to exempt from federal income tax interest on municipal bonds,[229] which clearly represents earnings for financial purposes. However, the Treasury Department is also alert to the possibility of differing interpretations of the proper "book" treatment of accounting items which could result in uneven administration of the tax law among taxpayers.[230] During the era in which the shouting for more conformity was perhaps the loudest, IRS Commissioner Cohen summed up the challenge in clear terms:

> There are, it must be granted, good reasons for many of the variances between tax, financial and regulatory accounting. However, some variances result from the wide disparity in practice and usage on the part of accountants as to what are "generally accepted accounting principles." This has resulted in a total lack of uniformity in financial accounting. Consequently, governmental bodies have been forced to limit the number of accounting practices that can be used for their purposes since a more definite

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[228] *See supra* text accompanying note 224.

[229] I.R.C. § 103 (2002).

[230] A concern expressed by the Court in Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 541-44 (1979).

> system of accounting is required by the legislation under which they operate.[231]

The Supreme Court sympathized with this administrative dilemma in *Thor Power*, citing several authorities on the diverse (and presumably acceptable) interpretations of GAAP in accounting practices,[232] including one in which the author suggested that accountants "are quite prone to define 'generally accepted' as 'somebody tried it.'"[233] Of course, since the establishment of the FASB in 1973, great strides have been made in promulgating and compiling accounting standards and seeking more uniform application of GAAP. Nonetheless, the FASB has recently been criticized for its slowness in issuing guidance on complex business transactions, such as the use of SPEs,[234] and there remains insufficient certainty in the application of GAAP to ignore the Supreme Court's admonition in *Thor Power* that: "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 [Internal Revenue] Code inequitable; they would make it unenforceable."[235]

The Treasury Department's actions in the conformity area over the last half century reflect this primary concern

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[231] Cohen, *supra* note 210, at 781.

[232] *Thor Power*, 439 U.S. at 544 n.22.

[233] *Id.* (citing Cannon, *supra* note 208, at 421).

[234] *See, e.g.*, Lynn E. Turner, SEC Chief Accountant, The State of Financial Reporting Today: An Unfinished Chapter III, at 6, *at* http://www.sec.gov/news/speech/spch508.htm (June 21, 2001) [hereinafter The State of Financial Reporting Today, Remarks by Lynn Turner, June 21, 2001] (noting in his 2001 speech that the FASB commenced a "consolidation" project in 1982 which was not yet finished and commenting: "In the meantime, investors [were] still waiting for an answer, especially for structures, such as special purpose entities (SPEs) that have been specifically designed, with the aid of the accounting profession, to reduce transparency to investors. If we in the public sector and investors are to look first to the private sector, we have the right to expect timely resolution of important issues.").

[235] *Thor Power*, 439 U.S. at 544.

with the lack of uniform application of GAAP. Proposals to implement booking requirements came naturally as a means of at least trying to make sure the taxpayer was putting its money where its (tax) mouth was. Meanwhile, the Treasury Department has generally deferred to the view that tax law should not prescribe financial statement accounting standards.[236] For many years, particularly in the three decades following the push for more conformity that preceded the enactment of the I.R.C. of 1954, the Treasury Department and IRS seemed to recognize the need to try to simplify business accounting by striving for increased conformity, within acceptable limits, of tax to book treatment, and invited the accounting profession to take a "lead role" in eliminating unnecessary divergence.[237] After the Supreme Court's assault on book-tax conformity in its 1979 decision in *Thor Power*, the push for enhanced conformity, as a matter of substantive tax law to ease the burdens on accountants, waned.[238] As noted *supra*, when it was perceived at one point that corporations were not paying a fair share of income tax, Congress did enact, for a short period (1987-89), an alternative minimum tax on a portion of

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[236] *See* Cohen, *supra* note 210, at 793 ("The government has neither the desire to be the final arbiter of what are 'generally accepted accounting principles' nor the desire to dictate how a taxpayer should keep his books.").

[237] *See id.* at 789 (recognizing a "responsibility" on the part of the IRS to narrow the gap between tax, financial and regulatory accounting); Gilbert Simonetti, Jr., *A Challenge: Can the Accounting Profession Lead the Tax System?*, 126 J. ACCT. 66 (1968) (reporting the comments of Jerome Kurtz, Tax Legislative Counsel for the Treasury Department in 1968, suggesting that the accounting provision could "lead the tax system" where tax and accounting objectives coincide and implying that the accounting profession was not doing enough to work with Treasury to achieve the "common goal" of "an equitable tax system, the results of whose operation are controlled and disclosed, and which operates more in keeping with generally accepted accounting principles").

[238] *See* Raby, *supra* note 226, at 1170 (asserting, from an accountant's perspective, that: "Enactment of the original Internal Revenue Code of 1954, which closely conformed tax to financial accounting, was . . . the technical high point of tax accounting -- from which the tax law has been going downhill for most of the subsequent 40 years.").

the difference between regular taxable income and book income and the Treasury Department issued detailed regulations on the book-tax reconciliations needed to comply with that tax law.[239] And, there have been some proposals to consider a tax on "book income" of one form or another which are controversial and have not, thus far, gained much momentum. For the reasons articulated by the Supreme Court in *Thor Power,* such proposals are likely to encounter tremendous resistance if framed as an attempt to have a single, comprehensive computation of net income, as opposed to efforts to attack conformity on an item by item (or transaction by transaction) basis.[240]

More recently, the emphasis has been on *disclosure* of book-tax differences. In addition to the long-standing, but somewhat limited, requirement that certain book-tax differences be disclosed on Schedule M of federal corporate income tax returns,[241] over the last few years there have been

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[239] *See* 1986 JCT Report, *supra* note 177, at 433; Treas. Reg. § 1.56-1 (as amended in 1990). *See also* Canellos & Kleinbard, *supra* note 17, at 999-1000 (discussing the potential usefulness of "long-dormant" Treas. Reg. § 1.56-1).

[240] *See* sources cited *supra* notes 2, 19 & 177. As Engler points out, even a system of overall presumptive conformity, with reconciling adjustments for tax preferences and other quirks of the tax system, would be inordinately complex and not feasible as a practical matter, leading him to his conclusion that book-tax linkage from the federal income tax perspective is more apt to succeed on a "non-comprehensive basis." Engler, *supra* note 19, at 548-70 (suggesting that consideration be given to limited measures such as attacking corporate tax shelters by denying certain tax deductions for which there is no corresponding "book" deduction).

[241] *See* I.R.S. Form 1120, U.S. Corporation Income Tax Return (2001); U.S. Treasury Department's White Paper, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals at 15 (July 1999) [hereinafter the Treasury Dep't's 1999 Corporate Tax Shelter Rep.] (discussing the requirement to report book-tax disparities on Schedule M-1, but noting that "[a]lthough some disclosure of book-tax disparities is required both for Federal income tax and GAAP purposes, the amount of detail is limited and provides the IRS with little evidence concerning the existence of corporate tax shelters."). *See also* Canellos and Kleinbard, *supra* note 17, at 3 (pointing out the shortcomings of Schedule M,

proposals and action by the Treasury Department to require more helpful disclosures of book-tax differences to facilitate the identification of potential tax shelter activity worthy of audit.[242] As discussed in Part IV *infra*, enhanced use of such

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including the fact that it "aggregates the net effects of many diverse items" and similarly criticizing Schedule L to Form 1120, which addresses the corporate "balance sheet" and might be used to flag off-balance sheet liabilities, but has apparently been applied inconsistently); *see also* Mills, Newberry & Troutman, *supra* note 19, at 17, 19-21 (observing that "while a body of academic literature associates book-tax differences with both tax aggressiveness and earnings management, there is no comprehensive firm-level analysis of the aggregate and components of such differences using both financial statement and tax return data" and, *inter alia,* discussing apparent weaknesses in the quality of liabilities information on Schedule L and some possible causes for the failure of Schedule L disclosures to adequately reconcile book-tax differences); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach,* 55 TAX L. REV. 325, 344 (2002) ("[I]t seems futile to start with the overall difference between book income and taxable income, to add and subtract differences due to factors, and to use the remaining difference as an estimate of tax shelter activity."); George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405, 419 (2002) (analyzing, *inter alia*, the extent to which book-tax "disjunction" regarding recent "notorious" corporate tax shelter cases might have been discerned to expose the nature of the underlying transactions using Schedule M information, suggesting that existing methods of obtaining book-tax divergence information are inadequate and concluding that: "Book-tax disparities in fact may be useful signals of corporate tax shelter activity, but we may be unable to perceive such signals at this time.").

[242] *See* the Treasury Dep't's 1999 Corporate Tax Shelter Rep., *supra* note 241, at 84 (discussing recommendations that would force disclosure of information regardless of whether the transaction meets the definition of a corporate tax shelter, but would require reporting only where the transaction meets certain "filters," such as a book-tax difference in excess of a certain amount); Treas. Reg. § 1.6011-4(b)(6) (2003) (generally requiring disclosure by certain publicly held and large companies of transactions involving book-tax differences in excess of $10 million); Rev. Proc. 2003-25, 2003-11 I.R.B. 1 (listing thirty exceptions to items taken into account in determining book-tax differences for purposes of Treas. Reg. § 1.6011-4(b)(6), including, among others, items "resulting from the treatment as a sale, purchase, or lease for book purposes and as a financing arrangement for tax purposes"). *See also* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1786 (1999)

measures merits serious consideration as part of an overall program to utilize book-tax comparisons to combat tax and financial accounting abuses.

B. Federal Securities Regulation and Book-Tax Conformity

1. Disclosure Requirements

It is widely acknowledged that the federal securities laws are disclosure oriented.[243] The SEC itself has said that its "primary mission" is to "protect investors and maintain the integrity of the securities markets" and explained that the federal securities laws and rules are based on the concept that "all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it."[244] In keeping with that theme, "the SEC requires public companies to disclose meaningful financial and other information to the public."[245] Thus, the function of the SEC is not to tell companies how to do business, but rather to require the companies it regulates

(suggesting that Schedule M-1 book-tax reconciliation "can be used as a source of information on shelters and might serve as a more useful source with increased IRS audit resources and expertise"); Cannellos & Kleinbard, *supra* note 17; Shevlin, *supra* note 19.

[243] *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2[3][A] (4th ed. 2002) ("The theory behind the federal regulatory framework is that investors are adequately protected if all relevant aspects of the securities being marketed are fully and fairly disclosed. The reasoning is that full disclosure provides investors with sufficient opportunity to evaluate the merits of an investment and fend for themselves."). *See also* STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, 108TH CONG., REPORT ON FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS (2002), *available at* http://www.senate.gov/~gov_affairs/100702watchdogsreport.pdf [hereinafter Gov. Affairs SEC-Enron Report].

[244] *See* SEC, The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity, *at* http://www.sec.gov/about/whatwedo.shtml (last modified Jan. 14, 2003).

[245] *Id.*

to provide adequate and accurate disclosure upon which investors, creditors and others can make informed decisions.

The SEC has broad statutory authority in many areas, which includes the authority to require extensive financial disclosures.[246] The SEC has exercised that authority in a number of ways, including promulgating extensive regulations applicable to most public companies directly governing financial reports in documents companies file with it[247] and requiring management to make various disclosures of financial information.[248] The SEC also maintains a staff devoted to accounting issues, which regularly issues bulletins and interpretations regarding financial accounting disclosures and works with the FASB and other accounting institutions.[249]

In the substantial efforts made by the SEC to improve the quality and usefulness of financial disclosures over the years, it has expressed concerns regarding the transparency of financial accounting for complex transactions, such as off-balance sheet financing arrangements,[250] but has not yet placed sufficient emphasis on book-tax comparisons as a tool for testing the propriety of the financial statement treatment of such transactions. For example, its principal disclosure regulation regarding financial statements to be included in registration statements and periodic filings by public companies (Regulation S-X) lacks express requirements for comprehensive, transaction-based disclosure of book-tax differences.[251] Regulation S-X does, in addressing "Income

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[246] *See* Notice of Adoption of Amendment to Regulation S-X to Provide for Improved Disclosure of Income Tax Expense, Security Release Nos. AS-149 et al., 3 SEC DOCKET 155 n.1, 1973 WL 149379 (Nov. 28, 1973) [hereinafter SEC Release AS-149] (discussing the changes to Rule 3-16(o) of Regulation S-X adopted by the SEC in 1973 to improve disclosure of income tax expense in financial statements).

[247] 17 C.F.R. § 210.1-01 *et seq.* (2002).

[248] *See* 17 C.F.R. §§ 229.301-306 (2002).

[249] *See* SEC, The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity, *supra* note 244.

[250] *See* Herdman et al., *supra* note 8.

[251] 17 C.F.R. § 210.1-01 *et seq.* (2002).

