» AN ACCOUNTING AND TAXATION CONUNDRUM

A PAN-EUROPEAN PERSPECTIVE ON TAX ACCOUNTING IMPLICATIONS OF IFRS ADOPTION

SEPTEMBER 2007

THE WORLD BANK
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FINANCIAL REPORTING REFORM

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JOHN HEGARTY

The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors.
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Previous to this, Frédéric worked as a Lead Financial Management Specialist with the World Bank from February 2002 to April 2007, focusing on private sector accounting and auditing in the Europe and Central Asia, as well as the Middle East and North Africa Regions. He was also a member of the Private Sector Committee of the World Bank's Financial Management Sector Board, which fosters capacity development in accounting, auditing, and financial management for the private sector in countries borrowing from the World Bank. In that context, he was seconded to the Financial Reporting Council (UK) where he primarily worked on the implementation of the new Eighth European Union (EU) Company Law Directive on statutory audit.

From 1998 to 2002, Frédéric was Senior Audit Manager with Ernst & Young International in the Asia Pacific Region and with Ernst & Young LLP in the United States. He specialized in the audit of financial institutions.

Frédéric earned graduate degrees at *Hautes Etudes Commerciales*, Belgium, and University of Trier, Germany, where he studied engineering and business administration. Upon graduation, he joined the Luxembourg office of Arthur Andersen. In 1994, he obtained a post-graduate degree in accounting at *Hautes Etudes Commerciales*. In 1997 he qualified as a Member of the Institute of Certified Public Accountants (*Réviseur d'Entreprises*) in Luxembourg, and in 2003 he qualified as a U.S. Certified Public Accountant in Virginia.

Frédéric is a member of the Accounting and Auditing Practices Committee of the International Corporate Governance Network (ICGN). He is also a member of the International Accounting Standards Board (IASB) Small and Medium Enterprise (SME) Working Group.

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John took up his current appointment in August 2007. Previously, he had been the Manager, Financial Management for the ECA Region, based in Washington DC, and was responsible for fiduciary controls over Bank lending and for fostering the development of financial management capacity (covering accounting, auditing, and financial management) in the public and the private sectors, at the level of both the individual projects which the Bank finances and borrower countries as a whole. He was a member of the Bank's Financial Management Sector Board, and chaired its Private Sector Committee.

Prior to joining the World Bank in August 1999, John Hegarty had been – since January 1987 – Secretary General of the Federation des Experts Comptables Europeens (FEE), the representative organisation for the accountancy profession in Europe. In that capacity, he was a member of the FEE delegations to the Council of the International Federation of Accountants (IFAC), and to the EU's Accounting Advisory Forum and Committee on Auditing. He was a member of IFAC's Legal Liability and GATS Task Forces, and of the US Independence Standards Board's Conceptual Framework Task Force. John was a member of the European Tradable Services Network, which advised the European Commission during the Uruguay Round of trade negotiations; EU Sector Coordinator (Accountancy Services) on the Transatlantic Committee on Standards, Certification and Regulatory Policy under the Transatlantic Business Dialogue (TABD); and Chairman of the Policy Committee of the European Services Forum, the private sector body advising the European Commission in its preparations for the trade in services negotiations under what became the WTO Doha Development Round. He served on the Boards of the European Policy Centre (Brussels), the Centre for European Policy Studies (Brussels), the Centre for International Accounting Research (Hull), and the Maastricht Accounting and Auditing Research Centre. John was also a member of Groupeuro, the European Commission's panel of expert speakers on the introduction of the single currency, and he served on the Editorial Advisory Boards of Euro-impact, the European Accounting Review, and Auditing: A Journal of Practice and Theory.

Born in Sligo, Ireland in 1958, John Hegarty was educated at Newbridge College and University College, Dublin, where he studied business administration. On graduation he joined the Dublin office of Arthur Andersen, and became a manager in the audit division. In 1981 he qualified as an Associate of the Institute of Chartered Accountants in Ireland, and in 1992 was admitted as a Fellow of that Institute. In 1984, he was appointed Technical Director of the Union Europeenne des Experts Comptables, Economiques et Financiers (UEC), based in Munich, Germany, which at the time was one of two organisations representing the accountancy profession in Europe. When, with effect from January 1, 1987, UEC merged with the other organisation – the Groupe d'Etudes des Experts Comptables de la CEE – to form FEE, John Hegarty moved to Brussels, Belgium to become first Secretary General of the new body.

Abstract

The introduction of new financial reporting standards in the European Union (EU) is having significant direct consequences for many of the preparers and users of financial information. These consequences are generally well documented and explored by many distinguished experts. However, less well documented are some of the indirect consequences of the implementation of new financial accounting standards in the EU. One such area is in the relationship between corporate financial accounting ('financial accounting') and corporate income tax accounting ('tax accounting'). In some EU Member States a long-standing and complex relationship exists between financial accounting and tax accounting which may be significantly influenced by the introduction of new financial reporting standards such as International Financial Reporting Standards (IFRSs). In this paper we review the effects of the introduction of new financial reporting standards on tax accounting within the EU. This paper also assesses the evolution of the relationship between tax accounting and financial accounting in the context of the growing influence of IFRSs. This paper recommends that consideration should be given to macro-economic implications of associating or disassociating financial accounting and tax accounting, noting that this decision should only be made after considering related policy issues at the highest level within relevant government agencies and a thorough consultative interaction between these agencies and relevant private sector advisers and interest groups.

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Foreword

It was Benjamin Franklin who first said: “In this world nothing can be said to be certain, except death and taxes.” The inevitability and indeed the importance to an economy of efficiently collecting taxes is as much an issue today as it was in Mr. Franklin’s era. Of course central to any efficient tax system today as it was 200 years ago is an appropriate measurement framework for the calculation of tax revenues and liabilities. Measurement frameworks and revenue calculations are as important to financial accountants as they are to tax practitioners. Indeed almost all tax measurement frameworks use corporate financial statements to some extent in the calculation of taxes. These links between financial and tax accounting can be as complex and challenging as they are inevitable.

We live today in an increasingly integrated global economy. Economic, fiscal, financial and regulatory issues are no longer simply domestic concerns but form part of regional and global agendas. Co-coordinated approaches to regulation across countries and regions offer new opportunities, benefits and challenges. One area that has seen an unprecedented level of international co-ordination and harmonization in the last decade is the field of accounting. The emergence of International Financial Reporting Standards (IFRS) and in particular the commitment by the European Union (EU) to mandate the use of IFRS for certain EU entities has set in motion a series of changes in global accounting that can only be described as revolutionary.

Whilst globalization and the emergence of IFRS as the global accounting standard yield undoubted benefits, these developments have also created many challenges. IFRS enhance the comparability and reliability of financial accounts, but companies operating cross-border may still need to prepare financial statements using local accounting regimes, or in different formats to meet different local and national regulations. Increased capital mobility and cross-border investment activity only serve to underline the importance of reliable and comparable financial information across countries and regions.

Global and EU accounting developments have also created very specific challenges for tax authorities. Historically, accounting figures have formed the starting point of tax calculations in many countries. Changes in accounting standards therefore need to be closely examined by tax authorities to determine whether or to what extent accounting figures may be appropriate to use in tax calculations. The introduction of IFRS in Europe introduces a whole new set of accounting standards for tax authorities to consider. The interactions between tax and financial accounting are complex and tax authorities must always consider macroeconomic implications and managing national tax security. In addition, authorities must be mindful of the regulatory burden on firms and the importance of ensuring equitable tax treatment for IFRS and non-IFRS companies operating in their jurisdiction. It certainly is a challenging time for financial and tax accountants!

This paper examines these issues and challenges, whilst also contemplating the important macro-economic implications of associating or disassociating financial and tax accounting. I welcome this very timely publication and I am confident that it will represent a very valuable contribution to this ongoing policy debate.

Executive Summary

The primary policy objective discussed in this paper is the adoption of an optimal tax accounting system. In this context, this paper sets out a framework to assist policymakers in reviewing the tax accounting system in place within their jurisdiction. While it focuses primarily on the situation in Member States of the European Union (EU), the lessons learned in Member States with different traditions should also be of interest to policymakers outside of the EU. Finally, while the focus of this paper is on policy considerations rather than technical issues, the business sector and tax professionals should also benefit from this paper and participate in the policy debate.

A. Conceptual Framework

Figure 1, *Conceptual Framework*, sets out the approach adopted in preparing this paper. It is articulated around five building blocks, i.e.:

Figure 1: Conceptual Framework

- **Fundamental concepts:** The policy elections regarding tax accounting cannot be made in isolation of those regarding financial accounting. The first building block defines 'accounting profit' (financial accounting) and 'taxable profit' (tax accounting).
- **Underpinning framework:** A Member State's policy elections with respect to the calculation of accounting profit and taxable profit are subject to a number of external constraints, including EU law requirements. The second building block sets out the framework impacting upon the decisions to be made by policymakers when determining how taxable profit should be calculated. It captures the influence of ongoing harmonization with the EU (in financial and tax accounting) and the growing influence of International Financial Reporting Standards (IFRSs) on financial accounting within the EU.
- **Objectives of Tax and Financial Accounting:** The third building block does not purport to set out a universally valid definition of the objectives of financial and tax accounting. Rather, policymakers should determine these objectives in the circumstance of their country. The building block provides policymakers with a framework, in the form of a list of criteria generally accepted to be suitable for tax accounting, to

assist them in making policy elections regarding tax accounting. In this context, they should rank these criteria based on their relative merits given the circumstance of their country. Finally, this building block points to three fundamental concepts underlying IFRSs, and hence financial accounting within the EU to a large extent. It notes that these concepts are meant to achieve the objectives of financial accounting and are not consistent with the criteria suitable for tax accounting.