Tax Expense," require reconciliation ("in the income statement or a note thereto") of over 5 percent timing differences and deviations between total income tax reported and the amount that would be derived by multiplying the total income before tax by the applicable federal income tax rate.[252] However, those provisions of Regulation S-X are rather general and, as various items may "net out," could result in failure to disclose particular items with dramatic book-tax divergence.[253]

Explaining the reasons for these limited book-tax reconciliation rules when they were originally issued in 1973, the SEC stated:

> The objectives of these disclosure requirements are to enable users of financial statements to understand better the basis for the registrant's tax accounting and the degree to which and the reasons why it is able to operate at a different level of tax expense than that which would be incurred at the statutory tax rate. By developing such an understanding, users will be able to distinguish more easily between one time and continuous tax advantages enjoyed by a company and to appraise the significance of changing effective tax rates. In addition, users will be able to gain additional insights into the current and prospective cash drain associated with the payment of income taxes.[254]

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[252] *See* 17 C.F.R. § 210.4-08(h) (2002).

[253] Notably, in Securities Act Accounting Series Release No. 149, which accompanied the 1973 promulgation of the similar predecessor "Income Tax Expense" provisions, the SEC flatly rejected the assertion by several commentators that it violated rules prohibiting the disclosure of confidential information from corporate income tax returns, citing the broad statutory grant to require disclosure in registration statements of such information "as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors," as well as more specific statutory authority to specify "the items and details to be shown in the balance sheet and earnings statement." *See* SEC Release AS-149, *supra* note 246, at 2.

[254] *Id.* at 1.

The SEC clearly recognized that disclosure of book-tax differences would render more transparent the substance of a reporting company's financial condition and operations. Nonetheless, recent experiences with the types of transactions explored in Part II *supra* reveal that the level of "footnote" disclosure historically required has been inadequate to disseminate material information about major transactions that exploit book-tax differences. Thus, as discussed in Part IV *infra*, attention should be given, from a disclosure perspective, to more detailed and comprehensive requirements for publicly available reporting of book-tax differences of the type recently proposed.[255]

2. Involvement in Setting Accounting Standards

In the article published in *The Journal of Accountancy* in 1957, Marquis Eaton, the then president of the AICPA, wrote:

> As a matter of fact, the Securities and Exchange Commission already has the authority to control the financial reporting of a major segment of business society. Fortunately, the Commission has wisely chosen not to exercise it, preferring to enforce the principles developed in the evolutionary process by the accounting profession and by business.[256]

In keeping with this theme, the SEC has placed substantial confidence (and authority) in the accounting profession and, since 1973, in the FASB, to fashion and interpret the GAAP rules that control financial accounting.[257] The accounting profession and its governing bodies are, in turn, expected to self-regulate toward consistent and fair application of those rules.[258] The SEC has certainly been

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[255] *See* Canellos & Kleinbard, *supra* note 17 and accompanying text.

[256] Marquis G. Eaton, *Financial Reporting in a Changing Society*, 104 J. ACCT. 25, 30 (1957).

[257] *See* GAO 1996 ACCT. PROF. REPORT, *supra* note 45, at 3, 27; GAO 2001 SEC REPORT, *supra* note 16, at 5-7.

[258] *See* GAO 1996 ACCT. PROF. REPORT, *supra* note 45, at 12 (describing the AICPA-created peer review program, SEC Practice Section,

more than a passive bystander in the development of GAAP. It regularly targets issues for consideration by the FASB and participates in such critical endeavors as the work of the Emerging Issues Task Force.[259] Nevertheless, the General Accounting Office ("GAO") has been somewhat critical of the SEC's historical deference to FASB and the accounting industry, and others have now joined in that criticism.[260] Enron and other recent corporate audit failures demonstrate

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and Public Oversight Board); *see also* Michael V. Seitzinger et al., *Enron: Selected Securities, Accounting, and Pension Laws Possibly Implicated in its Collapse* (Congressional Research Service, Jan. 16, 2002), available through the Library of Congress, *at* http://www.lcweb.loc.gov.

[259] *See* The State of Financial Reporting Today, Remarks by Lynn Turner, June 21, 2001, *supra* note 234, at 8 (commenting that the EITF has worked well since its 1983 inception, but suggesting that its relationship with the SEC is sometimes strained, noting that SEC staff efforts to catalogue EITF issues led to criticism that the SEC was "controlling the agenda" and that the SEC "seem[s] to receive criticism whenever we send issues to the EITF").

[260] *See, e.g.*, GAO 1996 ACCT. PROF. REPORT, *supra* note 45, at 21 ("GAO believes that the SEC has not always strongly asserted leadership in its relationship with the standard setters and that more progress could be achieved in resolving major issues facing the standard setters if that were to occur"); GAO 2002 ACCT. PROF. REPORT, *supra* note 15 (in which the GAO reviews various weaknesses in the accounting profession's self-regulatory system and various proposals to improve the system, including enhanced SEC funding and actions); Letter from Rep. John Dingle, Chairman of the Committee on Energy and Commerce's Subcommittee on Oversight and Investigations, to the Honorable David M. Walker, the Comptroller General of the GAO, *available at* http://www.house.gov/commerce_democrats/press/107ltr60.htm (June 7, 2001) (requesting a report on the "adequacy and effectiveness of the Securities and Exchange Commission's oversight of the [auditing] profession's governance system"); Gov. Affairs SEC-Enron Report, *supra* note 243, at 20-24 (suggesting failures by accounting industry "watchdogs" under SEC oversight); Joel Seligman, No One Can Serve Two Masters: Preliminary Observations on Enron, Remarks at the 2002 F. Hodge O'Neal Corporate and Securities Law Symposium, Washington University School of Law (Feb. 23, 2002) (observing on the implications of Enron and other major accounting failures that "[t]he Commission and others need to carefully review whether SEC oversight of the generally accepted accounting principles and the context of its mandatory disclosure system has unacceptably deteriorated").

that the GAAP rules are not a model of purity and are just as prone to loophole manipulation as the I.R.C., and that self-regulation by the accounting industry has been deficient.[261] The public has long been conditioned to expect the government to commit substantial resources in attacking tax shelters and exploitation of tax loopholes. However, it seems that only recently has it come to realize that the magnitude and implications of accounting schemes designed to put a favorable gloss on modern financial statements are equally worthy of concentrated governmental initiatives.

Now, in view of the passage of the Sarbanes-Oxley Act of 2002, the SEC has the opportunity to answer the calls for it to become more actively involved in shaping financial accounting rules themselves.[262] Prophetically, while asserting in 1957 that the SEC had "wisely" deferred to the accounting profession and business in the evolution of financial reporting rules, AICPA President Eaton was

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[261] *See* description of recent revelations of questionable accounting, *supra* note 11. *See also In re* Sunbeam, 176 F. Supp.2d 1323 (S.D. Fla. 2001) (approving a settlement with Arthur Andersen, L.L.P. in the amount of $110,000,000 including attorneys' fees); David S. Hilzenrath & Kathleen Day, *PwC to Pay $5 Million To Settle SEC Case,* WASH. POST, July 17, 2002, at E01 (reporting a settlement by PricewaterhouseCoopers with the SEC of allegations of auditor independence violations); Peter J. Howe, *Andersen Indicted in Shredding of Records*, BOSTON GLOBE, Mar. 15, 2002, at A1 (discussing the bankruptcy filings of Global Crossing and Enron); Carol J. Loomis, *In 1999 We Wrote About Some Bad Guys Who Seemed to Have Airtight Cases Against Them, Guess How Many Went to Jail*, FORTUNE, Mar. 18, 2002, at 78 (discussing the Sunbeam and Waste Management disasters and Andersen's involvement).

[262] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §107 (giving the SEC broad authority and responsibility to oversee the rule-making and other actions of the new Public Company Accounting Oversight Board); *id.* § 108(c) (confirming the SEC's ultimate authority to establish accounting principles or standards for purposes of enforcing the securities laws); *id.* § 108(d) (directing the SEC to conduct a study "on the adoption by the United States reporting system of a principles-based accounting system"); Gov. Affairs SEC-Enron Report, *supra* note 243, at 61-68 (making various recommendations for more aggressive SEC financial oversight in view of perceived failures by "private-sector watchdogs").

careful to cite the following admonition from Jerome Frank, an early SEC Chairman:

> Accounting is the language in which the corporation talks to existing stockholders and to prospective investors. We want to be sure that the public never has reason to lose faith in the reports of public accountants. To this end, standards of thoroughness and accuracy [must be] protected. I understand that certain groups in the profession are moving ahead in good stride . . . but if we find that they are . . . unable . . . to do the job thoroughly we won't hesitate to step in to the full extent of our statutory powers.[263]

It would seem that the time alluded to by Chairman Frank for the SEC to step in and become more engaged in the standard setting for financial statements may have arrived. As the SEC reassesses its role in the process of the development of GAAP, it would be well served to determine the extent to which enhanced book-tax comparisons and, where appropriate, consistency requirements might improve the transparency of tax and financial reporting. At the same time, the SEC should consider the extent to which private sector bodies and the accounting profession would, in the absence of governmental initiatives, strive to use book-tax conformity to target and eliminate the "take both roads" practices which have characterized many of the abusive transactions publicized in the aftermath of Enron.

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[263] *See* Eaton, *supra* note 256, at 30.

IV. USING BOOK-TAX COMPARISONS AND SELECTIVE CONFORMITY REQUIREMENTS AS A DEFENSE AGAINST TAX AND FINANCIAL ACCOUNTING ABUSES

A. History Suggests a Need For More Regulatory Involvement in Setting Financial Accounting Rules

1. The Traditional Role of the SEC

In the year preceding his appointment to the Supreme Court, and while serving as Chairman of the Securities and Exchange Commission, William O. Douglas delivered an address entitled "Capitalism and Trusteeship."[264] He stressed the importance of the trust placed in the management of public companies as the servant of the stockholders, observing that "if the American public has a large stake in the country's corporate business, so American corporations have their stake in the public confidence."[265] Reflecting on the abuses of this trust, which led to the Securities Act of 1933 and the Securities Exchange Act of 1934, Douglas explained the mission of the SEC:

> Responsible management has always recognized its position as the servant of the stockholders. Yet the blight of capitalism has been a specious brand of morality for corporations, a morality which draw [sic] a distinction between the allegiance which the management demanded of its staff and the allegiance which management owed to its stockholders. You know and I know that there can be no such distinction. You and I know that once capitalism forsakes the standards of trusteeship, it bids fair to destroy itself. It is the job of the SEC to eradicate that specious brand of morality and to restore old

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[264] William O. Douglas, Capitalism and Trusteeship (Sept. 21, 1938), *in* FEDERAL SECURITIES LAW AND ACCOUNTING 1933-1970 SELECTED ADDRESSES 93 (Gary John Previts & Alfred R. Roberts, eds., 1986).

[265] *Id.* at 96, 98.

> fashioned standards which place business above suspicion or reproach for questionable financial practices.[266]

Over the years the SEC has ably performed the critical role Douglas described as a well run and highly respected regulatory agency.[267] It has promulgated rules and regulations designed to balance the need to allow markets to operate as business becomes increasingly complicated with the need to prevent abuses. And, it has exercised its enforcement authority when abuses occurred. With a limited staff and resources,[268] keeping pace with new and often incredibly intricate forms of business transactions is an extremely challenging task. The stories in the Powers Reports of inordinately complicated and apparently artificial financial arrangements employed by Enron, together with the subsequent revelations of questionable financial practices by other large companies, suggest that no matter how well most corporate managers and legal and accounting professionals understand the duties and trust reposed in

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[266] *Id.* at 96. *See also* Seligman, *supra* note 260, at 4 (citing similar reflections by Justice Harlan Stone in 1934 on the fiduciary duties involved, and suggesting that there has since been a "lulling of our institutional sensibilities" and that "[a] deterioration of the integrity of our corporate governance and mandatory disclosure systems may well have advanced, not because of a novel strain of human cupidity, but because we had so much success, for so long, that we started to forget why fundamental principles of full disclosure and corporate accountability long were considered essential").

[267] *See, e.g.*, JAMES D. COX ET AL., SECURITIES REGULATION 13 (3d ed. 2001) ("The SEC has long held a reputation for quality and vigor that sets it apart from many of its regulatory peers."); Hazen, *supra* note 243, at 26 ("In spite of its broad range of authority and the general criticism of governmental over regulation, the Commission has been recognized as one of the most efficient and effective federal agencies.").

[268] *See* U.S. GEN. ACCT. OFFICE, SECURITIES AND EXCHANGE COMM., HUMAN CAPITAL CHALLENGES REQUIRE MANAGEMENT ATTENTION, REP. NO. GAO-01-947, at 1-5 *available at* http://www.gao.gov (Sept. 2001); Gov. Affairs SEC-Enron Report, *supra* note 243, at 8-16, 62-63. But note that Sarbanes-Oxley Act § 601 provided an additional $776 million in funding for the SEC for fiscal year 2003.

them, some will seek to exploit loopholes or elevate form over substance to reach unjustifiable ends.