» **Relationship between Financial and Tax Accounting:** The fourth building block sets out the range of approaches to the calculation of taxable profit, which vary depending on the degree of relationship and on the method for 'leveraging' financial accounting in determining taxable profit:
» **Degree of relationship:** Historical developments have resulted in a range of approaches in EU Member States. At the one end of the range, there are Member States which have kept tax and financial accounting completely separate. At the other end of the range, there are Member States which have established a statutory and direct relationship between financial and tax accounting in order to avoid creating two distinct sets of rules.
» **Method for 'leveraging' financial accounting:** This may involve a 'positive' approach, whereby the tax legislation refers to carefully targeted aspects of financial accounting and adopts those aspects either in wording or in concept. This may also involve a 'negative' approach, whereby the tax legislation adopts financial accounting as the 'default' position, and then adjusts out those aspects of financial accounting which are inappropriate as a basis for the computation of taxable profit.
» **Policy Considerations:** The fifth building block brings the fourth preceding steps together, proposing an approach for tax policymakers to achieve the objective above, i.e. to develop an optimal tax accounting system within the constraints of international law, EU law, and existing practices.

B. Policy Considerations

This paper recommends a two-step process to achieve this objective, i.e.:

» first, to agree the overall policy objectives of financial and tax accounting; and
» second, to evaluate the appropriateness of the existing relationship between financial and tax accounting based on their respective objectives.

B.1 Overall Policy Objectives

As discussed above, in a perfect world, policymakers would seek to enhance tax accounting with a view to developing an optimal definition of 'taxable profit'. This paper recognizes that policymakers will need to accommodate existing national tax accounting practices and may not be in a position to achieve an optimal tax accounting system. However, the lessons learned in this paper demonstrate that agreeing the overall policy objectives of tax accounting, before delving into the mechanics of the tax accounting system, should be the number one step taken by policymakers. The principles generally considered to be suitable for tax accounting will be helpful in reviewing available policy options within the constraints imposed by international tax law and the legacy of historical and political developments.

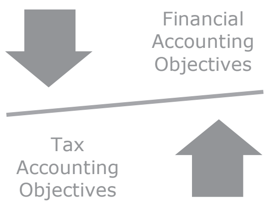

Figure 2: Differing Objectives

In this context, it is important to recognize that a similar exercise has been (and is being) conducted, usually by other policymakers, regarding financial accounting. Increasingly, within the EU, policymakers are adopting IFRSs or embedding IFRS concepts into national financial accounting to achieve the objectives of the financial accounting framework. Figure 2, *Differing Objectives,* illustrates the significant differences that now exist between the objectives of tax accounting and financial accounting. These differences tend to grow over time as financial accounting evolves to meet the evolving needs of users of financial reporting.

B.2 Evaluating the Relationship between Financial and Tax Accounting

Due to historical developments, several Member States have established a statutory and direct relationship between financial and tax accounting, involving a 'negative' approach as described above. The stronger the relationship between tax and financial accounting, the less policy elections regarding tax and financial accounting can be made in isolation.

This paper argues that, given the differing objectives of tax and financial accounting, policymakers should revisit the existing degree of relationship between tax and financial accounting in their jurisdiction. Accepting the status quo may have detrimental consequences, including:

- unintended consequences on the economy;
- unforeseen effects on tax collections;
- the development of a yet more complex tax accounting system; or
- the maintenance of a financial accounting system which may not be responsive to the needs of a modern market economy.

As a consequence, right at the outset, significant consideration should be given to the macro-economic implications of associating or disassociating tax and financial accounting. This paper argues that this decision should only be made after considering these implications at the highest level within the relevant government agencies and after a thorough consultative interaction between these agencies and the relevant private sector advisers and interest groups.

Section I – Introduction

This paper sets out a framework to assist policymakers in reviewing the tax accounting system in place within their jurisdiction. Before delving into policy considerations about the development of an optimal tax accounting system, this introduction sets out:

- a definition of the fundamental concepts in the context of existing practices in most European Union (EU) Member States (Section I.A);
- an overview of the framework (laws, regulations, and interpretations) underpinning these fundamental concepts (Section I.B);
- the objectives of this paper and its target audience (Section I.C);
- the methodology applied in preparing this paper (Section I.D); and
- the structure of this paper (Section I.E).

A. Fundamental Concepts

In the EU, companies generally maintain accounting records, which form the basis for, among others:

- the mandatory publication of their annual accounts.[1, 2] This forms part of the corporate financial accounting requirements ('financial accounting'). Within this paper, financial accounting refers to the recognition and measurement principles that a company applies in preparing its annual accounts, i.e. in determining the accounting profit (loss) for the period. The following are examples of such recognition and measurement principles:
  - Recognition: "Revenue from the sale of goods is included in accounting profit when goods are delivered."
  - Measurement: "When the net realizable value of an item of inventory is less than the previous carrying amount, the company reduces the carrying amount of the asset."
- the mandatory filing of their corporate income tax returns with the tax authorities. This forms part of the corporate income tax accounting requirements ('tax accounting'). Within this paper, tax accounting refers to the recognition and measurement rules that a company applies in preparing its tax returns, i.e. in determining the taxable

1 Annual accounts are also referred to as 'legal entity financial statements' or 'separate financial statements'.

2 In the EU, unlike in the United States for example, there is a statutory requirement for limited liability companies, both publicly and privately held, to make public their annual accounts prepared in conformity with applicable financial accounting rules. This requirement is set out in the Fourth EU Company Law Directive on Annual Accounts of Companies with Limited Liability. For additional information on this matter, refer to Gielen, van der Plaats, Hirata, Tranter (2007), *Corporate Sector Accounting and Auditing within the Acquis Communautaire – A Building Block of the Internal Market*, World Bank, Washington, USA, p. 21.

profit (tax loss) for the period. The following are examples of such recognition and measurement principles:

- Recognition: "Revenue from the sale of goods is included in taxable profit when cash is collected."
- Measurement: "When the net realizable value of an item of inventory is less than the previous carrying amount, that reduction is ignored for tax purposes until the asset is sold."

A.1 Accounting Profit (Loss) before Tax

'Accounting profit (loss) before tax' is a frequently used measure of the performance of a company. Simply put, it is determined by deducting expenses (before corporate income tax) from income. The recognition and measurement of income and expenses, and hence profit, depends on the financial accounting principles (or rules) the company applies. Except where further precision is deemed necessary, the term 'accounting profit' is used to mean 'accounting profit (loss) before tax' from this point onwards.

A.2 Taxable Profit (Tax Loss)

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which corporate income taxes are payable (recoverable). Except where further precision was deemed necessary, the term 'taxable profit' is used to mean 'taxable profit (tax loss)' from this point onwards.

B. Underpinning Framework

The framework underpinning the determination of accounting profit and taxable profit in EU Member States has evolved over time with respect to various layers of international law, EU law (also referred to as the 'acquis communautaire'), national laws and regulations, accounting standards, interpretation, and generally accepted practices.

B.1 Accounting Profit (Financial Accounting)

In EU Member States, the principles underpinning the determination of accounting profit are generally derived with respect to the following sources:

- the *acquis communautaire* as it relates to financial accounting;[3]
- the implementation of the *acquis communautaire* in the Member State's statutory framework;
- IFRSs and/or national accounting standards; and
- interpretations and generally accepted practices.

[3] The *acquis communautaire* is the body of EU laws. For an overview of the *acquis communautaire*, refer to Gielen, van der Plaats, Hirata, Tranter (2007), op. cit.

B.2 Taxable Profit (Tax Accounting)

In EU Member States, the rules underpinning the determination of taxable profit are derived with respect to the following sources:

- international tax law (e.g., bilateral treaties between a Member State and another nation);
- the Member State's tax laws and regulations;
- case law and rulings; and
- interpretations and generally accepted practices.

B.3 Harmonization of Financial Accounting and Tax Accounting

In the context of this paper, the distinguishing factor between financial accounting and tax accounting relevant to policymaking relates to the presence of a common EU platform in the area of financial accounting and the absence thereof in the area of tax accounting. In other words, while policymaking in the area of financial accounting is significantly influenced by the *acquis communautaire*, policymakers have a lot more flexibility in their elections vis-à-vis the tax accounting system.

One of the main objectives of the Treaty of Rome (1957) was the creation of a single common market, with free movement of goods, persons, services and capital, to accelerate improvements in standards of living. Over time, the harmonization of financial accounting across the EU became a means by which the greater transparency and comparability of financial reporting could facilitate freer trade and movement of capital across Member States. Consequently, a certain degree of harmonization has been achieved in financial accounting with the introduction of a number of accounting Directives and Regulations, which set out common financial accounting requirements that all EU Member States have to observe.[4]

In parallel to the harmonization of financial accounting and in line with the European Commission's stated position that key to building a dynamic Europe-wide economy is economic integration. The elimination of cross-border tax obstacles has become increasingly debated within the EU under the Common Consolidated Tax Base (CCCTB) initiative. As discussed in Appendix II, a key part of this debate centers on agreeing upon a common ground for national tax systems. However, at the present time, the *acquis communautaire* is largely silent as regards to tax accounting. As a result, 27 separate tax accounting systems are now in operation within the EU.