As John Murray observed in concluding an article on synthetic leasing: "Additional innovative variations of this type of structured financing are sure to be created and implemented by creative lawyers and other professionals, subject only to the constraints of existing and future state and federal case, statutory and regulatory restrictions."[269] Many of these structured finance techniques may be legitimately imaginative and defensible.[270] Others may comply with the technical requirements of the law but create difficulties in producing commonly understandable disclosure of the full economic effects of the associated transactions. Still others may be contrary to law or sound public policy. The SEC, principally through its Office of Chief Accountant, has been actively involved in sorting through new and different types of transactions to play a critical role in working with private sector institutions in attempts to improve the quality of financial disclosures affected by such transactions.[271] The SEC's work has included cooperation with the private institutions that set accounting standards. But, with relatively wide support, the

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[269] *See* Murray, *supra* note 3, at 240-41 n.7. In the footnote accompanying this statement, Murray said: "As the court noted succinctly, and perhaps cynically, in *In re* Winston Mills, Inc., 6 B.R. 587, 596 (Bankr. S.D.N.Y. 1980) '[s]o long as people do not mean what they say or do not say what they mean, there will be enough uncertainty to keep everyone busy hiding intent and obfuscating meaning.' In *In re* Best Products, Inc., 157 B.R. 222, 224, (Bankr. S.D.N.Y. 1993) after discussing whether a transaction denominated by the parties as a lease should be recharacterized, the court quoted *Winston Mills* and stated, '[n]ot a lot has changed since Judge Roy Babitt wrote those words.'"

[270] *See The Enron Collapse* (questions addressed to Robert K. Herdman), *supra* note 66, at 31 (discussing the use of SPEs in various legitimate and transparent financing and liability apportionment transactions); FASB's 2002 SPE Proposed Interpretation, *supra* note 90, at i ("[m]ost SPEs serve valid business purposes, for example, by isolating assets or activities to protect the interests of creditors or other investors or to allocate risks among participants.").

[271] *See* GAO 2001 SEC REPORT, *supra* note 16, at 5-7.

SEC has delegated substantial authority to private sector accounting bodies and the FASB and traditionally stopped short of controlling accounting standards in the manner former SEC Chairman Jerome Frank warned might someday be necessary.[272]

2. Limits on the Effectiveness of the Accounting Profession and FASB

"Auditor independence" has been a concern throughout the history of federal securities regulation and has been a particularly high-profile topic in recent years.[273] Speaking generally to the relationship between the SEC and the accounting profession between 1936 and 1970, James J. Needham, the first certified public accountant appointed as an SEC Commissioner, identified a fear in the accounting profession that the SEC might someday exercise its "latent power to prescribe accounting principles and methods." Commissioner Needham cited authorities tracing the fear to the following statement by SEC Chairman Landis in 1936:

> The impact of almost daily tilts with accountants, some of them called leaders in their profession, often

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[272] *See supra* note 16 (citing authorities describing the SEC's traditional deference to the FASB, including legislative history of provisions of the Sarbanes-Oxley Act of 2002 designed to strengthen the independence of FASB).

[273] *See, e.g.*, 17 C.F.R. § 210.2-01 (2002) (the regulation S-X rules on "Qualifications of Accountants," as amended in 2000 to impose more stringent auditor independence rules); Lynn E. Turner, SEC Chief Accountant, Current SEC Developments: Independence Matters, Remarks at the 28th Annual National Conference of Current SEC Developments (Dec. 6, 2000), *available at* http://www.sec.gov/news/speech/spch445.htm [hereinafter Current SEC Developments, Remarks by Lynn Turner, Dec. 6, 2000] (explaining various details of the new auditor independence rules inserted in Regulation S-X in 2000); David M. Becker, SEC General Counsel, A Temperate Peace, Remarks at Corporate Accountability Conference (Mar. 10, 2001) *available at* http://www.sec.gov/news/speech/spch478.htm (reflecting on the controversy surrounding the formulation of the rules promulgated in 2000, and alluding to reports which had characterized the project as "one of the nastiest rulemaking fights Washington has seen in years").

> leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor.[274]

Commissioner Needham went on to cite commentary addressing the following thirty-four years of sometimes strained accounting profession/SEC cooperation (chronicled in a book by Jack Carey, a long-time officer of the AICPA, aptly entitled HONEYMOON ENDS) and quoted SEC Chairman Manuel F. (Manny) Cohen's 1966 remarks that:

> Congress has given [the SEC] the final responsibility for insuring that adequate standards of disclosure are maintained and it is a responsibility that we take very seriously. However, we prefer -- and I anticipate that the Commission will always prefer -- to accomplish these objectives through cooperation as long as we are persuaded that it is an effective and expeditious way to achieve them.

Significantly, Commissioner Needham then noted Jack Carey's suggestion that the SEC's "thinly veiled" threat to step in if necessary to set accounting principles and methods "prodded the [accounting] profession to make improvements both in accounting and auditing that otherwise might have taken longer to achieve," before concluding, under the circumstances prevailing in 1970, that:

> I see little possibility the relationship between the profession and the Commission will change materially; and while the "honeymoon" has ended, I trust the two groups can maintain some marital bliss. Like other groups which have their own personality and which must work continually in close proximity, some friction will develop; but, the beneficial results so far have made the relationship one to be envied by other professionals.[275]

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[274] James J. Needham, Some General Remarks about the SEC and the Accounting Profession (Oct. 20 1970), *reprinted in* FEDERAL SECURITIES LAW AND ACCOUNTING 1933-1970 SELECTED ADDRESSES 334, 335 (Gary John Previts & Alfred R. Roberts eds., 1986).

[275] *Id.* at 335-36.

Recent reports issued by the GAO suggest that in the three decades since Commissioner Needham's 1970 remarks, the relationship between the SEC and the accounting profession has indeed remained relatively consistent.[276] There has been significant collaboration in dealing with accounting issues despite the bumps in the road concerning the quality of public company audits and "auditor independence."[277] However, there have also been suggestions, well before Enron, that the SEC take a more proactive role in the setting of accounting standards.[278] There are many reasons to respect the work of accounting bodies and the FASB in bringing a general quality of disclosure to U.S. securities markets that is envied throughout the world, but the trust placed in non-governmental bodies susceptible to various pressures must be carefully circumscribed.[279]

In the context of the current accounting crisis, perhaps the most significant aspect of Commissioner Needham's 1970 address was his personal analysis of the auditor

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[276] *See* S. REP. NO. 107-205, *supra* note 16, at 12-13; GAO 2001 SEC REPORT, *supra* note 16, at 5-7.

[277] *See* GAO 1996 ACCT. PROF. REPORT, *supra* note 45; GAO 2002 ACCT. PROF. REPORT, *supra* note 15.

[278] *See* GAO 1996 ACCT. PROF. REPORT, *supra* note 45, at 6 ("GAO believes that the leadership the SEC has shown in addressing issues that concern independence of the standard setters should also be extended to working cooperatively with the accounting profession to address the other important unresolved issues that studies have continued to identify. The effective resolution of these issues cannot be accomplished by the accounting profession alone. The SEC's responsibilities under the securities laws place it in a pivotal position to assume a leadership role to work not only with the accounting profession, but also with stock exchanges, public companies, and users of financial reporting to resolve these issues.").

[279] *See, e.g.*, Current SEC Developments, Remarks by Lynn Turner, Dec. 6, 2000, *supra* note 273 (commenting in the context of new auditor independence rules: "America's accounting firms have established a proud heritage of excellence through the years, fulfilling a mandate established in 1933 to provide investors with information that is both comprehensive and reliable. Yet, competitive pressures and an imperfect self-regulatory presence gave rise to a need to address both perceived and actual conflicts of interest.").

independence issue. He characterized the "financial interest" prohibitions as the easy part of the independence inquiry[280] and focused instead on the accountant's duty to "use accounting to convey to the public the clearest picture of the financial condition and results of a business," in comments which, in view of today's business and regulatory climate, are worth quoting at length:

> The real test of the accountant's independence often comes when he must make a decision with respect to an accounting treatment of a matter not covered by a specific APB Opinion. Too many times the accountant rationalizes or justifies his decision by pointing to the fact that his problem has not been specifically dealt with in the accounting literature. This is the most specious form of reasoning.
>
> I believe that too many times when confronted with close questions some accountants ignore one of the fundamentals of accounting -- namely that substance shall triumph over form. This means that despite complicated legal instruments and whatever other documentation presented by a client, the accountant is charged, in the first instance, with the responsibility of seeing to it that the business impact of the transaction in question is reported rather than a literal reflection of a legal document.
>
> Furthermore, structuring a "business deal" in an attempt to exploit unsettled accounting principles is unfair to everyone and at times can come perilously close to commercial fraud. Management, as well as accountants, has a responsibility to see to it that the real significance of financial transactions is set forth properly in financial statements.

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[280] Needham, *supra* note 274, at 337. Interestingly, direct and indirect financial interests appear to have remained the focus of much of the "auditor independence" controversy. *See* 17 C.F.R. § 210.2-01(c) (2003) (containing rules adopted in 2000 pursuant to which an accountant may be deemed not independent if the accountant has certain direct or material indirect financial interests in the audit client).

> Truly independent accountants are well aware of their responsibilities in this area. As a matter of fact, the vast majority discharge those responsibilities in keeping with their code of professional ethics. Nevertheless, too often the valuable time of the Commission and its staff is consumed in discussions [sic] with issuers and their professional advisors who are not motivated towards full and fair disclosure but more towards the reporting of improved earnings.
>
> This practice is of real concern to the professional staff of the Commission. I urge the business community and its professional advisers to have this matter foremost in their minds.[281]

The history of the book-tax accounting conformity debate in the United States, and the proliferation of transactions exploiting book-tax differences, support Needham's argument that the "real" issue is what the accountants do when management is pushing them in a given direction. One of the principal arguments against tax-law imposed booking requirements chronicled *supra* was the fear that accountants would compromise financial accounting principles to achieve tax objectives pressed by corporate management. Synthetic leases and off-balance sheet partnerships arose as a means to satisfy management's desire to keep large debts off of corporate balance sheets by side-stepping a handful of mechanical tests and taking advantage of what the FASB itself has called "fragmented and incomplete" rules on SPE consolidation.[282] Employee stock option expense often yields income tax deductions, but under an optional method of GAAP accounting, no corresponding charge applies against income in the income statement, despite general recognition that an expense is involved. Hybrid instruments reported as debt for tax purposes but equity for financial statement purposes[283]are

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[281] Needham, *supra* note 274, at 337-39.

[282] *See supra* text accompanying note 92.

[283] *See supra* text accompanying note 70.

yet another example of the quest for loopholes -- whether they be under the tax law, GAAP, or both. Many of these trick plays appear to have flourished, ironically, under a "safety in numbers" perception. For example, when there was no clear guidance and everyone seemed to be using 3 percent as the outside equity requirement for SPE non-consolidation, the practice of using 3 percent appears to have become, in effect, the rule for several years despite warnings that such a figure might be too low in some circumstances.

The FASB itself was the product of the need for improvement in the process of setting accounting standards.[284] It was created approximately three years after Commissioner Needham's above quoted observations concerning the potential problems with uneven interpretation of the proper accounting treatment in areas lacking express guidance. The FASB has made great strides in the formulation and implementation of GAAP and GAAP interpretations, but has been severely criticized by some for being slow to act and subject to financial constraints.[285] Even the quality of its rule making has been questioned, as colorfully expressed by Paul Brown, the head of New York University's Accounting Department: "It's the old adage of a F.A.S.B. rule. It takes four years to write it, and it takes four minutes for an astute investment banker to get around

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[284] *See* PAUL B.W. MILLER & RODNEY REDDING, THE FASB, THE PEOPLE, THE PROCESS, & THE POLITICS ix (1986) (describing the formation of the FASB as the result of efforts to create "a new independent organization to assume primary responsibility for establishing standards for financial reporting in the private sector of the United States" following a study of the "establishment of accounting standards and to make recommendations for improving the process . . . that had been in the hands of the AICPA for nearly 40 years").

[285] *See, e.g.*, Seligman, *supra* note 260, at 35-37 (quoting Roderick M. Hills & David Ruder, both former SEC Chairmen testifying during recent congressional hearings held on February 12, 2002); The State of Financial Reporting Today, Remarks by Lynn Turner, June 21, 2001, *supra* note 234, at 6 (generally praising the contributions to the quality of accounting in the United States made by the FASB, but noting that "it has taken too long for some projects to yield results necessary for high quality transparency for investors").

it."[286] As Professor Joel Seligman, a leading scholar on securities regulation in the United States, observed after noting that Enron's off-balance sheet transactions were effected under existing generally accepted accounting standards, "This has appropriately focused attention on the quality of the existing accounting standard setting organization . . . Long before Enron, the political and financial weaknesses of the FASB were much discussed."[287]

Although the Sarbanes-Oxley Act takes steps to both strengthen the financing and independence of FASB and create an innovative oversight board with the ability to affect accounting and auditing standards and practices,[288] history suggests that government regulators should consider taking a more active role than in the past in shaping the rules and standards that ultimately result in the disclosures required in public company financial statements.[289] Many will argue

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[286] *See* Seligman, *supra* note 260, at 35 (quoting Roderick M. Hills, who was in turn quoting Paul Brown). *But cf.* Shevlin, *supra* note 19, at 435 (generally praising the manner in which financial accounting standards are set in the United States and stating that "the information role of financial accounting information is often underappreciated by non-financial accountants such as tax accountants, tax lawyers, and others").

[287] Seligman, *supra* note 260, at 36. *See also* Rob Garver, *Accounting Fight Finally Finds FASB, at* http://www.monitorydaily.com/index.cfm (June 25, 2002) (discussing legislative proposals to strengthen FASB which appeared to be directed at giving FASB more and the SEC less control of the setting of accounting principles).