[4] Directives and Regulations are legal instruments adopted by EU institutions. They form part of the *acquis communautaire*. For additional information, refer to Gielen, van der Plaats, Hirata, Tranter (2007), op. cit., p.3.

B.4 The Growing Influence of IFRSs

Our final comment with respect to the frameworks underpinning financial and tax accounting relates to the growing direct and indirect influence of IFRSs on financial accounting. In several EU Member States, this will have a knock-on effect on tax accounting because of the established relationship between financial accounting and tax accounting.

In Section IV, we will analyze the impact of the degree of association or disassociation between financial accounting and tax accounting and set out how it affects policy considerations. In order to do this, it is first important to understand how IFRSs influence financial accounting in the EU:

- **In all Member States, IFRSs have a direct influence on consolidated accounts:** Regulation (EC) No 1606/2002 of the European Parliament and the Council of July 19, 2002 on the application of international accounting standards (now, IFRSs) requires companies whose securities are admitted to trading on a regulated market of any Member State (hereinafter, publicly traded companies) to present their consolidated accounts (also referred to as 'consolidated financial statements') in accordance with *endorsed* IFRSs from 2005.[5, 6]
- **In some Member States, IFRSs may also have a direct influence on annual accounts:** In accordance with the principle of *proportionality*,[7] article 5 of Regulation (EC) No 1606/2002 leaves to EU Member States the option to permit or require publicly traded companies to prepare their annual accounts in conformity with IFRSs. Member States may also decide to extend this permission or this requirement to other companies regarding the preparation of their consolidated accounts and/or their annual accounts.[8]
- **In other Member States, IFRSs have an indirect influence on annual accounts:** The growing use of IFRSs has resulted in several Member States (e.g., France and the United Kingdom) modernizing the national accounting standards, which underpin the preparation of annual accounts by incorporating recognition, measurement, and

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5 To be adopted for application in the EU (i.e., to be *endorsed*), a standard must meet the conditions set out in Article 3 of Regulation (EC) No 1606/2002. Its application must result in a true and fair view of the financial position and performance of an enterprise; it must be conducive to the European public good; and it must meet basic criteria as to the quality of information required for financial statements to be useful to users. For additional information on the endorsement process, refer to Gielen, van der Plaats, Hirata, Tranter (2007), op. cit., p 36.

6 Within this paper, *endorsed* IFRSs are referred to as IFRSs for simplicity.

7 The principle of *proportionality* requires that any EU action should not go beyond what is necessary to achieve the objectives of the Treaty. For additional information on the principle, refer to Gielen, van der Plaats, Hirata, Tranter (2007), op. cit., p. 5.

8 Appendix I, *Planned Implementation of Regulation (EC) No. 1606/2002 in the EU and EEA*, provides a summary of how Member states, Iceland, Liechtenstein, and Norway are planning to use these options.

disclosure requirements based on IFRSs within their national accounting standards. Within this paper, we refer to these modernized national accounting standards as 'IFRSed national accounting standards.'

The distinction between consolidated accounts and annual accounts is of importance to understand the impact of such 'IFRSation' on tax accounting, which will be discussed in the following sections. Simply put, the effects of the use of IFRSs in the preparation of consolidated accounts on tax accounting are likely to be minimal (see Box 1: *Consolidated Accounts*). By contrast, the extension of the permission or requirement to use IFRSs (or IFRSed national accounting standards) in the preparation of annual accounts may have important consequences on tax accounting.

Box 1: Consolidated Accounts

In most EU Member States, the effects of the use of IFRSs in the preparation of consolidated accounts on tax accounting are likely to be minimal because:

» several Member States do not allow groups of companies to determine taxable profit on a consolidated basis (e.g., Belgium, Greece, Czech Republic, Estonia, Hungary, Lithuania, Slovakia, and the United Kingdom); or

» the concepts of a group for tax purposes, in the Member States which allow group taxation, differ significantly from IFRSs. Most member states applying group taxation require parent companies to hold at least 90% of shares in a subsidiary to allow consolidation for tax purposes (e.g., Finland, France (95%), Luxembourg (95%), Portugal, Sweden, Latvia, Poland (95%), Slovenia, and the Netherlands (95%)).

C. Objectives of the Paper and Target Audience

In many EU Member States, there is a widespread view that tax systems contain a number of anomalous complications and inconsistencies as a result of many successive changes. This bewildering process of altering each element in the tax system has often resulted in increased uncertainty and lack of confidence in the stability of present arrangements. This can represent a serious impediment to Member States' efforts to improve their economic performance.

In this paper, we have restricted our attention to the relationship between tax accounting and financial accounting, an area often prone to such complications and inconsistencies. This paper was prepared at the request of policymakers in the Czech Republic who are keen to use the opportunity of significant developments in financial accounting, including the adoption of IFRSs and/or their indirect influence on national accounting standards, to reassess their policy elections in the area of tax accounting, and the relationship between tax accounting and financial accounting.

While this paper is primarily addressed to assist policymakers in EU Member States in reviewing available policy options, the business sector and tax professionals have also expressed interest in earlier draft versions. This paper encourages their participation in the policy debate.

Finally, based on earlier draft versions it appears that an important audience outside of the EU is also interested in the experience of EU Member States in this area. To facilitate their reading, the paper provides additional explanation of terminology specific to the EU where relevant (e.g., the term '*acquis communautaire*').

Based on these objectives and target audience, this paper gives preference to understanding over technical accuracy. Where relevant, footnotes provide additional technical guidance to interested readers.

D. Methodology

This paper draws on:

- a review of existing academic literature;
- a review of the existing and forthcoming *acquis communautaire* primarily through desk research and interviews with the European Commission;
- the selection of a group of relevant Member States representing a variety of legal traditions, financial accounting and tax accounting systems. The selected countries are Belgium, Denmark, Estonia, France, Germany, Luxembourg, the Netherlands, Poland, and the United Kingdom; and
- detailed interviews with: (a) preparers of annual accounts and tax returns (corporates); (b) tax professionals; (c) accountants; (d) academia; and (e) the tax authorities in each selected Member State.

Although this paper draws on the experience of a wide range of EU Member States with different traditions, it does not contemplate each and every possible situation and, consequently, only addresses a number of systemically important issues. We also focus primarily on the situation in EU Member States.

E. Structure of the Paper

The remainder of this paper is divided into three sections. Section II discusses the objectives of tax accounting vs. financial accounting. Section III presents an overview of how EU Member States tend to organize their tax and financial accounting systems based on a pan-European survey. Section IV presents and draws conclusions for tax policymakers, recommending the exercise of caution and suggesting a structured approach to policymaking.

In this Section, we introduced the concepts of 'tax accounting', 'tax profit', 'financial accounting', and 'accounting profit'. We presented how these concepts were derived over time noting that there is greater harmonization around financial accounting in the EU than around tax accounting. We also noted that the paper has been written to assist policymakers in reviewing available policy options in the area of tax accounting and the relationship between tax accounting and financial accounting.

Section II
Objectives of Tax Accounting vs. Financial Accounting

When electing how to design its financial accounting and tax accounting systems within the confines of international and EU law (refer to Section I.B),[9] and Appendix II, a Member State should have due regard to the objectives of these systems and the resulting principles which will govern financial accounting and tax accounting. This Section presents an overview of the criteria that policymakers may wish to consider to ensure that financial and tax accounting systems achieve their objectives.

Box 3: Corporate Income Tax

Despite their widespread use, the case for the imposition of corporate income taxes remains controversial for theoretical and practical reasons, including:

» The burden of taxes levied on corporations falls on its owners, employees and customers. But there is no agreement about how the burden is distributed among these groups.

» These taxes result in high administration and compliance costs.

Nevertheless, despite the existence of an exception within the EU (refer to the case study on Estonia in Section III), the remainder of this paper is based on the premise that corporate income taxes, which are determined through a profit-based system, are here to stay.

A. Tax Accounting

The different tax systems currently observed in EU Member States are the result of historical and political developments. To some extent, differences between Member States are the result of different choices representing trade-offs between conflicting principles as discussed under Section II.A.1 below. However, other differences are likely to be the result of historical evolution. Because tax accounting and financial accounting are often closely related (refer to Section III), the ongoing developments in financial accounting as well as the CCCTB initiative (refer to Section I.B.3 and Appendix II) provide an opportunity to think about what tax accounting rules would be optimal from an economic point of view.

[9] Policymakers may have to deal with constraints such as their Member State's constitutions and international treaties, which may limit the possibilities available to them.