[288] As discussed *infra* in text accompanying notes 313-23.

[289] The focus herein is on public company reporting, as lack of transparency concerning the implications of book-tax differences has been a particularly acute problem for large publicly-traded companies. *See* Yin, *supra* note 19, 54 SMU L. REV. 227, 228 (suggesting that if a "tax on adjusted book income" were adopted it should apply to only public companies "because of the discipline imposed by public markets on the amount of corporate earnings reported" and also noting that public corporations "probably represent the heart of the corporate tax shelter problem" and that many unincorporated private companies have the ability, not shared by a publicly-traded company, to avoid classification as a corporation subject to entity level federal corporate income tax). *See also* C. Bryan Cloyd et al., *supra* note 224, at 42 ("The finding that public firms appear to have greater incentive to boost reported income should encourage users [of financial statements] to exercise more caution when

that the last thing needed is more governmentally imposed rules,[290] or that the mere threat of government "intrusion" into the standard setting domain of accounting's governing bodies will suffice in view of the currently high-profile demand for better accounting. Yet, past experience tells us that gray areas will breed abuse in the absence of administrable anti-abuse rules written by agencies whose job

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analyzing the financial reports of public firms."). However, the benefits from increased use of book-tax comparisons in the regulation of tax and book accounting suggested in this article might, in many cases, also apply to privately-held companies required to give a clear picture of their financial condition to their owners and creditors, and to the taxing authorities. *But see* Engler, *supra* note 19, at 587 n.137, 592-93 n.155, 594-95 n.159 & 596-97 n.163 (noting possible distinctions in tax policy and other circumstances regarding public versus private companies which might complicate the establishment of a system of book-tax "linkage" from the tax perspective that would apply uniformly to both types of firms).

[290] In this regard, then SEC Chairman Harvey Pitt stated in the aftermath of Enron that one key factor in avoiding more major audit failures is "[p]rivate-sector standard setting that responds expeditiously, concisely and clearly to current and immediate needs." Harvey L. Pitt, SEC Chairman, How to Prevent Future Enrons (Dec. 11, 2001), *at* http://www.sec.gov/news/speech/spch530.htm. Similarly, in support of his pre-Sarbanes-Oxley Act proposal for a new accounting oversight board, Chairman Pitt was reported to have explained his view that a private board would be the "most expeditious and efficient solution." Rachel McTague, *Pitt Outlines SEC's Plan for New Board to Govern Accountants, Restore Confidence*, SEC. REG. & L. REP., Jan. 21, 2002, at 101. More recently, then Chairman Pitt proposed that, in connection with the recognition of FASB as authority on GAAP under Sarbanes-Oxley Act § 108, the SEC may seek more influence on FASB's agenda, creating some potential controversy. *See* Steve Burkholder, *FASB Concerned at Pitt Suggestion of Increased SEC Influence Over Board*, SEC. REG. & L. REP., Feb. 17, 2003, at 294. *See also* Shevlin, *supra* note 19, at 428, 434-35 (advocating comparative study of book-tax linkage in other countries and more thorough examination of corporate financial statements to help discern "footprints" of tax shelter activity and "model" likely shelter suspects, and noting that the measures suggested "would be helpful to both tax and financial auditors," but cautioning that more closely aligning taxable income to book income might confuse and render more "cumbersome" the setting of financial accounting standards, noting, *inter alia,* the political pressure brought to bear on FASB in the mid-90s debate on expensing employee stock option costs); sources cited *supra* note 219.

is to protect the public. Speaking shortly after the 60th anniversary of the SEC, then Commission Chairman Arthur Levitt reflected on the job description of the SEC by recalling the words of William O. Douglas from his tenure as the SEC Chairman: "We've got exchange advocates; we've got investment banker advocates; and we are the investor's advocate."[291] Similarly, when it comes to eliminating abusive corporate tax shelters, the Treasury Department is, in effect, the public's advocate in terms of equitable administration of the tax system. Both agencies serve critical policing functions by creating and enforcing rules that one cannot reasonably expect the private sector to satisfactorily self-impose. And, in serving their missions in the area of developing transparent accounting rules, both can benefit from collaborative efforts to develop book-tax comparisons and, where appropriate, conformity requirements.

B. The Need to Expand on Recent Legislative Actions

Following the December 2001 Enron bankruptcy filing, and other high-profile restatements of financial statements to reverse questionable accounting by other companies, outcries for governmental action to restore confidence in the integrity of public company financial statements have come from many fronts, prompting a variety of proposals. Among the measures suggested in early 2002 were: creation of an independent board to oversee disciplining of the accounting industry;[292] reducing the number of members on the FASB board and changing voting requirements to facilitate timely

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[291] Arthur Levitt, SEC Chairman, The SEC Today, Remarks to the Greater Boston Chamber of Commerce (Nov. 6, 1995), *at* http://www.sec.gov/news/speech/speecharcive/1995/spch065.txt

[292] *See, e.g.*, Public Statement by SEC Chairman: How to Prevent Future Enrons, Harvey L. Pitt, *supra* note 290; H.R. 3970, 107th Cong. (2002) (legislation, entitled "The Truth and Accountability in Accounting Act," introduced into the House of Representatives by Rep. John D. Dingell on March 14, 2002 [hereinafter Dingell Bill]; Rachel McTague, *Bush Offers Plan to Improve Financial Data for Investors, Executives' Duty, Auditing*, SEC. REG. & L. REP., Mar. 11, 2002, at 377.

rule-making;[293] requiring that public companies rotate their auditors every few years;[294] limitations on auditors performing non-audit services for the companies they audit;[295] more mandatory "real time" disclosure of major company actions and insider trading than is required under current rules;[296] making the board of directors, audit committee, and/or key officers of a company more directly responsible for questioning accounting treatment;[297] and a call by the (then) "Big 5" accounting firms for more clarity in accounting and disclosure rules and standards in certain complex areas.[298] Such proposals led to the passage by the U.S. House of Representatives of a bill entitled the "Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002,"[299] the passage by the Senate of a bill entitled "Public Company Accounting Reform and

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[293] The Financial Accounting Foundation ("FAF"), the parent group of FASB announced that it would reduce its membership requirement to facilitate rule-making and speed-up and streamline operations in the aftermath of Enron. DAILY TAX REP., Mar. 15, 2002, at G-6.

[294] *See, e.g.*, Dingell Bill, *supra* note 292, § 406 (proposing that companies rotate their auditors every seven years).

[295] *See, e.g., id.* § 406 (proposing a ban on auditors providing any consulting services, including federal tax law advice to their audit client and limiting other non-audit services to 20 percent of fees charged to the client for professional services).

[296] *See* SEC Press Release 2002-22 (Feb. 13, 2002); McTague, *supra* note 290.

[297] *See, e.g.*, Warren Buffett, Comments at Roundtable Discussion in New York, New York (Mar. 4, 2002), *available on audio at* http://www.sec.gov/news/extra/marchroundcast.htm (suggesting that "chief executive officers ought to view themselves as the chief disclosure officer"); Kip Betz, *Panel Offers SEC Guidance for Overhaul of Financial Disclosure Rules*, SEC. REG. & L. REP., Mar. 11, 2002, at 408.

[298] *See* Big Five Petition, *supra* note 12 and the SEC's response, Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Release Nos. 33,8056, 34,45321 (Jan. 22, 2002).

[299] H.R. 3763, 107th Cong. (2002) (passed in the House on April 24, 2002).

Investor Protection Act of 2002,"[300] and, ultimately, the enactment of major reforms in the Sarbanes-Oxley Act, which became law on July 30, 2002 and included several of the foregoing proposals in one form or another.[301]

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[300] H.R. 3763, 107th Cong. (2002) (as amended and passed by the Senate on July 15, 2002, based largely on elements of the House bill and on the expansion of S. 2673, as proposed by the Senate Committee on Banking, Housing and Urban Affairs).

[301] In general, the Sarbanes-Oxley Act contains a multitude of provisions aimed at improvement of corporate governance and responsibility and accounting reform, including, among other measures, sign-off/certification requirements aimed at making key corporate officers stand behind public company periodic filings under federal securities laws, *see* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302; a "sense of the Senate" resolution that the federal income tax returns of a corporation should be signed by its chief executive officer, *id.* § 1001; new rules regarding the composition and responsibilities of audit committees, *id.* § 301; various additions to criminal statutes and associated sentences/penalties relating to securities fraud and obstruction of justice, *id.* §§ 801-07, 901-06, 1101-07; the creation of obligations to notify account participants in retirement plans in advance of certain so-called "blackout periods" involving prohibitions or restrictions on diversifying account balances or receiving loans or distributions from the plan, *id.* § 306(b); special prohibitions on insider-trading during pension fund blackout periods, *id.* § 306(a); a requirement that the SEC develop rules requiring attorneys to report securities violations to various levels in a client's corporate hierarchy, *id.* § 307; whistleblower protections, *id.* §§ 806, 1107; a mandate for the development of rules to deal with conflicts of interest involving securities analysts, *id.* § 501; and additional "auditor independence" restrictions, including prohibitions on the provision of non-audit services by accounting firms serving as corporate auditors, a limitation on the number of consecutive years a firm's "audit partner" in charge of coordinating or reviewing a public company audit can perform audit services for that client without disqualifying the firm from providing audit services to the client, required reports by auditors to client company audit committees regarding accounting matters and alternative accounting treatments discussed with management, preclusion of a firm from acting as auditor if any of certain specified client positions are held by a person employed by the accounting firm within a year prior to the beginning of the audit, and the commissioning of a study of the potential effects of a system of mandatory rotation of auditing firms on a periodic basis, *id.* §§ 201-207.

This article will not endeavor to comprehensively examine the many provisions of the Sarbanes-Oxley Act.[302] Most important for purposes of the analysis in this article, the Act contains crucial provisions specifically addressing enhanced financial disclosures,[303] the creation of a public company accounting oversight board and related provisions regarding the development of auditing standards and the regulation of accountants performing public company audits,[304] and an amendment to the Securities Act of 1933 directed at the SEC's authority to recognize "generally accepted" accounting principles established by a private standard setting body (e.g., the FASB) meeting certain requirements.[305]

With respect to financial disclosures, the Sarbanes-Oxley Act contains provisions mandating enhanced disclosure of insider transactions and material correcting adjustments, expressly granting the SEC authority to require more "real time" disclosures, and a variety of other measures designed to improve the integrity of financial disclosures.[306] The new law also includes a special provision regarding off-balance sheet financing, which adds to the Securities Exchange Act of 1934 language directing the SEC to issue rules:

> [P]roviding that each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures,

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[302] For summaries of the key provisions of the Sarbanes-Oxley Act see S. REP. NO. 107-205, *supra* note 16.

[303] Sarbanes-Oxley Act §§ 401-409.

[304] *Id.* §§ 101-109.

[305] *Id.* § 108.

[306] *Id.* §§ 401-409.

> capital resources, or significant components of revenues or expenses.[307]

The sweeping disclosure mandate of this provision did not expressly direct the SEC to promulgate rules that require debt to be put on the balance sheet or to consolidate certain types of entities. Section 401(c) of the Sarbanes-Oxley Act does direct the SEC to complete (within a year) a study of public company filings and disclosures and to issue (within six months after completion of such study) a report to determine "the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities"[308] and "whether generally accepted accounting principles or the rules of the Commission result in financial statements of issuers reflecting the economics of such [off-balance sheet] transactions to investors in a transparent fashion."[309] The SEC is, among other things, directed to include in the resulting report its conclusion as to "whether generally accepted accounting principles specifically result in the consolidation of special purpose entities sponsored by an issuer in cases in which the issuer has the majority of the risks and rewards of the special purpose entity," as well as "any recommendations of the Commission for improving the transparency and quality of reporting off-balance sheet transactions in financial statements and disclosures required to be filed by an issuer

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[307] *Id.* § 401(a) (adding new subsection (j) to Section 13 of the Securities Exchange Act of 1934). In response to this Congressional mandate, and as a continuation of ongoing initiatives to improve disclosure of such transactions, the SEC has issued a Final Rule requiring detailed disclosures, in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of pertinent reports and registration statements, of various aspects of off-balance sheet arrangements, contractual obligations and contingent liabilities and commitments. *See* Securities Act Release No. 33-8182 and Securities Exchange Act Release No. 34-47264 (Jan. 27, 2003). The SEC's new rule does not expressly require discussion of differences in book and tax accounting for such transactions.

[308] *Id.* § 401(c)(1)(A).

[309] *Id.* § 401(c)(2)(C).

with the Commission."[310] Of particular note is the fact that these off-balance sheet/SPE provisions made no mention of book-tax disparities and, as it turned out, set sufficient time periods for the SEC action to allow the FASB to complete its SPE project[311] before the SEC might have to recommend an actual incursion into the GAAP rule making process. This suggests invocation of Jack Carey's theory[312] that a "thinly veiled threat" of government intervention may cause accelerated non-governmental attention to improved accounting rules.