A.1 Principles suitable for Tax Accounting[10]

The central principles that are generally considered to be suitable for tax accounting include:

- **Neutrality** – The most frequent definition of neutrality is that investment decisions should not be affected by tax accounting. While a fully neutral tax accounting system is rarely implemented (e.g., most countries adopt a definition of taxable profit that allows the cost of debt to be deducted and therefore discriminates against equity finance), the neutrality principle is a useful criterion. It implies for example a certain degree of symmetry in the tax accounting system, meaning that positive and negative components of the tax base should have a symmetrical treatment when they have a similar nature.
- **Simplicity** – A simple tax system promotes efficiency and competitiveness. By contrast, the administrative burden of ever more detailed and complex tax rules constitutes a significant burden. The costs of monitoring such systems are also very high. Simplicity is a matter of competitiveness in that it enables businesses to direct their resources from administrative tasks to productive activities that promote growth. Simplicity should therefore be a very important objective for policymakers.
- **Enforceability** – The tax system should be easily enforceable and taxes should be difficult to avoid and evade. Importantly, an enforceable system has to define with certainty which items are included in taxable profit and clearly limit taxpayer discretion in implementing accounting techniques that will affect taxable profit.
- **Tax capacity (realization)** – In theory, taxable profit should include (deduct) any accrued gains (losses). In practice, however, this would raise unacceptable problems both for taxpayers and governments and infringe on the widely accepted principle of tax capacity. In a world with imperfect capital markets, taxpayers may have great difficulty in financing the payment of taxes on unrealized gains. As a result, they are likely to forgo some otherwise profitable investment and may in extreme cases go bankrupt, even if making profits. The government, on the other hand, may have their ability to raise revenue impaired if accrued losses are deductible. For all these considerations, taxable profit usually includes capital gains and losses only at realization.
- **Revenue position** – The reason for the existence of most taxes is the provision of revenues to the government. Therefore a tax must be able

10 This Section draws on Malcolm Gammie, Silvia Giannini, Alexander Klemm, Andreas Oestreicher, Paola Parascandolo, Christoph Spengel (2005), *Achieving a Common Consolidated Corporate Tax Base in the EU*, Centre for European Policy Studies (CEPS), Brussels, Belgium.

to provide the revenue expected with a sufficient degree of certainty. One implication of this principle is that the definition of taxable profit should limit the taxpayer's ability to allocate revenue and cost items to different fiscal years.

- **Public policy** – Corporate income tax is sometimes also used as a policy tool. By permitting allowances or other benefits in the form of deductions from taxable profit or tax credits, the tax system can be used as an incentive to stimulate investments or certain types of investments, notably research and development. To the extent that these incentives correct some market imperfection, they may be an important ingredient of a tax system. It should be noted, however, that such incentives typically add to complexity and must therefore be fully justified as capable of achieving their particular objective before being adopted.
- **Cost of reform –** A final concern is the cost of the reform itself. If a rule that is different from those currently in force can be shown to be preferable, a change in tax law can only be justified if (over time) the relative value of the benefit exceeds the cost of implementing the change.

B. Financial Accounting

As discussed in Section I.B, the different financial accounting systems currently observed in EU Member States are the result of the harmonization of accounting around the *acquis communautaire*, in particular the following Directives and Regulations:

- the Fourth EU Company Law Directive on Annual Accounts (the 'Fourth Directive') of 1978, as amended;[11]
- the Seventh EU Company Law Directive on Consolidated Accounts (the 'Seventh Directive') of 1983, as amended;
- the Banking Accounts Directive of 1986, as amended;
- the Insurance Accounts Directive of 1991, as amended; and
- Regulation (EC) No 1606/2002 on the use of IFRSs of 2002, and related European Commission's Regulations.

In Section I.B.4, we pointed out the growing influence of IFRSs on EU financial accounting through Regulation (EC) No 1606/2002 (direct influence) and IFRSed national accounting standards (indirect influence). In that context, it is important to understand the principles underlying IFRSs.

[11] The Fourth Directive, the Seventh Directive, the Banking and Insurance Accounts Directives were amended on several occasions to reflect IFRS recognition, measurement, and disclosure requirements. These amendments to the Directives allowed EU Member States to amend their national accounting standards in line with IFRSs. We have referred to this process as the adoption of IFRSed national accounting standards.

B.1 Fundamental Concepts underlying IFRSs

IFRSs are often described as essentially 'investor-focused'. The central focus of IFRSs is on providing financial information to providers of risk capital so as to enable them to make informed decisions regarding the companies in which that risk capital is (should be) invested.

The investor focus can be seen in some of the fundamental concepts underlying IFRSs, specifically:[12]

» **Balance sheet approach** – IFRSs are balance-sheet focused, in that the intention is to provide a statement of financial position of a company at a specific point in time to enable the investor to make an investment decision. The income statement is almost a by-product as opposed to the central focus of the accounts. This is further reflected in the discussions which have taken place during the IASB's project on 'reporting financial performance,' which has been working on a model of financial reporting which is expected ultimately to eliminate any single overall accounting profit (loss) figure from the accounts.

» **Fair value accounting** – In assessing the financial position of a company, the focus is on the ability to generate cash, the fundamental driver of the value of the company. This is the underlying principle behind those parts of IFRSs which insist on 'fair value' accounting and in particular the treatment of financial assets under IAS 39, *Financial Instruments: Recognition and Measurement*.

» **Substance over form** – IFRSs require that transactions be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

In this Section, we presented the principles which are generally considered to be suitable for tax accounting and the fundamental concepts underlying IFRSs. We noted that—as a consequence of the growing influence of IFRSs—the objectives of tax and financial accounting are becoming increasingly different.

12 This Section draws on *IFRS: Tax Implications for the EU Financial Services Industry – Are you Ready?*, PriceWaterhouseCoopers, 2007.

Section III
Relationship between Tax and Financial Accounting in the EU

As discussed in Section II, the objectives of financial accounting as influenced by IFRSs differ fundamentally from those of tax accounting. However, this has not always been the case. Historically, the objectives of financial and tax accounting in some EU Member States had some similarity, resulting in a certain degree of relationship between the two.

Historical developments have resulted in a range of approaches to the relationship between tax and financial accounting in EU Member States. At the one end of the range, there are Member States (e.g., the Netherlands) which have kept tax and financial accounting completely separate (at least from a statutory point of view), i.e. there is no statutory relationship between the two. At the other end of the range, there are Member States (e.g. Germany) which have established a statutory and direct relationship between financial and tax accounting, i.e. they are closely related.

This Section introduces a simplified typology (four categories) to categorize the different approaches within the EU. It then presents nine case studies summarizing the experience of a sample of EU Member States. The last part of this Section draws lessons based on the experience of these nine Member States.

A. The Degree of Relationship between Tax and Financial Accounting

The degree of relationship between tax and financial accounting varies greatly across the EU. Member States have tended to divide between those where there is a statutory relationship (meaning that financial accounting principles follow tax accounting rules or that tax accounting rules follow financial accounting rules) and those where there is no relationship (meaning that there are different rules for financial accounting and tax accounting). Table 1 illustrates the diversity of approaches in the EU.

Table 1: Degree of Relationship between Financial and Tax Accounting in selected Member States

Country	Degree of Relationship between financial and tax accounting	Illustration
The Netherlands	**No statutory relationship** There is no statutory relationship between tax accounting and financial accounting.	**Valuation of fixed assets** The independence of tax and financial accounting is illustrated by the fact that every option (allowed alternative) under Dutch accounting standards (financial accounting) is acceptable in the tax returns irrespective of the treatment actually applied in the annual accounts.
France	**Intermediate statutory relationship** The *Code général des impôts* (Tax Code, also known as the C.G.I.) sets out that companies are required to follow national accounting standards (financial accounting) to determine taxable profit. In some instances, tax accounting rules differ from financial accounting rules. As a result, companies make a limited number of adjustments to accounting profit to compute taxable profit.[13]	**Depreciation** In general, there is a relationship between financial and tax accounting for depreciation. The tax accounting rules incorporate a number of specific requirements, including the use of zero disposal values, guidelines on useful lives, and pro rata charges for assets bought or sold in the year. The tax rule is generally followed for both tax accounting and financial accounting purposes.
Germany	**Strong statutory relationship** The relationship between financial and tax accounting is given a legal position in that the calculation of taxable profit rests upon the calculation of accounting profit. This	**Depreciation** Tax regulations set out maximum depreciation rates to be charged on specific assets. To claim the maximum allowances in determining taxable profit, the annual accounts must also reflect the allowance

13 It should be noted that the national accounting requirements are sometimes influenced by tax accounting. For example, the C.G.I. requires that accelerated depreciation expenses, which represent tax incentives permitted by the C.G.I., be recorded in the annual accounts to be tax deductible. This requirement illustrates the relationship between financial and tax accounting, which works both ways.

	principle is referred to as the '*Maßgeblichkeitsprinzip*' in German. However, this principle is sometimes applied in reverse in that a company will use a specific financial accounting treatment in its annual accounts in order to achieve a particular tax treatment in its tax return. This practice is often referred to as '*umgekehrte Maßgeblichkeit*'.	claimed within the tax return. The tax rule is therefore often applied in preparing the annual accounts.