As for accounting and auditing oversight, the Sarbanes-Oxley Act establishes the "Public Company Accounting Oversight Board" (the "New Oversight Board") and vests in it substantial authority:

> [T]o oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.[313]

The New Oversight Board is to operate as a nonprofit corporation funded by assessments and fees to be paid by public companies.[314] It will be subject to oversight by the SEC, which will appoint its five members, only two of whom can be or have been a licensed certified public accountant, with the additional restriction that the chairperson may not have been a practicing certified public accountant for at least five years prior to appointment.[315] The Board's key duties, as summarized in Section 101(c) of the Act are: perhaps most importantly, to administer a system of registration by inspection and disciplining of public company auditing firms

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[310] *Id.* § 401(c)(2)(D), (E).

[311] *See supra* text accompanying notes 99-109.

[312] *See supra* text accompanying note 275.

[313] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(a).

[314] *Id.* §§ 101(a), 109.

[315] *Id.* §§ 101(e), 107.

and enforcement of compliance by such firms with securities laws, professional standards and rules of the New Oversight Board relating to audit reports and accountants' associated obligations and liabilities;[316] to establish or adopt auditing, quality control, independence and other standards relating to auditing;[317] and to perform other functions the New Oversight Board or the SEC determines necessary or appropriate "to promote high professional standards among, and improve the quality of audit services."[318] The authority of the New Oversight Board is sufficiently broad as to allow it to establish or adopt quality control measures for public company auditing that would include book-tax comparisons, though in describing examples of quality control actions the Act makes no express reference to such comparisons.[319]

With regard to the establishment of the generally accepted accounting principles themselves, Section 108 of the Sarbanes-Oxley Act prescribes the authority of the SEC to defer to a FASB-like private organization, modifying existing law by adding an express provision on "Recognition of Accounting Standards."[320] Responding to criticisms of the FASB, the new provisions include a requirement that the standard setting body "has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices."[321] The new law also creates an improved funding mechanism for the standards-setting body (presumed to be the FASB).[322] In addition, Congress has directed the SEC to

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[316] *See id.* §§ 101(c)(6), 102, 104, and 105.

[317] *See id.* § 103.

[318] *Id.* § 101(c)(5).

[319] *See id.* § 103.

[320] *Id.* §108, adding a new section to the Securities Act of 1933, § 19(b) codified as amended at 15 U.S.C. 77s (2002).

[321] *See* § 19(b)(1)(A)(iv) of the Securities Act of 1933, as amended by the Sarbanes-Oxley Act. *See also* Thylin, *supra* note 13, at 267 (discussing a similar proposal which was made in 1977-1978).

[322] *See* Sarbanes-Oxley Act § 109. *See also* S. REP. NO. 107-205, at 12-13.

conduct (and within a year submit a report on) a study on the possible adoption of a "principles-based accounting system." The study is to include an examination of "the extent to which principles-based accounting and financial reporting exists in the United States . . . the length of time required for changes from a rules-based to a principles-based system . . . the feasibility of and proposed methods by which a principles-based system may be implemented [and] . . . a thorough economic analysis of the implementation of a principles-based system."[323] Legislative history indicates that the background for this study is a desire to compare "an accounting regime that contains detailed rules for the treatment of particular items, and a regime that simply outlines general concepts (or 'principles')" in response to testimony noting "the possibility that the overly-detailed approach of U.S. standard setters may have delayed updating of necessary guidance and at the same time drawn the focus of auditors away from the overriding principle that a set of financial statements, taken as a whole, must fairly and completely reflect the economic results and operations of the company being audited."[324] Significantly, Section 108 of the Act contains the express statement that "[n]othing in this Act, including this section and the amendment made by this section, shall be construed to impair or limit the authority of the [SEC] to establish accounting principles or standards for purposes of enforcement of the securities laws."[325] As with the other provisions of the Sarbanes-Oxley Act summarized *supra*, there is no reference in the section on "Accounting Standards" to book-tax comparisons as a relevant factor.

Indeed, for the most part, neither Sarbanes-Oxley nor most other highly publicized post-Enron accounting reform

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[323] Sarbanes-Oxley Act § 108(d).

[324] *See* S. REP. NO. 107-205, at 13 (2002), *available at* http://www.senate.gov/~banking/docs/reports/reports.htm (last visited Dec. 15, 2002).

[325] Sarbanes-Oxley Act § 108(c). *See also id.* § 3(c) (broadly indicating that nothing in the Act or the rules of the New Oversight Board shall be construed to impair or limit the SEC's authority on accounting matters).

proposals have featured enhanced use of book-tax accounting conformity requirements to improve the financial reporting of transactions. This omission is consistent with the traditional practice exhibited by all three branches of the federal government to avoid prescribing financial accounting rules. The general lack of sufficient focus on the value of book-tax comparisons is not unprecedented. For example, in its landmark report in 1996 on "The Accounting Profession -- Major Issues: Progress and Concerns,"[326] the GAO, while endeavoring to put forth a comprehensive set of recommendations to address a perceived crisis in the public's confidence in financial statements, did not target divergent financial statement and tax accounting as an area to be studied. Similarly, in a January 2002 report for Congress on "Enron: Selected Securities, Accounting, and Pension Laws Possibly Implicated in its Collapse," the Congressional Research Service did not highlight exploitation of book-tax differences as an accounting problem area.[327]

At the same time, the types of transactions with dramatic book-tax accounting divergence explored in Part II *supra* -- synthetic leases, off-balance sheet partnerships and employee stock options -- *have* been the subject of a tremendous amount of "how can this be?" attention. The Sarbanes-Oxley Act, despite its reaffirmation of the role of the FASB, leaves room for the SEC to take a more proactive role in shaping accounting standards and principles. The magnitude of the dollars involved in the types of book-tax divergent transactions studied herein suggests that the SEC, along with the Treasury Department, should revisit the potential value of book-tax comparisons and conformity in exercising that authority. Perhaps legislative and regulatory reform proposals under consideration would be modified to expressly add more book-tax conformity tests and conformity

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[326] *See* GAO 1996 ACCT. PROF. REPORT, *supra* note 45, at 3.

[327] *See* Michael V. Seitzinger et al., *Enron: Selected Securities, Accounting, and Pension Laws Possibly Implicated in its Collapse* (Congressional Research Service, Jan. 16, 2002), available through the Library of Congress, *at* http://www.lcweb.loc.gov.

requirements to the arsenal of anti-abuse weapons, used from both a securities regulation and tax perspective, if there were more widespread acknowledgment that, had such measures been in place in the past, they might have highlighted the true nature of these and other "take both roads" transactions and perhaps helped in reducing the number of major audit failures.

C. Revisiting the Sample Transactions

Each of the three examples of divergent book-tax accounting transactions described in Part II *supra* involves complex legal, accounting and policy issues, on which there are large and expanding bodies of literature, as well as debates as to precisely how each should be dealt with as a matter of tax or securities regulation or accounting practice. The following discussion will suggest ways that book-tax comparisons, and perhaps consistency requirements, could be utilized to identify and prevent abuses through the use of these and similar transactions.

1. Synthetic Leases

Many of the book-tax differences that have caused the conformity debate have been issues of timing, such as in accounting for prepaid income or deductions for future expenses. Accordingly, they often implicate tax policy goals -- such as the perceived benefits of taxing prepaid income upon receipt because of the taxpayer's ability to pay the tax at that time -- that are conceptually quite different from GAAP's notions of the proper measurement of the timing of income recognition. Similarly, the tax law may allow accelerated methods of writing off depreciable property to encourage economic activity, whereas GAAP may provide that the cost of the property be amortized over a longer recovery period which more closely approximates the economic useful life of the asset.[328]

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[328] *See* I.R.C. § 168 (2002). *See also* the discussions of the differences between tax and GAAP depreciation in Engler, *supra* note 19, at 565

Synthetic leases, on the other hand, involve divergent book-tax accounting in identifying the party to the transaction who should be recognized as the "owner" of the purportedly leased property and the obligor of the debt that financed the property -- a much more fundamental transparency issue than mere "timing" differences. As discussed in Part II *supra*, it seems clear that applying income tax principles of substance over form to the typical synthetic lease arrangement yields the conclusion that the "lessee," in fact, possesses such an overwhelming portion of the benefits and burdens of ownership that it must be treated as the owner of the property, and thus the borrower of the associated mortgage loan. Because accounting principles, like the tax law, profess to be seeking substance over form reporting of transactions and, indeed, FASB 13 purports to achieve that end,[329] one cannot reasonably argue that "differing objectives" of book and tax accounting of the type described by the Supreme Court in *Thor Power* support inconsistent reporting on the ownership issue in these transactions. And to the extent SPEs are involved, both the FASB and Congress have recently spoken loudly on the importance of reviewing all of the "facts and circumstances" to determine the underlying substance of the arrangements[330] -- the type of analysis that has permeated tax shelter cases in the leasing area for many years.

As the Supreme Court observed in *Thor Power*, accountants may often be called upon to make reasonable estimates and judgment calls in the course of applying GAAP.[331] They also naturally favor the comfort of fixed rules[332] -- such as those set forth in the basic four-part test to

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nn.82-83 and accompanying text; Yin, *supra* note 19, 54 SMU L. REV., at 224 n.88 and accompanying text.

[329] FASB 13, *supra* note 48, ¶¶ 60-61.

[330] FASB's 2003 Consolidation Interpretation, *supra* note 63; Sarbanes-Oxley Act § 401(c).

[331] *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 543 (1979).

[332] *See, e.g.*, Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, *supra* note 114, at 152; Big Five Petition, *supra* note 12 (in which, as part of their early response to the public outcry about public

distinguish "operating leases" from "capital leases" under FASB 13 and the formerly mechanical interpretation of SPE consolidation rules relying on less than "majority" ownership and 3 percent outside equity. With respect to synthetic leases, the mechanical rules failed when accountants for numerous public companies hung their hats on literal compliance with inadequate tests for true economic ownership and control. The tax law's more subjective benefits and burdens approach yields the right answer if the right answer means, as it should, determining who in economic substance owns the property and owes the debt; but that subjective analysis has its complications. As Professor Weidner put it in his article on synthetic leases:

> There is no easy solution. By their very nature, the financial accounting standards try to draw clear lines. Clear lines invite side-stepping. FASB has worked for years gradually improving the system of accounting for leases. Improvement will be incremental, and it is hard to imagine a set of accounting rules that would balance all of the factors discussed in the [federal income tax] case law.[333]

Weidner concludes that the primary solution is for the FASB to adopt a requirement of "full disclosure."[334] Mere

company auditing, following Enron's bankruptcy filing, the then Big Five, requested that the SEC promulgate more specific disclosure rules in certain areas).

[333] Weidner, *supra* note 3, at 487. *But cf.* Vasconcellos, *supra* note 57, at 1829 (advocating GAAP adoption of business purpose and substance over form doctrines "analogous" to those utilized in the tax law).

[334] Weidner, *supra* note 3, at 487. Professor Weidner also suggests the continued development of accounting standards to eliminate differences between accounting for leases in sale-leasebacks and other financing arrangements -- a step which makes sense in that it would seem the reporting on the true nature of a "lease" should be based on the particulars of the lease and associated documents, and not be substantially affected by whether or not the corporate "lessee" previously owned the property. The FASB does not currently seem inclined to eliminate the differences between the rules applicable to leases resulting from sale-leasebacks and leases which do not relate to sale-leasebacks. In fact, in recently issuing its Statement of Financial Accounting Standards ("SFAS") No. 145, the

footnote disclosure in financial statements, under existing accounting rules, of the terms and rental obligations under long-term lease arrangements[335] has, despite recent use by rating agencies to convert financial statement figures to take into account in their reports the effects of these transactions, generally been an insufficient means of bringing timely, widespread transparency to synthetic lease transactions.[336] Whether better footnote disclosure is the best course is debatable. Even assuming the goal is simply to provide investors with adequate information in SEC filings, determining how much and what kind of disclosure would be "full" and sufficiently "transparent" to allow investors (or the securities analysts on whom they rely) to draw informed conclusions as to the effects on a company of synthetic leasing activity, or any other complex business transaction for that matter, is a difficult question.

With regard to synthetic leases, Weidner suggests a statement along the lines that the tenant disclose "that it has a contractual understanding that it, rather than the landlord, will report to government officials that it owns the

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FASB has perpetuated the special status of sale-leasebacks by providing that if a capital lease is modified to qualify as an operating lease, it must be tested under the SFAS 98 rules. *See* FASB Statement of Financial and Accounting Standards No. 145 (issued July, 2002).

[335] *See* FASB 13, *supra* note 48.

[336] *See supra* text accompanying note 27. While rating companies may have begun to catch up with the financial condition implications of synthetic leases, their analyses to date were obviously not enough to spread the word generally, as evidenced by the surprise on the part of market observers and the apparent embarrassment on the part of corporations when the magnitude of this "off-balance sheet technique" was recently revealed to the public. *See supra* reports cited at note 9. And, in any event, relying on rating companies to identify such problems and then create the necessary adjusting figures is a poor substitute for requiring public companies to make clear disclosure in the first instance in their financial disclosures filed with the SEC. While the new SEC rules cited *supra* note 307 may help by requiring more comprehensive disclosure of financial obligations associated with off-balance sheet financing, they still appear to fall short of expressly requiring description of book-tax divergence in clear terms.

encumbered asset."[337] That would be a definite improvement, but is it enough? Under the sentiments expressed by Congress in directing that the SEC look into off-balance sheet financing disclosures,[338] perhaps a more descriptive approach would be a requirement that the tenant in a synthetic lease of real estate include, in a prominent place in the financial statement notes, something along the following lines:

> The Company has leased a building that cost the party called the landlord $__ to acquire/construct. The Company's rent payments are scheduled to be as follows: ... There is a $__ mortgage against the property. The Company is in its tax returns taking the position that, despite being named the "tenant" under the lease, it has so many of the risks and potential rewards involved that it should be treated as the owner of the property and the borrower of the mortgage loan for federal income tax purposes. However, under its interpretation of financial accounting rules, the Company is treating itself as merely a rent-paying tenant under the lease and is not including the asset nor the $__ mortgage liability in the balance sheet included in these financial statements. If the "leased" property declines in value, then at the end of the lease the Company will have to satisfy financial obligations under residual value guarantees or other arrangements.

It may be that the Sarbanes-Oxley Act will result in some sort of "plain English" disclosure of this type, though it may oversimplify the synthetic lease arrangements in some respects. Of course, this only makes sense in the context of synthetic leases if one assumes that the GAAP treatment as an operating lease is acceptable. At least one commentator has concluded that "FASB should adopt certain modifications in financial accounting rules that would bring the synthetic lease where it belongs -- on a corporation's balance sheet, not

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[337] Weidner, *supra* note 3, at 487.

[338] *See supra* text accompanying notes 308-10.

buried in the footnotes."[339] While that certainly has great appeal (and may, in some cases, result in any event under FASB's 2003 Consolidation Interpretation), and is likely the right answer with respect to the "typical" synthetic lease arrangements discussed in tax and accounting literature, it leaves some work to be done if creative planners tinker with the typical arrangements so as to arguably put pressure on the FASB to clearly define "synthetic" -- unless it is defined by reference to the corporation's tax treatment of the transaction. While Weidner stopped short of such an approach in his conclusion, noting that even the disclosure he suggested might raise objections from the accounting profession "on the ground that FASB should not base financial accounting treatment upon federal income tax classification,"[340] it is time to recognize that there is no sin in having book accounting follow tax law when the tax law has the better answer.

A consistency requirement on the reporting of synthetic leases should be seriously considered by FASB and the SEC. It might best take the form of a transaction-based presumption. For example, perhaps a public company intending to claim federal income tax ownership in a synthetic lease arrangement should be required to report consistently in its balance sheet in the absence of a letter ruling from the SEC permitting off-balance sheet treatment (for which the burden of proof should be on the corporation to clearly show why the benefits and burdens analysis justifying its tax position should not carry the day for financial accounting purposes). It is doubtful many such rulings would be sought or granted in typical synthetic lease transactions, but this approach would leave an avenue for fair treatment of non-abusive situations. In addition, it

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[339] *See* Nesvold, *supra* note 3, at 113.

[340] Weidner, *supra* note 3, at 487 (arguing that accountants could be shown that the tax law in this area is well-settled and "remarkably stable" and that "the proposed change need not be viewed as basing financial accounting on tax classification").

might be necessary or appropriate to have some coordinating procedures between tax and book reporting in the event the desired tax treatment is successfully challenged by the IRS. These procedures might be facilitated by enhanced inter-agency collaboration as suggested herein.

2. Off-Balance Sheet Partnerships

The book-tax divergence inherent in off-balance sheet partnerships such as the Chewco/JEDI I structure explored in Part II *supra* is more subtle than the tenant/owner dichotomy in the book and tax accounting for synthetic leases. The federal income tax law generally takes an "aggregate" or "flow-through" approach to a taxpayer's participation in a partnership. For income tax purposes, the objective is to make sure each partner is allocated and carries over to its own tax return the partner's proper "distributive share" of the partnership's profits, losses, credits and items thereof.[341] In addition, each partner is allocated an appropriate share of the partnership's liabilities, which is indicated on the partnership information return filed on IRS Form 1065 and the Schedule K-1 issued annually to the partner and affects the partner's tax basis in its interest in the partnership.[342] This flow-through occurs for all partners, regardless of whether they have a "controlling" interest in the partnership in economic or other terms. There are, however, anti-abuse rules which can result in reallocations of items away from purported "partners" when they are, in substance, acting as straw parties for others, or better characterized as having a relationship with the partnership other than in a partner capacity.[343] The focus in financial accounting, in contrast, has been largely in the area of whether or not to "consolidate" a company's assets, liabilities and operations with another because of the latter's control of the former.

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[341] *See* I.R.C. §§ 702, 704 (2002).

[342] *See* I.R.C. §§ 705, 722, 752 (2002).

[343] *See, e.g.*, I.R.C. § 707(a) (2002); Treas. Reg. § 1.701-2 (as amended in 1995); Treas. Reg. § 1.704-1(e) (as amended in 1997).

Nevertheless, tax accounting and financial accounting share the common goal of trying to separate the real from the ethereal in addressing the consequences of partnerships and purported partnerships.

Just as the federal income tax law has been suspicious of arrangements involving family members or controlled parties, sometimes acting as only "nominal" or "transitory" partners, financial accounting could benefit from more rigorous use of such substance over form analysis. FASB's 2003 Consolidation Interpretation recognizes the need to force accountants to make more of an effort to look beyond "form" appearing to be in literal compliance with detailed mechanical rules, responding to recent criticism of preexisting rules as inadequately revealing the true economic substance of many complex arrangements.[344] Under prior prevailing accounting rules and practices Michael Kopper and his domestic partner might still have been viewed as investors who were sufficiently independent of Enron if the comedy of errors described in the Powers Report had not resulted in clear breach of the 3 percent outside equity threshold which had come to be treated as a safe harbor rather than as a minimum requirement guideline.[345] The analysis should involve a reasoned determination of independence taking into account a thorough examination of all relevant facts and circumstances. The accounting profession's standard setters would be well served to consider in applying, refining, and interpreting the consolidation standards some of the expositions of relevant factors to consider in working through potentially disguised transactions contained in Treasury Regulations in the partnership area.[346]

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[344] *See supra* text accompanying notes 99-109; Vasconcellos, *supra* note 57, at 1829 (positing that "U.S. GAAP adheres to the axiom that substance is form" and suggesting that some of the abusive Enron transactions might have been precluded if financial accounting had utilized tax law economic substance doctrines).

[345] *See supra* text accompanying note 98.

[346] *See* Treas. Reg. §§ 1.707-3 to 1.707-9 (1992) (regarding disguised sales and disguised service payments); I.R.C. § 704(e) and Treas. Reg. §

Somewhat ironically, the most helpful Treasury Regulations in the context of off-balance sheet partnerships may be those designed to prevent a partner from claiming *more* responsibility for partnership debt than the underlying economics would support. Developed largely in response to imaginative tax shelter arrangements designed to make it appear that certain partners should be allocated a share of liabilities for which other partners or their affiliates actually bore the "economic risk of loss," Treasury Regulations Section 1.752-2 looks through various machinations (such as interest guarantees, direct or indirect pledges of outside assets or other "arrangements tantamount to a guarantee") in a search for the answer to one key question: If the partnership assets are insufficient to pay off a partnership "recourse liability," from whose pocket will the payment come?[347] It is quite possible, then, that express disclosure in SEC filings by a company engaging in off-balance sheet partnerships of the share of recourse liabilities of partnerships, allocated to such partner for federal income tax purposes under these Treasury Regulations, could be helpful in providing a more transparent view of the risk exposure of such company in respect of the debts of those partnerships, independent of the complexities of consolidation analysis. There are legitimate book-tax

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1.704-1(e) (2002) (possible adjustments for non-arm's length arrangements in "family partnership" context); Treas. Reg. § 1.701-2 (as amended in 1995) (general anti-abuse rules purporting to give Commissioner of IRS broad authority to recharacterize partnership transactions on substance over form grounds under a multi-factored analysis); Treas. Reg. § 1.752-2 (1991) (regarding the economic substance of liability sharing).

[347] *See* Treas. Reg. § 1.752-2 (1991). Note that if no partner or "related party" to a partner has in substance a personal "economic risk of loss" for the partnership liability, then it is treated as "nonrecourse" and allocated under Treas. Reg. § 1.752-3 (as amended in 2000) (which generally allocates such liabilities among the partners by reference to their sharing of tax benefits and partnership profits); if a partnership liability is not "nonrecourse" under this analysis, then it is a "recourse liability" to be shared among the partners in accordance with their relative "economic risk of loss." *See* Treas. Reg. § 1.752-1(a) (as amended in 2001), Treas. Reg. § 1.752-2(a) (1991).

differences that would have to be worked through because the tax regulations generally predicate the analysis on the worst case assumption that the partnership assets become entirely worthless[348] and financial accounting would need to be careful to avoid artificial separation of the debt from the partnership assets available to repay it. A thoughtful, comprehensive book-tax differences disclosure schedule could, however, be fashioned in a manner that provides appropriate reconciliation.

3. Employee Stock Option Costs

Neither tax law nor current GAAP requires a theoretically pure accounting for the employer's costs in granting such options. The elective "intrinsic value" method allowed by the applicable FASB standards, which has been utilized by most large public companies in their financial accounting, often yields absolutely no charge against income in the company's income statement, despite general recognition that there is indeed a cost involved. By focusing on the difference (often "zero") between the stock value and exercise price on the date the option was granted, the intrinsic value method ignores the fact that value has been passed to the employee by granting her a binding right to wait until a propitious time to buy into the company at what she and the company hope will be a bargain price because of post-grant appreciation in the value of the stock. If a bargain were not intended, then these options would simply not be held out or discussed as "compensation."

Under Treasury Regulations Section 1.83-7, the federal income tax law, in response to the administrative difficulties frequently inherent in valuing the "wait and see" right that has been passed to the employee, as of the grant date, generally postpones the determination of what has transpired until the "exercise date." At that time the compensation is fixed and defined as the spread between the strike place and the value of the stock at that time. This

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[348] *See* Treas. Reg. § 1.752-2(b)(1) (1991).

income tax approach ignores the fact that the exchange of property for services really occurred at the time of the grant of the option -- in other words, the option right itself is the compensation. Changes in the stock value after the grant date essentially affect the employee's outcome as an investor in the option. In accordance with basic federal income tax principles, if an employee were given, for example, a piece of unique artwork created by a relatively unknown artist as compensation for services, he would have to take a position on its fair market value in reporting compensation income on his tax return upon his receipt of the artwork, even if there is no easily ascertainable market value.[349] He would not be allowed to argue that he can defer recognizing the income until a discernable market develops and provides a better measure of how his bargain turned out. In its regulations under Section 83 of the I.R.C., the Treasury Department has simply chosen not to deal with the thorny valuation issues when the consideration exchanged for services is an option (unless the value is "readily ascertainable," as narrowly defined in Treasury Regulation Section 1.83-7). This approach may have practical appeal for at least two reasons. First, the large number of companies using nonqualified stock options could, indeed, create substantial administrative difficulties in terms of a high volume of valuation disputes to sort through. Second, employees may in many cases lack sufficient cash to pay the tax if it were due long before the time the employee could acquire and then sell at least part of the underlying stock. Under the current rules, however, if there is unanticipated appreciation in the stock value and then an employee exercises at a bargain, it seems likely that the employee's compensation

[349] Treas. Reg. § 1.61-1(a) (1957); Treas. Reg. § 1.61-2(d) (as amended in 1995). Moreover, as noted *supra*, the federal tax law already requires nonqualified compensatory stock option valuation, utilizing GAAP-like methodology, in limited circumstances involving golden parachute payments and gratuitous transfers. *See supra* note 126.

income will be overstated, as will the employer's corresponding compensation deduction.[350]

It may be that accounting for nonqualified employee stock options is an area where book and tax should be allowed to go their separate ways. As the Supreme Court observed in *Thor Power*, income tax law often takes into account a need for certainty and the timing of a taxpayer's ability to pay tax associated with income recognition. I.R.C. Section 83 and the Treasury Regulations thereunder indeed seem responsive to those concerns.[351] Financial accounting, as the Court indicated in *Thor Power,* must often use estimates and educated guesses in trying to provide an accurate picture of a company's financial condition. Under the current U.S. accounting system, therefore, complex valuation models are mandated to provide such estimates either for a charge against income or "pro forma" footnotes to provide information on the implications of the existence of the options.[352]

Thus, even though the heated debate over expensing employee stock option costs for financial accounting purposes may be some of the best evidence of the inadequacy of footnote disclosure, that controversy does not, as in the other

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[350] And, unlike the case of other property that may be transferred to an employee with restrictions that lead to deferral of the day of reckoning under I.R.C. Sections 83(a) and (h) (2002), in the case of options, the employee is not allowed to make a "Section 83(b) election" which would cause up front valuation of the property received and recognition of corresponding compensation income, with a possibility of recognition of capital gains, at a time chosen by the employee, for post-grant appreciation due to market forces. *See* Treas. Reg. § 1.83-7(a) (1978).