While there is a continuum of approaches available to policymakers when deciding on the degree of relationship between tax and financial accounting — ranging from none at all to identical systems -- this paper proposes a simplified typology of four conceptual approaches:[14]

- **Type 1 (strong direct relationship, extremely rare in practice)** – Under the first approach, the taxable income is determined by reference to accounting profit without any adjustment. Few countries use this approach, since it leaves little room for public policy considerations (e.g., there are arguments for not allowing a deduction for fines and penalties from a tax point of view).
- **Type 2 (strong relationship, frequent in the former Soviet Union)** – Under the second approach, annual accounts must be prepared in conformity with accounting standards (financial accounting) and tax accounting requirements. Consequently, a company cannot record an accounting entry in its annual accounts if it conflicts with a tax accounting requirement. Under this example, a company could not record a fine or penalty in its annual accounts if tax rules do not allow a deduction for fines and penalties. This approach still prevails to some extent in some countries of the former Soviet Union.[15]
- **Type 3 (intermediate to strong relationship, common in EU Member States)** – The third approach combines the first and second approach. Taxable profit is determined by reference to accounting profit except where specific tax accounting rules apply. Belgium,

14 Adapted from Dendaux, Servais (2001), *Articulation en droit belge des rapports entre le droit fiscal et le droit comptable: état de la question et perspectives d'évolution à l'aune de l'utilisation des normes IAS*, Comptabilité et Fiscalité Pratiques, pp. 365 – 394, Belgium.

15 In these circumstances, companies are required to post a significant number of adjustments off-the-books when preparing accounts in conformity with IFRSs for their bankers or investors.

France, Germany, Luxembourg, and the United Kingdom have adopted different variations of this approach. This may involve a 'positive' approach, whereby the tax legislation refers to carefully targeted aspects of financial accounting and adopts those aspects either in wording or in concept. This may, and usually does, involve a more comprehensive alignment, whereby the tax legislation adopts financial accounting as the 'default' position, and then adjusts out those aspects of financial accounting which are inappropriate as a basis for the computation of taxable profit.

» **Type 4 (no statutory relationship, found in some EU Member States)** – Under the fourth approach, the annual accounts and the tax returns are independent. A company could in theory prepare its tax returns without drawing on its annual accounts. The Netherlands has adopted this conceptual approach. However, the theoretical independence between tax and financial accounting is often mitigated by 'indirect' linkages between tax and financial accounting (e.g., through the principle of '*goedkoopmansgebruik*' in the Netherlands).

As the typology above illustrates, while a useful distinction, it is important not to draw too sharp a dividing line between different approaches. In practice, tax accounting systems tend to have regard for the rules of financial accounting. In recent years, tax authorities have increasingly looked to financial accounting principles as a means of resolving particular aspects of income measurement.

B. Pan European Survey

The following case studies present a summary, for nine EU Member States, of:

» the historical context of the relationship between tax and financial accounting;
» the definition of taxable profit;
» the use of IFRSs in financial accounting; and
» the lessons learned.

B.1 Belgium[16]

B.1.1 Historical Context

The Law on Accounting (July 17, 1975) and the related Royal Decree (October 8, 1976) form the basis of Belgian financial accounting requirements, which are in turn based on the Fourth Directive (discussed at Section II.B). The

[16] This case study was prepared by Mr. Bruno Colmant, Ph.D. in Applied Economics. Mr. Colmant is *Directeur Cellule Stratégique du Ministre des Finances* (Chief of Staff and Director for Strategy at the Ministry of Finance) and Member of the Belgian Commission on Accounting Standards.

objective of the Law on Accounting is to ensure that annual accounts provide a true and fair view to shareholders and third parties of the financial condition and performance of a company.

Since 1976, tax accounting rules can differ from financial accounting rules only in specific cases. On this basis, the Law on Accounting takes precedence over tax law except in specific cases.

B.1.2 Definition of Taxable Profit

Belgian tax laws explicitly refer to the rules and principles set out in the law on accounting, the related Royal Decree, and pronouncements by the Belgian Commission on Accounting Standards (*Commission des Normes Comptables/Commissie voor Boekhoudkundige Normen*). Therefore, except when tax laws provide for a specific tax accounting treatment, taxable profit is determined based on the same principles and rules as those used for the preparation of annual accounts.

Consequently, any amendment to existing accounting standards or any new accounting standard which impacts upon the accounting profit also impacts upon the taxable profit unless a specific tax accounting rule neutralizes its effect.

B.1.3 The Use of IFRSs in Financial Accounting

Belgium has not used the options set out in Article 5 of Regulation (EC) No 1606/2002 (refer to Section I.B.4 above). Belgian companies are neither permitted nor required to prepare their annual accounts in conformity with IFRSs. The strong degree of relationship between financial and tax accounting was among the factors that significantly impacted the decision by policymakers to instead require that annual accounts be prepared in conformity with national accounting standards.

The Belgian Commission on Accounting Standards has recently confirmed that the Law on Accounting will be amended. However, the amendment will maintain an accounting framework different from IFRSs.

B.1.4 Lessons learned

A number of Belgian companies are required to prepare their consolidated accounts in conformity with IFRSs. A number of companies prepare annual accounts in conformity with IFRSs for their lenders or parent company. These companies must nonetheless also prepare their annual accounts in conformity with national accounting standards, which differ significantly from IFRSs. Because Belgian accounting standards have been only marginally impacted by IFRSs, the Belgian tax accounting system has not been significantly impacted by IFRSs.

The Minister of Finance, the Minister for Economic Affairs, the Minister for Small and Medium-sized Enterprises, and the Minister of Justice are jointly responsible for accounting law matters. Over the last two years, several multi-disciplinary groups have met in order to discuss and agree how the Law on Accounting should be amended / modernized.

The results of these workshops can be summarized as follows:

- the use of IFRSs should be confined to publicly traded companies and financial institutions;
- privately-held companies should be permitted to publish IFRS annual accounts in addition to preparing and publishing statutory annual accounts in conformity with Belgian accounting standards;
- IFRS annual accounts are not suitable for tax purposes. The accounting profit determined in conformity with Belgian accounting standards remains an adequate basis for taxable profit. Disassociating financial and tax accounting is not desirable; and
- the Belgian Commission on Accounting Standards is responsible for amending and keeping Belgian accounting standards up-to-date.[17]

B.2 Denmark[18]

B.2.1 Historical Context

Historically, the Danish legislative framework shares features with both continental European and common law legal systems. However, it is generally noted that principles underpinning the relationship between tax and financial accounting demonstrates strong common law characteristics. It is generally fair to say that tax accounting and financial accounting rules are not closely linked and that numerous adjustments are required to the accounting profit in order to determine the taxable profit. This independence was primarily driven by the implementation of the Fourth Directive (discussed at Section II.B) by Denmark in 1981 which separated financial and tax accounting.

B.2.2 Definition of Taxable Profit

Taxable profit is calculated on the basis of the accounting profit reported in the annual accounts prepared in accordance with the principles set out in the Annual Accounts Act (based on the Fourth Directive), submitted to and

[17] It should be noted that the Belgian Commission on Accounting Standards has decided that the review of the Belgian Law on Accounting should consider the introduction of a requirement whereby all new standards and pronouncements should include a reference to IFRSs and highlight whether and how they converge / diverge from IFRSs.

[18] This case study was prepared by Mr. Patrick Corrigan, Consultant, Helm Corporation, Ireland based on interviews conducted with a range of stakeholders in Denmark.

approved by the shareholders and filed with the Commerce and Companies Agency. However, as stated above, taxable profit is generally very different from the accounting profit presented in the annual accounts, since tax laws permit, and in some cases require, adjustments such as:

- companies can often report higher depreciations for tax purposes than for financial accounting purposes; and
- some expenses are disallowed or not fully deductible for tax purposes. For example, entertainment costs are only deductible up to 25% of the actual costs incurred.

B.2.3 The Use of IFRSs in Financial Accounting

As set out in Appendix II, Denmark has elected to permit all companies to use IFRSs in their annual accounts. All companies, including those that prepare annual accounts in accordance with IFRSs, are still required to prepare a tax return in conformity with current tax accounting rules.

B.2.4 Lessons Learned

Policymakers and stakeholders we interviewed believe that the independent relationship between corporate tax and financial accounting reduces the consequences of the use of IFRSs in the annual accounts of Danish companies when compared to some other EU Member States. Tax accounting and financial accounting rules are not closely linked and numerous adjustments are already required to the accounting profit in order to determine the taxable profit. Essentially a 'two-standard' system is in place in Denmark.

The introduction of IFRSs in the annual accounts of Danish companies is reported to have been relatively smooth though it resulted in an increase in the number of required adjustments to determine the taxable profit. Preparers and taxation authorities appear to have coped well with the introduction of IFRSs though they noted that the following aspects require careful consideration:

- deferred tax in relation to share-based payment;
- deferred tax in relation to inter-company transactions; and
- the measurement of tax assets in relation to tax loss carried forward.

B.3 Estonia[19]

B.3.1 Historical Context

Since 2000 Estonia has implemented a unique corporate income tax regime when compared to the traditional corporate income tax regimes found in most

[19] This case study was prepared by Mr. Valner Lille, Chief Specialist, Ministry of Finance, Estonia.

other EU Member States. In Estonia, no corporate income tax is charged on the accrued profit at the moment the profit is generated. Instead, the moment of taxation is postponed until the profits are distributed. Thus, a company that does not distribute any profits is not obliged to pay corporate income tax. Estonian policymakers believe that this system has advantages such as being administratively cheaper and removes any temptation or need for corporations to hide profits or earnings. In addition, Estonian policymakers regard the system as clear and transparent. Furthermore, it has been attractive to investors and encourages them to leave more money in the business and so far has been fiscally attractive to the Estonian government.

However, the current regime, where income tax is levied on only corporate income distributed to shareholders (along with non-business expenses, donations etc.) was, upon Estonian entry to the EU, held to be contrary to EU law. The current system was deemed to be in violation of one of the fundamental freedoms of the EU — free movement of capital. This was because (to the extent that the company tax to be levied on distribution can be seen as a kind of withholding tax on cross-border dividends) this is prohibited in certain conditions by the Parent and Subsidiary Directive. The Estonian Ministry of Finance is currently assessing how to resolve this issue.

B.3.2 Definition of Taxable Profit

The tax base for corporate income tax is currently the amount of distributed profits. The profit distribution includes dividends fringe benefits and gifts as well as costs and payments not related to the business of the company.

B.3.3 The Use of IFRSs in Financial Accounting

Since 2005, all publicly traded companies, credit institutions, insurance undertakings, financial holding companies, mixed financial holding companies, and investment firms are required to apply IFRSs instead of national accounting standards in their annual accounts. Since 2003, all entities are permitted to apply IFRSs instead of national accounting standards in their annual accounts. In addition, national accounting standards are 'harmonized with' IFRSs and cross-referenced to applicable IFRS paragraphs. Any differences in the national accounting standards compared to IFRSs are explained and justified.

B.3.4 Lessons Learned

Estonia is among the first EU Member States to also require or allow IFRSs in the preparation of annual accounts. This decision was supported by the fact that, in Estonia, corporate tax is charged on dividends, not on profits. Therefore, the accounting framework does not affect the tax basis and the state budget revenues.

B.4 France[20]

B.4.1 Historical Context

In France, the '*principe de la connection entre la fiscalité et la comptabilité*' (Article 38 quarter of appendix III of the French Tax Code) sets out that taxable profit is based on the annual accounts of the relevant company, subject to specific adjustments.

This principle has two consequences:

- At balance sheet level, the measurement principles applied by the company in accordance with the financial accounting rules set out in the Company Law must also be followed for tax accounting purposes unless the Tax Law provides otherwise.
- At income statement level, items that are recognized as an expense in annual accounts are deductible for tax purposes, except if a specific tax provision provides that the expense is not tax deductible (e.g., provisions for retirement benefits are not tax deductible).

Therefore, except where a specific tax accounting provision applies, a company is required to prepare its tax return using the same recognition and measurement principles as the ones it uses in its annual accounts, i.e. financial accounting recognition and measurement principles.

As a Civil law country, France adopted a legal ownership approach to financial accounting. For example, French financial accounting does not adopt a substance-over-form approach (as opposed to IFRSs as discussed in Section II.B.1 above).

Also, the measurement basis for the elements of the annual accounts under French national accounting standards is generally the historical cost. As a consequence of the principle above, the tax returns are prepared using the same measurement basis.

In recent years, French accounting standards started converging with IFRSs to meet the needs of the different users of financial information. This modernization of French accounting standards has a consequential impact on tax accounting.

[20] This case study was prepared by Mr. Dominique Villemot.. Mr. Villemot is the Managing Partner of the French law firm Villemot, Névot, Barthès Associés. He specializes in tax law and more precisely in taxation of mergers and acquisitions. Mr. Villemot chairs the IFRS and Tax Committee of the French Accounting Standards Board.

B.4.2 Definition of Taxable Profit

The assessment of corporate income tax is based on the accounting profit, determined in the annual accounts of a company prepared in conformity with French accounting standards, subject to certain adjustments. Historically, France has kept the number of required adjustments to a minimum in order to minimize the administrative burden on companies.

In practice, it is also worth noting that there are instances where tax accounting rules influence financial accounting. For example, companies tend to record accelerated depreciation expenses in their annual accounts because they can only claim these expenses in determining taxable profit if they have recorded the expenses in their annual accounts. Such is the incidence of the close relationship between financial and tax accounting established by the '*principe de la connection entre la fiscalité et la comptabilité*'.

B.4.3 The Use of IFRSs in Financial Accounting

France has not used the options set out in Article 5 of Regulation (EC) No 1606/2002 (refer to Section I.B.4 above). French companies are neither required nor allowed to prepare their annual accounts in conformity with IFRSs.

However, the French Accounting Standards Board started modernizing national accounting standards by implementing some concepts set out in IFRSs (e.g., definition of an asset, depreciation rules). This modernization process is impacting the determination of taxable profit as financial accounting rules are being amended.

B.4.4 Lessons Learned

To establish and measure the tax effects of modernizing national accounting standards based on IFRSs, the French Accounting Standards Board established an IFRS and Tax Committee in 2003. The Committee is comprised of accountants, tax lawyers, and the tax authorities.

The report of the Committee issued in 2005 covered the tax effects of IFRS concepts which had already been implemented in national accounting standards as of January 2005. It also discussed the tax issues to be addressed in the event of a switch to full IFRSs in annual accounts.

On December 30, 2005 the tax authorities issued an instruction with respect to the tax consequences of the harmonization of national accounting standards with IFRSs, which applies to accounting years started on or after January 1, 2005. The tax authorities were guided by three priorities in this instruction: (i) the maintenance of the relationship between tax and financial accounting; (ii) ensuring tax neutrality; and (iii) ensuring that adjustments to determine taxable profit based on accounting profit remain simple.

The instruction addresses the definition of fixed assets for tax purposes (i.e., identifiable, positive economic value, controlled by the company, reliable valuation); the definition of acquisition costs of fixed assets; the application of the 'per components' depreciation method; the determination of the depreciation period; and the tax consequences of the 'per components' depreciation method. The implementation of this instruction in annual accounts (e.g., definition of an asset, depreciation of assets and components, business combination deferred taxes) has occurred smoothly with no tax drawbacks, either for companies or for tax authorities.

Further instructions deal with discounting and share-based payments to employees. Full implementation of fair value accounting and the substance-over-form principle will be the challenges for the coming years.

B.5 Germany[21]

B.5.1 Historical Context

The conformity principle (*Maßgeblichkeitsprinzip*) has significantly underpinned the development of the relationship between tax and financial accounting in Germany. The conformity principle, found in the German Income Tax Code, states that annual accounts of legal entities are used for tax purposes unless specific tax regulations require departures from national accounting standards.

The conformity principle was supplemented with the so-called reverse conformity principle (*umgekehrtes Maßgeblichkeitsprinzip*) whereby companies elect a specific financial accounting treatment in their annual accounts in order to achieve a particular tax accounting treatment (refer to Section III.B.5.2 below).

The conformity principle and the reverse conformity principle originally aimed to simplify accounting in Germany by allowing companies to prepare only one set of annual accounts serving both financial accounting and tax accounting purposes. This is often referred to as the 'unitary balance sheet' approach (*Einheitsbilanz*).

B.5.2 Definition of Taxable Profit

Taxable profit is determined on the basis of the accounting profit reported in the annual accounts prepared in conformity with national accounting standards. As discussed above, the annual accounts prepared by German

21 This case study was prepared by Dr. Gerrit Adrian, *Steuerberater*, KPMG, Germany.

companies for financial accounting purposes are closely related to the returns prepared for tax accounting purposes and the computation of taxable profit.

The concept of the unitary balance sheet has led to some tax accounting standards being accepted for financial accounting purposes. For example, article 254 of the German Commercial Code sets out that additional depreciation expenses recorded in accordance with tax accounting rules (accelerated tax depreciation) are acceptable for financial accounting purposes even if they result in the company carrying items of fixed or current assets at a lower value than the value that would have resulted if they had been depreciated over their 'economic useful life'.

B.5.3 The Use of IFRSs in Financial Accounting

Under certain conditions, companies are allowed to publish IFRS annual accounts in addition to, not in lieu of, their annual accounts prepared in conformity with national accounting standards. When considering whether to permit or require companies to use IFRSs in their annual accounts, policymakers determined that IFRSs would represent a significant paradigm shift away from the principal idea of the protection of creditors, which lies at the heart of German national accounting standards. To avoid the consequences of this paradigm shift, IFRSs cannot be used for the preparation of annual accounts (see Box 4, *Comparison between IFRSs and German Accounting Standards*).

Box 4: Comparison between IFRSs and German Accounting Standards

There are significant conceptual differences between IFRSs and German accounting standards. Whereas IFRSs aim to reflect a "true and fair view" of a company's financial position and performance, German accounting standards focus on the concept of 'creditor protection'. The presiding principle in German accounting standards is the principle of prudence (Vorsichtsprinzip). As a consequence, income must not be recognized until realized (realization principle, Realisationsprinzip). By contrast, expenses must be recognized when probable (imparity principle, Imparitätsprinzip).

B.5.4 Lessons Learned

If an entity decides to prepare its annual accounts in conformity with IFRSs in addition to German accounting standards, the company must effectively prepare three sets of accounts, i.e. IFRSs, German accounting standards, and tax returns.

If IFRSs were introduced in lieu of German accounting standards, significant adjustments would have to be recorded to determine taxable profit based on accounting profit. For example, measurement of an asset above its historical cost pursuant to fair value accounting would not be acceptable from a tax perspective, because it would result in an unrealized gain to be subject to tax. This would be incompatible with the principle of 'tax capacity' (refer to Section II.A.1).

Furthermore, annual accounts prepared for financial accounting purposes fulfill multiple functions in Germany due to the conformity principle. They serve as a basis for determining the profit available for distribution (dividends) and taxable profit. Accordingly, policymakers are likely to maintain the close relationship between financial and tax accounting.