[351] It should be noted that once the ability to exercise the option becomes vested, it is the employee's choice to defer acquiring the stock (hoping for a better bargain). Moreover, as Warren Buffet observed, if the employee is in a bargain position, she may be able to engage in market "maneuvers" that produce cash. *See* Buffett, *supra* note 120, at A19. In such circumstances, consideration might be given to use by the tax system of financial reporting disclosing the number of vested options as a means of facilitating a system under which the tax consequences of the compensatory transaction might be recognized prior to the actual exercise date.

[352] *See supra* text accompanying notes 129-40.

examples discussed *supra*, necessarily cry out for book-tax comparisons and the implementation of consistency requirements in all situations involving employee stock options. Still, on a visceral level, as reflected in the recent Levin-McCain proposal, it does seem both systems of accounting should be interested in identifying the compensation element of these stock option grants and, logically, the true economic cost should ideally be the same for book and tax purposes. It is difficult to explain to the public why companies are claiming huge tax write-offs for these compensatory devices without reducing income by the same amount. Accordingly, there would be some potential value in the Treasury Department joining with the SEC and FASB in studying the book and tax accounting for typical compensatory options and considering the degree to which more conformity is desirable and feasible.

D. Regulatory Action Should Not Be Inhibited by Misleading Generalizations Evidenced in the History of the Conformity Debate

1. Reassessing the Potential Value of Conformity Requirements

Throughout the long history of the book-tax conformity debate in the United States, the main forces in the accounting profession (such as the AICPA and the FASB) have generally succeeded in protecting their turf and convincing all three branches of government that book-tax accounting divergence may be a tax law concern, but is not a significant GAAP financial statement problem area. Many commentators have pointed to perceived impurities in tax accounting -- such as artificial acceleration of income recognition to maximize tax revenues, and numerous subsidy provisions (tax incentives designed to promote social change) which do not necessarily comport with traditional notions of income and expense -- as justification for allowing financial accounting under GAAP to stand on its own as the proper measure of net income and financial condition for financial

statement purposes. Their reasoning has been strongly supported by the Supreme Court's 1979 decision in *Thor Power*. One significant problem with the conformity debate thus far is, however, that it has been principally confined to the tax arena and the question of the extent to which tax should follow book accounting principles. The accounting industry has generally succeeded in convincing decision makers that the notion of conformity in the other direction -- book accounting following (or even learning from) tax accounting -- is simply anathema.

Yet, as Enron has revealed, the tax law can sometimes have a better read on the underlying substance of a business transaction (or a transaction by a business enterprise that in reality lacks business purpose or substance) than does financial accounting under uncertain interpretations of GAAP. Moreover, the arguments traditionally made by the accounting profession in opposition to booking requirements, under which use of an accounting method for tax purposes would be conditioned on the use of the same method for financial accounting purposes, are unpersuasive. The scope of recent audit failures and the fact that there have been other failures in the past[353] have exposed as self-serving and

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[353] *See, e.g.*, Thylin, *supra* note 13 and accompanying text (discussing major audit failures of the late 1970s). Thylin noted that a House subcommittee chaired by Congressman John E. Moss concluded that "the SEC should play a more active role than it had in the past with respect to the setting of accounting principles and the establishment of auditing standards." *Id.* at 266. Moreover, Thylin characterized the recommendations of a Senate subcommittee chaired by Senator Lee Metcalf as a criticism of delegation of authority to the private sector and a call for Congress to step in "by establishing comprehensive accounting objectives to guide federal agencies and departments in performing their responsibilities which include setting financial accounting standards for privately owned corporations," noting that the Metcalf subcommittee also recommended that "auditing standards be established by the General Accounting Office, the SEC, or federal statute." *Id.* Despite these recommendations, in the approximately twenty-five intervening years leading up to the recent "major audit failures," the government has continued to defer substantially to the FASB and the AICPA in the establishment of accounting principles and auditing standards. *See supra* text accompanying notes 16, 272 & 320-23.

dubious the general proposition that the government should not meddle in financial accounting. The argument that tax-financial statement consistency requirements would result in compromise of financial accounting standards under pressure to obtain tax benefits is also disingenuous. Even if that contention reflects a realistic assumption about corporate greed, it is insufficient justification for perpetuating a system which invites the selection of the tax treatment of an item that makes net income appear lower than book income when it is not, or which allows an instrument to represent tax-favored "debt" for income tax purposes, but something other than balance sheet debt on financial statements.

Another shortcoming which has pervaded the conformity debate in the United States for over half a century has been the tendency to argue about broad propositions, such as whether a comprehensive identity of book and tax accounting should be adopted from the tax perspective in the form of a tax on book income,[354] or whether the tax law should uniformly follow the "matching principle," which is the centerpiece of financial accounting under GAAP,[355] or even just a rebuttable presumption that tax accounting should follow book accounting across the board, an issue addressed by the Court in *Thor Power*.[356] Those arguments were destined to be relatively unproductive to the extent they focused on proposals for a comprehensive conformity rule because there are, indeed, some marked differences between the goals and constraints of the tax system and the goals and constraints of financial accounting acknowledged by the Supreme Court. But most of those differences relate to the sorts of timing issues which were the subject of the failed statutory provisions on prepaid income and estimated expenses discussed *supra*[357] and the timing of inventory cost

[354] *See supra* text accompanying notes 177-178.

[355] *See supra* text accompanying note 201.

[356] *See supra* text accompanying notes 189-91.

[357] *See supra* text accompanying notes 193-98 for a discussion of the enactment and repeal of I.R.C. §§ 452 and 462 in 1954 and 1955.

recovery examined in *Thor Power*.[358] With the constantly increasing complexity of business transactions and financial products, and the proliferation of enormously detailed provisions of the I.R.C. enacted for a variety of reasons (which often have had little to do with traditional notions of the measurement of "book" income), the rationale for rejecting a blanket conformity requirement enunciated by the Supreme Court in *Thor Power* over three decades ago is perhaps even stronger now than it was then.[359]

Recognition that a "one set of books" requirement is neither practical nor desirable does not mean, however, that notions of book-tax conformity should not have a prominent place in securities regulation and income tax enforcement in the United States. Erosion of public confidence in financial statements (a concern before Enron and a front burner crisis now) and in the administration of the income tax system have precipitated well publicized assaults in the last few years on the accounting profession, the SEC in its capacity as a watchdog over public accounting, corporate tax shelters and the professionals involved with them, and the IRS. Enron is not unique; it is symptomatic of systemic problems.[360] Skillful accounting and tax professionals are in the business of helping untold numbers of companies find loopholes in both GAAP and the tax law and are apparently disinclined to self-moderate their aggressive pursuit of those loopholes.

The regulatory agencies charged with enforcing the securities and tax laws have often countered the quest for

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[358] Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979) (also dealing with an accounting "timing" issue relating to bad debt reserves). *See also supra* note 200 (discussing representative cases and commentary from the book-tax debate in the context of the "clear reflection of income" exception to the "general" conformity rule of I.R.C. 446(a)).

[359] *See, e.g.*, Engler, *supra* note 19, at 548-58 (citing various reasons why "comprehensive linkage" is simply not feasible). *See also* Rev. Proc. 2003-25, I.R.B. 1 (implicitly acknowledging the perceived acceptability of many types of book-tax differences in excluding several items from the disclosure requirements of Treas. Reg. § 1.6011-4(b)(6)).

[360] *See, e.g.*, Seligman, *supra* note 260, at 38-47.

loopholes with "anti-abuse" regulations designed to look beyond literal compliance with provisions which simply failed to account for some of the creativity employed to manipulate the basic rules in question.[361] In the context of corporate tax shelters, such regulatory efforts have prompted a recent wave of intense philosophical debate over the fundamental underpinnings of the rule of law; the relative advantages of rules versus standards and the possible codification of judicially crafted substance over form and business purpose doctrines; and the proper limits of the authority of regulatory bodies.[362] That important dialogue creates a useful conceptual framework for analysis of various broad measures under consideration as potentially desirable long term programs to curb abusive practices -- for example, the SEC might look to the many thoughtful expositions of the pros and cons of general "anti-abuse standards" as it undertakes the study of a "principles based" accounting system required under the Sarbanes-Oxley Act.[363] However, that type of debate can obscure the need for prompt, pragmatic action through specific, objective enforcement mechanisms.

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[361] From the tax perspective, see, e.g., the regulations described *supra* note 346. From the SEC perspective, see, e.g., Regulation S-Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.901 *et seq.* (2002) (commonly referred to as SEC Rules 901-905) (while Regulation S sets forth safe harbors under which certain offerings of securities outside the United States need not be registered under the Securities Act of 1933, this preliminary note warns: "In view of the objective of these rules and the policies underlying the Act, Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required."); *see also* 17 C.F.R. § 230.144A, Prelim. n.3 (2002) (setting forth a similar warning in the context of a safe harbor rule regarding exemption from registration of certain private resales of securities to institutions).

[362] See, for example, the many excellent articles in the SMU and NYU Symposia on "Corporate Tax Shelters," *supra* note 110.

[363] *See supra* text accompanying notes 323-24.

And regulatory action by the SEC and the Treasury Department should not be constrained by the traditional notions that the government should defer to private sector bodies to set financial accounting rules; nor should those agencies be reluctant to interfere in that private sector process by linking tax treatment of an item to financial accounting for the same item in appropriate cases. The problem with that traditional thinking is that often the tax law employs better analysis and reaches a more appropriate conclusion than GAAP (or at least GAAP interpretation). Some of Enron's endeavors, for instance, will likely prove to be dramatic examples of that reality, as was recently observed by Victor Fleischer of Columbia University who, in response to a student questioning how such a large company could avoid paying income tax for several years, answered: "Enron didn't pay a whole lot of income tax because it didn't have a whole lot of income."[364] Fleischer went on to posit that in many respects Enron's tax accounting was more likely closer to the truth about various transactions than was its financial accounting.[365] He then concluded by warning

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[364] Fleischer, *supra* note 70, at 1045-46.

[365] *Id.* at 1045 (commenting on certain aspects of Enron's off-balance sheet partnerships, treatment of a hybrid security as debt for tax purposes and equity for financial accounting purposes, and inconsistent book-tax treatment of the exercise of employee stock options, and arguing that the problems with these transaction lies are in the financial accounting, not their tax treatment). *See also* Stratton, *supra* note 70, at 412 (discussing an I.R.S. private letter ruling, commonly known as the "Enron Ruling," under which MIPS were treated as "debt" for tax purposes and "equity" for financial accounting purposes and quoting Steve Rosenthal of Miller & Chevalier as saying, "[i]t looks like the tax guys got the labels right and the book guys got the labels wrong"). *But cf.* JOINT COMMITTEE ON TAXATION, WRITTEN TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION ON THE REPORT OF INVESTIGATION OF ENRON AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, No. JCX-10-03, *available at* http://www.house.gov /jct/x-10/03.pdf (Feb. 13, 2003) [hereinafter JCT Enron Testimony]. The JCT Enron Testimony summarizes the Joint Committee's February 2003 Report, the results of an approximately one-year study of various Enron transactions, and includes, among many other matters, conclusions to the effect that Enron entered into numerous tax-motivated transactions which

tax lawyers of their potential responsibility for abusive schemes that are designed to exploit the differences between financial and tax accounting; but, like many before him, stopped short of arguing that the financial accounting should have been required to conform with the tax accounting for some of the subject transactions. [366]

Particularly outside of the arena of mere "timing" issues, the government should abandon the unfounded generalizations that have previously misdirected the book-tax conformity debate. Not all the literature has dwelled on the differences between book and tax accounting. Some commentators -- while recognizing that there will be some differences, principally on timing issues occasioned largely by unique aspects of the tax law that serve specific objectives in particular areas or that adopt a policy of income recognition when the taxpayer is most likely to have the cash to pay the tax -- have pointed out areas of commonality, arguing that both tax and financial accounting for business taxpayers in general should seek to accurately measure net "economic" income. [367] The conformity debate should not be

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"relied on differences between the tax treatment and financial accounting treatment of various items so that tax benefits could be used to generate financial statement income," that businesses "are engaging in tax-motivated transactions primarily to obtain financial accounting benefits . . . solely from the manipulation of the Federal income tax laws to create permanent book-tax differences," and that "this activity may be occurring because of certain aspects of the financial accounting rules governing accounting for income tax expense. *Id.* at 7, 14. While the JCT Enron Testimony highlights abuses designed around book-tax differences and recommends consideration of some financial accounting improvements, its principal focus is on manipulation of Federal income tax laws (and recommendations to improve them), suggesting that, in the Joint Committee's view, at least many of the Enron transactions were not instances of the tax law having the correct answers and financial reporting being the problem, but in essence, failure by both systems of accounting.

[366] Fleischer, *supra* note 70, at 1047.

[367] *See, e.g.*, Nolan, *supra* note 177, at 765-768 (discussing the reasons for "timing" differences, but then interpreting AICPA statements concerning the tax system's goal of "equitable" revenue raising from "business" taxpayers "by reference to the readily determinable increase in net worth or net economic resources of the taxpayer" as supporting "a

confined to identifying when tax should follow book and should not be hampered by fear of the government establishing financial accounting rules. In cases involving such issues as separation of "real" from "straw" parties or characterization of an instrument as "debt" or "equity," tax and financial accounting share the goal of reaching the best, most transparent conclusion. The regulatory agencies can and should take an active role in identifying and addressing those types of issues.