B.6 Luxembourg[22]

B.6.1 Historical Context

In Luxembourg, according to the "*principe de l'accrochement du bilan fiscal au bilan commercial*" or "*Maßgeblichkeitsprinzip*" set out in article 40 of the Luxembourg Income Tax Law, taxable profit is determined based on the annual accounts of the relevant business undertaking, subject to minor adjustments only.

This principle means that at balance sheet level, the valuation rules that have been applied in accordance with the accounting rules set out in Company Law to measure assets and liabilities will be followed for tax purposes to the extent the Income Tax Law does not provide for different rules.

At income statement level, items that are recognized as an expense in annual accounts are deductible for tax purposes, except if a specific tax provision provides that the expense is not deductible for tax purposes.

Therefore, except where a specific tax provision applies, a taxpayer is required to prepare its tax return (tax accounting) using the same recognition and measurement principles as the ones it has used in its annual accounts (financial accounting).

The process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the annual accounts (under Luxembourg accounting rules) and, consequently, the tax returns generally uses 'historical cost' as a basis of measurement.

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[22] This case study was prepared by Mr. Olivier Remacle, Tax Partner, and Ms.Samantha Nonnenkamp, Tax Manager, ATOZ Tax Advisers, Luxembourg (www.atoz.lu).

B.6.2 Definition of Taxable Profit

Taxable profit for the year is computed by using a balance sheet approach, that is, by comparing the net equity of the company at year end to the net equity as of the end of the previous year.

Allowable expenditures include all expenses that were incurred exclusively and directly for the business. However, certain types of business expenses are not tax deductible and are added back for tax purposes, mainly directors' fees, self-insurance provisions, creditable foreign taxes and expenses connected with exempt income, for example, dividends or capital gains. Losses may be carried forward indefinitely.

B.6.3 The Use of IFRSs in Financial Accounting

In Luxembourg, the use of IFRSs has been mandatory for all publicly traded companies since January 1, 2005 as per Regulation (EC) No 1606/2002. IFRSs are optional for banks (Law of March 16, 2006), insurance and reinsurance companies (Law of April 27, 2007).

As a consequence, the adoption of IFRSs in Luxembourg has had (or will have) an impact only with respect to a limited number of taxpayers, i.e. the companies that choose to prepare their annual accounts in conformity with IFRSs instead of Luxembourg accounting rules.

As discussed above, Luxembourg accounting rules generally use 'historical cost' as a basis of measurement. While 'historical cost' is also embraced by IFRSs, IFRSs require the measurement of a significant number of elements at fair value (e.g., most financial assets). Under the Income Tax Law, a number of elements are required to be measured at the 'lower of cost or market.' Therefore, a number of adjustments are required to 'cancel out' the effect of IFRSs on the accounting profit (e.g., with respect to business combinations, leases, hybrid financial instruments, derivatives, and investments in affiliates).

However, where specific tax provisions do not 'cancel out' the effect of IFRSs, the aforementioned '*Maßgeblichkeitsprinzip*' applies. Consequently, the taxable profit will differ depending upon whether a company applying IFRSs or Luxembourg accounting rules in preparing its annual accounts. For example, a company recognizing unrealized gains in conformity with IFRSs will be taxed on those gains even though they might never be realized in future. Based on Luxembourg accounting rules, these unrealized gains would not be recognized in the annual accounts and hence would not be taxable until realized.

B.6.4 Lessons Learned

Luxembourg anticipated the introduction of IFRSs by establishing an expert working group which examined the transactions that would be impacted by the implementation of IFRSs. The working group identified the areas where specific tax rules should be enacted to cancel out the effect of IFRSs.

However, at the time of writing this paper, Luxembourg policymakers have yet to act upon the recommendations made by the working group. Consequently, publicly traded companies and financial institutions still prepare their annual accounts in conformity with Luxembourg accounting rules. It is likely, however, that legislation will be drafted by the end of 2007.

B.7 Poland[23]

B.7.1 Historical Context

Since the enactment of corporate tax laws in the early 1990s, many significant changes have been introduced to the tax accounting environment in Poland through changes to the legislation, authority rulings, court decisions, and accepted practices. More recently, EU accession has led to further modifications and changes to the tax laws.

Taxable profit and accounting profit are determined independently, i.e. on the basis of different tax accounting and financial accounting laws and regulations. However, tax laws include a number of references to financial accounting legislation. For example, tax laws allow companies to determine foreign exchange gains and losses in accordance with the rules set out in the Accounting Act. Conversely, financial accounting legislation includes a number of references to tax accounting laws. For example, small companies which are not required to have a statutory audit are permitted to use tax accounting rules when accounting for leases in their annual accounts.

In 2000, the Accounting Act underwent a major reform aimed at achieving convergence with IFRSs, introduced greater use of fair value accounting. As a result of this reform, Polish financial accounting became significantly more complex.

B.7.2 Definition of Taxable Profit

According to tax regulations, taxpayers are required to keep accounting records in a manner that allows the determination of the taxable profit and the amount of tax due. While there is no need for separate accounting records for tax accounting purposes, there is a requirement to capture in the company's accounting records the information necessary to prepare tax returns.

[23] This case study was prepared by Mr. Jacek Gdański, Deputy Director, Accounting Department, Ministry of Finance, Poland, and Ms. Małorzata Szewc, Senior Specialist, Accounting Department, Ministry of Finance, Poland.

In addition, companies are required to disclose in their annual accounts the detailed approach that they have adopted to keep records for tax accounting purposes. For example, the tax law provides that in order to be tax deductible, identified expenses should be incurred with the aim of generating income. This may result in expenses recorded for accounting purposes not being deductible from a tax point of view.

B.7.3 The Use of IFRSs in Financial Accounting

The Accounting Act sets out the provisions regulating the preparation of annual accounts. It allows certain companies (publicly traded companies, companies in the process of becoming publicly traded, and companies whose parent entity prepares its consolidated accounts in conformity with IFRSs) to use IFRSs rather than applying national accounting standards.

As discussed above, national accounting standards were modernized in line with IFRSs. While the influence of IFRSs on national accounting standards is likely to remain important in the future, drastic changes, such as those that occurred in 2000, are not expected. At present, the conversion from national accounting standards to IFRS has been halted, since national accounting standards are deemed adequate for the current needs of the Polish economy. In addition, Poland is not contemplating requiring the use of IFRSs for the annual accounts of publicly traded companies.

Finally, irrespective of the type of financial accounting standards that companies use in their annual accounts, they are required to provide a reconciliation of accounting profit and taxable profit.

B.7.4 Lessons Learned

Essentially, in Poland there is little commonality between accounting profit and taxable profit. While the reconciliation between the two numbers is presented in a mandatory note to the annual accounts, there is no significant relationship between accounting law and tax law. Consequently, there are few direct effects of accounting recognition and measurement principles on the determination of taxable profit. Based on these characteristics, tax authorities determined that there is little tax risk associated with the adoption of IFRSs.

A positive outcome of such a remote relationship between financial and tax accounting relates to the fact that financial accounting can be modernized to respond to the evolving needs of the economy without impacting upon the determination of taxable profit. It also allows Poland to ensure a level playing field (from a tax point of view) between companies preparing their accounts in conformity with IFRSs and those preparing their accounts in conformity with national accounting standards.

Although the system adopted in Poland implies the existence of systemic differences between the tax and the financial accounting systems, it may pave the way for a wider use of IFRSs in future.

B.8 The Netherlands[24]

B.8.1 Historical Context

Since the introduction of a corporate income tax system, which replaced the former profit-distribution-based taxation system in 1941, there has been complete independence / disassociation between financial accounting and tax accounting in the Netherlands.

However, in seeking to ensure the efficiency of the legislative framework and to ensure that the taxation base (tax accounting) is acceptable and reasonable in economics terms, no comprehensive set of tax accounting rules has been developed for the calculation of taxable profit. Rather, the general rule is that taxable profit is determined according to 'good business practice' (*goed koopmansgebruik*). In 1957, the High Court ruled that 'good business practice' should be interpreted as "what the economy finds to be a proper way to determine income" with two exceptions, i.e.:

» specific provisions in tax laws; and
» the general structure and objective of tax laws.

B.8.2 Definition of Taxable Profit

In practice, despite the lack of a statutory relationship between tax and financial accounting, the basis for corporate taxation comprises accounting profit plus certain non-tax deductible expenses less deductible gifts and losses made in previous years.

Specific Provisions in Tax Laws

Some examples of cases in which the tax law explicitly rules out the application of 'good business practice' in the calculation of taxable profit include:

» the tax law forbids taking future price and salary increases into account in the calculation of the provision for pension obligations;
» the tax law does not allow calculation of depreciation expenses based on fair values (if higher than historical cost);

24 This case study was prepared by Professor Rien van Hoepen. Professor van Hoepen is full Professor of Financial Accounting and Auditing at the Erasmus School of Accounting & Assurance of the Erasmus University Rotterdam and an expert judge with the Enterprise Chamber of the Amsterdam Court of Appeal.

- the tax law allows accelerated depreciation expenses in certain cases even when the resulting depreciation expense does not reflect the pattern whereby the economic benefits of the asset are consumed;
- under certain conditions, the tax law allows the use of the pooling of interests method in order to prevent tax considerations from hindering merger and acquisition activities; and
- income from subsidiaries is exempted from taxable profit under certain conditions (affiliation privilege).

Almost all of these deviations from the 'good business practice' principle result from 'tax policy' reasons and 'tax capacity' reasons (refer to Section II.A.1).