2. Coordinated Disclosure of Book-Tax Differences as an Important First Step

There have been some recent signs of increased recognition of the potential value of publicly available book-tax comparisons as not just a tool from the tax perspective, but as a matter of securities regulation. In a July 8, 2002 letter jointly addressed to the Secretary of the Treasury and the Chairman of the SEC, Senator Charles Grassley questioned "whether the disclosure of key tax information would help the federal government police corporate practices and allow shareholders and the public to better monitor corporate transactions."[368] The answer to the Senator's question should be a resounding "Yes!"

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general identity of objectives between tax accounting and financial reporting" predicated on a shared purpose -- "the measurement of such increase on a practical basis, pursuant to uniform standards to permit financial comparisons within an industry and of companies in different industries"); Skinner, *supra* note 175, at 710 (quoting the AICPA's 1971 statement that although the "objectives" of federal income tax and financial accounting differ, "the manner of achieving these different objectives is essentially similar, i.e., the fair determination of business income on an annual basis"). *See also* PRESIDENT'S BUSINESS TAXATION REP., *supra* note 177, at 60 ("The objective of generally accepted accounting principles and tax accrual concepts is basically the same -- the determination of the net income of the business on an annual basis.").

[368] Letter from Sen. Chuck Grassley to the Hon. Paul O'Neill, Sec. Dep't of Treas. and Harvey Pitt, SEC Chairman, (dated July 8, 2002) *available at* http://grassley.senate.gov/releases/2002/p02r7-08.htm (seeking disclosure rules to address the general concern that there is poor information about the taxes companies actually pay, while giving due

The government is, of course, well aware that a "we do that for tax purposes only" approach often means something is wrong -- either the tax reporting or the financial reporting may be, in essence, a fabrication. And both the IRS and SEC have promulgated some existing disclosure rules which do focus on some book-tax reconciliation.[369] And, in the much publicized ongoing crackdown on corporate tax shelters, the Treasury Department and commentators have acknowledged the potential usefulness of more detailed disclosure of book-tax divergence as an audit tool in screening for potentially abusive tax avoidance transactions.[370] Such disclosures have the potential to serve the dual objectives of providing the regulators with red flags triggering further examination of potentially abusive transactions and accounting practices and, if accessible to investors who can understand them, telling such investors more about the true performance of the company. The filing of comprehensive, publicly available schedules detailing book-tax income statement and balance sheet differences of the type suggested by Canellos and Kleinbard[371] could prove extremely valuable in both respects. And to avoid the lack of transparency in some of the existing book-tax disclosure rules (due to disclosure formats involving divergence between taxable income and book income which can "net out" large items moving in opposite directions), such

consideration to traditional notions of regarding confidentiality of tax information). Although not expressly addressing book-tax divergence, the very fact that Senator Grassley suggests that the policing powers of both the SEC and the Treasury might be improved by sharing tax information is significant. *Cf.* Gov. Affairs SEC-Enron Report, *supra* note 243, at 67-68 (recommending better communication between the SEC and the Federal Energy Regulatory Commission under the heading "Coordinate Better with Other Agencies").

[369] *See supra* text accompanying note 241 (discussing Treasury Department use of Schedule M and tax shelter screening disclosures based on significant book-tax disparity), and *supra* text accompanying notes 251-54 (discussing the SEC's inclusion of certain book-tax disparity reconciliation requirements in Regulation S-X).

[370] *See supra* note 242.

[371] *See supra* text accompanying note 17.

a schedule should target transaction-based disclosure to the fullest extent practical.[372]

Better disclosure of book-tax differences is a critical step toward realization of the potential benefits of book-tax comparisons and consistency requirements as a defense against the types of trick plays in financial accounting and tax avoidance which have shaken public confidence in the integrity of the management and professional advisors of publicly held companies. Indeed, an argument can be made that better disclosure of book-tax differences is all that needs to be done to address book-tax accounting divergence.[373] Such disclosure would provide the IRS and the SEC with information to use in separately addressing abuses within their respective areas of principal authority and would, if publicly available, give investors and investment advisors better information for their investment analyses. One can certainly debate on an ideological level the degree to which government should help investors fend for themselves in such areas. The popular saying that "information is power" reflects a concept embedded deeply in American democracy. In a letter in which he alluded to the "general prey of the rich on the poor" under traditional European systems, Thomas Jefferson wrote:

> The basis of our governments being the opinion of the people, the very first object should be to keep that right; and were it left to me to decide whether we should have a government without newspapers, or newspapers without a government, I should not hesitate a moment to prefer the latter. But I should

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[372] This point has been suggested in commentary on "corporate tax shelters" and criticism of existing methods of book-tax comparison to wage that battle. *See supra* note 241.

[373] This issue has, for example, recently been at the forefront of debate over how best to address the problem of corporate tax shelters. *Compare* Ronald A. Pearlman, *Demystifying Disclosure: First Steps,* 55 TAX L. REV. 289, 289 (2002) (advocating disclosure as a valuable weapon in fighting tax shelters) *with* David A. Weisbach, *Ten Truths About Tax Shelters,* 55 TAX L. REV. 215, 225-30 (2002) (concluding that "[d]isclosure is not a sufficient solution to the problem").

> mean that every man should receive those papers *and be capable of reading them.*[374]

Jefferson obviously was not advocating anarchy, but rather stressing the importance of a responsible electorate as a whole having sufficient information to make informed decisions. Federal securities law reflects that core concept. Insider trading, if permitted to exist, would indeed allow the rich to prey on the less fortunate through an information imbalance. But there should also be some responsibility on the part of any investor to seek and analyze (or have a qualified representative analyze) information pertinent to investment decisions, as recently stressed by former SEC Chairman Arthur Levitt when he explained to investors:

> In a democracy that prizes the initiative and promise of the individual, it's not enough to talk about your rights, but also your *obligations.* As an investor, you certainly have the right to be treated fairly, to get straight answers to straight questions, to know what you are buying and what you are paying for it. But as an investor, you also have an obligation to ask questions -- many questions -- to seek out information and contemplate your own tolerance for risk.[375]

Such self-help is important, but works only if the disclosures -- the "answers" if you will -- are comprehensible. Sketchy details of complex business arrangements buried in the footnotes are often not sufficiently revealing, particularly for investors of lesser sophistication on technical issues. The dilemma was summarized nicely in 1941 by Andrew Cavanaugh, while working in the SEC's Registration Division:

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[374] Letter from Thomas Jefferson to Edward Carrington (Jan. 17, 1787), *reprinted in* THE PORTABLE THOMAS JEFFERSON 414-15 (Merrill D. Peterson, ed., Penguin Books 1979) (1975) (emphasis added).

[375] Chairman Arthur Levitt, Speech by SEC Chairman: The Future of America's Investors, (Jan. 16, 2001) *available at* http://www.sec.gov /news/speech/spch457.htm.

> Granted that many people are unable to read statements and certificates intelligently, it seems to me that the aim of the accounting profession should be to make those statements and certificates as clear and unambiguous as their technical nature permits. Financial statements which conform to conventions and customs are not adequate if, in fact, they serve to conceal or fail to bring to light financial conditions or results which an intelligent investor needs to know to form a judgment. Certificates are not adequate if they evade expression of opinion regarding accounting practices which are not sound. I question how far an accountant may, in good conscience, resort to a multitude of notes attached to statements to explain unsound, questionable, or irregular practices where clarity of statement and of opinion would be better obtained by showing as a part of the statements themselves, the adjustments necessary to bring those statements into accord with sound practices.[376]

With respect to complex business structures and transactions, description alone, at least if relegated to footnotes, will not always suffice to allow its recipients to "fend for themselves." Sometimes "buried in the footnotes," which appears to have been the goal of many companies in reporting their synthetic leases, off-balance sheet partnerships and employee stock options costs, is simply an inadequate approach. In some circumstances, it would seem advisable for the regulatory agencies to exercise their authority by requiring consistent practices, even if that means forcing companies to adopt book-tax conformity in numbers actually contained in their tax returns and financial statements. In a sense, this is still just a call for disclosure -- but more effective disclosure.

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[376] Andrew J. Cavanaugh, Standards of Disclosure in Financial Statements, *in* FEDERAL SECURITIES LAW AND ACCOUNTING 1933-1970 SELECTED ADDRESSES 137, 141-42 (Gary John Previts and Alfred R. Roberts eds., 1986).

3. Possible Steps Beyond Footnote Disclosure

From the regulators' perspective, once it is recognized that certain types of transactions are divergently reported for tax and book purposes, it would appear logical to next determine if the goals of the two systems of accounting are, with respect to the transaction or item in question, sufficiently similar as to warrant a consistency requirement, or at least a conformity presumption. Arrangements such as synthetic leases evidence a need to consider more "booking requirements" which would preclude a company from taking the position it is the "tax owner" but not the "book owner" of a given property without having first obtained permission from the SEC and/or IRS to use that divergent accounting. Studies might show that other issues, such as determining whether hybrid instruments, such as MIPS, constitute "debt" or "equity" (a problematic area for both tax and financial disclosure purposes), could similarly benefit from such a consistency presumption.[377] Similarly, and though only a timing issue, it might be productive for the two agencies to collaborate in comparing tax and financial accounting standards governing which public company costs are currently expensed (lowering taxable income) and which capitalized (avoiding decreases to book earnings), and to consider some presumptive consistency requirements in that area of difficult factual determinations.[378]

The concept of "we just do that for tax purposes" is and should be troubling in the absence of clear reasons for the divergence. Across the board book-tax conformity has been

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[377] *See supra* text accompanying note 70. *See also* JCT Enron Testimony, *supra* note 365, at 23 (suggesting, as one alternative in addressing debt/equity issues in structured financing transactions, that the tax characterization be made to follow the financial accounting treatment -- once again suggesting a "book follows tax" conformity requirement without acknowledging the possibility that it might be more appropriate for book to follow tax to avoid abusive inconsistency in certain situations).

[378] *But see* Geier, *supra* note 180, at 41-57 (analyzing the tax law perspective on "capitalization" and arguing that the underlying tax principles should not be based on GAAP's "matching principle").

demonstrated to be both impractical and undesirable. But selective use of consistency requirements, or at least presumptions, should be considered -- from both the tax reporting and financial statement perspectives -- especially in areas, such as off-balance sheet financing, where abuse has been perceived and the SEC has been directed to undertake studies.

Enhanced inter-agency examination of comprehensive book-tax disclosures would likely identify several key instances where booking requirements have potential value in terms of keeping honest and transparent both the book and tax accounting for business transactions. Since many emerging issues involve book-tax disparities, it seems the Treasury Department should be a strong force, along with the SEC and the traditional accounting industry participants, in the work of FASB's Emerging Issues Task Force. Such collaborative inter-agency exploitation of book-tax conformity analysis to defend against accounting tricks has significant potential to improve both the income taxation and securities regulation systems in the United States.

V. CONCLUSION

The Treasury Department and the SEC have by regulation acknowledged that there is value in book-tax comparisons. Nevertheless, the government has not given particularly high priority to inter-agency coordination of penetrating review of book and tax accounting differences to detect and address corporate tax shelters and financial accounting abuses. This circumstance is largely due to the success of the accounting profession in confining the accounting conformity debate to the question of the extent to which "tax should follow book" by promoting an unjustifiably monolithic view of the tax law as a system too quirky to use as a reference point for "proper" financial accounting. Differences between tax and book accounting on "timing" issues and tax subsidies may often be legitimate, but on such fundamental questions as "who really owns this property and owes this debt?" or "is there a compensation cost here?," tax and book accounting should share a common purpose.

More comprehensive and understandable public company disclosure of book-tax differences to the taxing authorities, the SEC, and the public would be a sensible and significant improvement to the current situation, facilitating more reasoned analysis of whether the reporting of given transactions results in justified book-tax divergence or abuse. A Treasury/SEC joint task force to develop the type of comprehensive book-tax comparison schedule commentators have proposed may be in order, drawing on the combined experiences of those agencies in dealing with the complexities of innovative tax shelters and managed earnings gimmicks.

A coordinated system of disclosure requirements is, however, only a first, though critical, step. It is also time to reconsider the restraint the government has customarily shown in the process of setting financial accounting standards. The spirit of the Sarbanes-Oxley Act seems to lead in that direction, though much discretion is again left to the SEC to determine how proactive the government will ultimately be in that key area. The history of the book-tax conformity debate suggests that the SEC should become more involved in the standard-setting process, and work in collaboration with the Treasury Department in this connection. Certainly the tax law can and should draw on many "generally accepted accounting principles." At the same time, in crafting better standards, the institutions involved should abandon the long standing reluctance to consider the possibility that financial accounting might follow (or at least learn some lessons from) a body of federal income tax law that has been forced to adopt creative anti-abuse rules and standards to identify and shut down overly imaginative tax shelters. In many respects income tax and financial accounting seek the same answers, supporting a collaborative approach to regulating accounting for both book and tax purposes.