General Structure and Objective of Tax Laws

Examples whereby the general structure and objective of tax laws result in the non-application of the 'good business practice' principle in the calculation of taxable profit include:

- where inter-company profits are not eliminated in calculating taxable profit except in the event that a group of companies qualifies as a group for tax purposes (fiscal unity), based on the general principle that each separate legal entity is liable to tax on an individual basis;
- accounting changes and correction of fundamental errors should always be included in the determination of taxable profit for the current period, based on the general rule of balance sheet continuity, i.e. the rule that the opening balance sheet of the current period has to be identical to the closing balance sheet of the previous period; and
- in most cases calculation of income for tax accounting purposes must be based on historical cost.

These deviations from the 'good business practice' principle also result from 'tax policy' reasons and 'tax capacity' reasons (refer to Section II.A.1).

'Good Business Practice and Allowed Alternatives'[25]

Therefore, as far as specific provisions in tax laws and the general structure and objective of tax laws do not prevent this, taxable profit must be determined based on 'good business practice,' i.e. in conformity with the discipline of financial accounting.[26]

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25 It should be noted that this principle is complemented by the concept of 'consistent application over time' *(bestendige gedragslijn)*

26 Now, these are referred to as 'generally accepted accounting principles' (GAAP), a term not in use in 1957 when the High Court decided on the meaning of 'good business practice.'

Due to the independence / disassociation between tax and financial accounting, every option (allowed alternative) under Dutch GAAP is acceptable in tax returns, irrespective of the treatment chosen for annual accounts. An example is the LIFO-rule of stock valuation. As this basis of measurement is an allowed alternative in the Dutch Civil Code (Section 385), this rule can be applied for tax accounting purposes, irrespective of the treatment in the annual accounts, in which another basis of measurement may be applied.

There are many more options available (allowed alternatives) under Dutch GAAP than under IFRSs, since the Dutch Civil Code has adopted almost all options permitted under the Fourth and Seventh EU Company Law Directives.

The result of this complete independence / disassociation between financial and tax accounting is that deferred tax accounting is a widespread practice in the Netherlands.

Finally, it is worth noting that few taxpayers use fair value accounting for tax purposes because of its consequences for the amount of tax to be paid.

'Good Business Practice' and Discretion

In practice, tax accounting undoubtedly influences the preparation of annual accounts (financial accounting). This is particularly the case where there is some 'discretion' in the measurement of an element of the annual accounts. For instance companies may align their accounting provisions with the provisions they have determined based on the tax accounting rules, since it would be rather difficult to argue (with the tax authorities) that a certain amount of provision is warranted for tax accounting purposes if the company recorded a lower amount of provision for financial accounting purposes. Other areas which may be impacted include the estimated lifetime or residual value of an asset, the moment of realization of revenues, and the measurement of bad debt.

As a consequence, in spite of the theoretical independence of tax and financial accounting in the Netherlands, there may exist an *umgekehrte Massgeblichkeit* as is observed in other jurisdictions, including Belgium and Germany (refer to Section III.B.1.1 and III.B.5.1 above).

B.8.3 The Use of IFRSs in Financial Accounting

As in other EU Member States, publicly traded companies are required to prepare their consolidated annual accounts in conformity with endorsed IFRSs. The annual accounts can be prepared in conformity with endorsed IFRSs, Dutch GAAP, or, if so justified by the international structure of the group the company belongs to, in conformity with the GAAP of another EU Member State.

Privately held companies are permitted to prepare their annual accounts as well as their consolidated annual accounts according to the three possibilities mentioned above for the annual accounts of publicly traded companies.

B.8.4 Lessons Learned

The influence of IFRSs on the determination of taxable profit in the Netherlands is rather moderate thus far. The application of IFRSs is only mandatory for the consolidated accounts of publicly traded companies. These consolidated accounts however do not have any influence on tax returns, not even in case of the existence of a so-called fiscal unity. Fiscal unity (a group for tax purposes) is only allowed in the Netherlands when the parent company holds at least 95% of the shares of subsidiaries resident in the Kingdom of the Netherlands. Therefore, the composition of a group for tax purposes differs considerably from that for accounting purposes. Moreover it is not mandatory to form a group for tax purposes; parent companies and subsidiaries can choose individual taxation even if the requirements to form a group are met.

In addition, the independence between tax and financial accounting reduces considerably the influence of IFRSs on the tax returns. The influence is only an indirect one, i.e. because IFRSs might influence the content of what is regarded to be 'good business practice.' As mentioned above, the Dutch Civil Code and Dutch GAAP have adopted almost all available options under the Fourth and Seventh EU Company Law Directives. Therefore, even in the event of a further reduction in the number of allowed alternatives under IFRSs, the allowed alternatives under the Dutch Civil Code and Dutch GAAP could still be used for tax accounting purposes unless prohibited by specific provisions in tax laws or the general structure and objective of tax laws.

In conclusion, there are three fields in which IFRSs may influence tax accounting:

- » First, the growing acceptance of IFRSs may result in a reduction of allowed alternative treatments in the Dutch Civil Code and thereby in a reduction of available alternatives for the calculation of the tax base. For example, the Dutch legislators contemplated abolishing the possibility of application of the LIFO-rule, but ultimately decided not to do so.
- » Second, under the influence of IFRSs, the tax law could introduce specific provisions that prevent the application of what otherwise, or formerly, would have been regarded to be 'good business practice.' For example, the tax law now requires the application of the percentage-of-completion method for construction contracts for which the outcome can be estimated reliably.

- Third, 'good business practice' itself may change under the influence of IFRSs. A possible (future) example of this might be that it may no longer be regarded to be 'good practice' to value stock options at intrinsic value (not specifically covered in the Dutch Civil Code) whereas Dutch GAAP is starting to recognize only fair value at the grant date as the only proper valuation.

B.9 United Kingdom[27]

B.9.1 Historical Context

The abolition of currency exchange controls and supply-side reforms of the 1980s created conditions for explosive growth of the financial sector in London and for the development of trading in new sophisticated financial instruments. The UK corporate tax system was not well equipped at that time to deal with these changes, including for example exchange rate fluctuations and the use of new financial instruments. In response, many tax reforms were implemented to address the situation over the following decades. The reforms tended increasingly to adopt financial accounting measures directly rather than as indirect evidence of the measure of profit, and the resulting tax accounting system used accounting profit as a basis for virtually all elements of the taxable profit computation (other than with respect to long-term investments consisting of land or shares). However, just as these reforms were fully implemented, the drive for the harmonization of financial accounting standards in the EU led to the implementation of IFRSs in the UK. The previous period of alignment of tax accounting with financial accounting consequently threatened to lead to a large-scale change in the tax accounting system without the benefit of due process and without a significant policy debate revolving around the principle of whether tax accounting following financial accounting is an appropriate policy objective.

B.9.2 Definition of Taxable Profit

As stated above, tax accounting in the UK follows financial accounting subject to certain adjustments. Some items of expenditure that are represented as reducing the accounting profit in the annual accounts are added back for tax purposes and deductions for tax purposes may then be allowable. For example, when dealing with the case of depreciable plant or machinery, fixed capital allowances (25% or 6% on a reducing balance basis depending on the longevity of the asset) are substituted for financial accounting depreciation in determining taxable profit. Following significant amendments to UK tax legislation arising from companies adopting IFRSs, adjustments to accounting profit shown in the annual accounts are required to determine taxable profit.

[27] This case study was prepared by Mr. Stephen Shea, Tax Partner, Clifford Chance, United Kingdom.

B.9.3 The Use of IFRSs in Financial Accounting

In the UK, publicly traded companies are required to prepare annual accounts either in conformity with IFRSs or national accounting standards (also known as 'accounting principles generally accepted in the UK,' or UK GAAP). For companies which make the transition from old UK GAAP to IFRSs, there is a radical change from a system based on historical cost accounting and traditional accrual accounting to one which includes large elements of fair value accounting. In view of the close link that has developed in the UK tax system between tax and financial accounting; this implied equally radical changes to taxable profit, in the absence of countervailing measures. In fact, the key tax issue with IFRSs may be not so much fair value accounting in itself, but rather the fact that IFRSs currently represents a half-way house between fair value principles and historical cost/accrual accounting, leading to accounting mismatches which do not always reflect economic reality.

With IFRSs in effect in the UK from January 2005, the related tax risks began to be appreciated from early 2003, and urgent consultations then began between the private sector and the tax authorities. As a result, significant changes have been made to the tax legislation on a piecemeal basis in order to loosen the link between financial and tax accounting in the areas which would have been worst affected by the potential anomalies referred to above – above all in the field of financial instruments. In one area in particular – the taxation treatment of securitization[28] special purpose vehicles (SPVs)[29] – the only solution that proved viable was to set aside financial accounting principles altogether as a measure of taxable profit, and instead introduce a separate set of tax accounting rules to measure taxable profit largely on a cash basis (see Box 5, *Unintended Consequences of the use of IFRSs on Securitization*).

This was found to be necessary, in this specific area, to maintain the basic policy principles of the UK tax system, including in particular taxation on the basis of ability to pay, against the incursion of IFRSs. The above tax reforms, with the exception of the rules relating to securitization SPVs, have introduced areas of unprecedented complexity into the tax accounting system, almost inevitably reflecting (and often exceeding) the complexity of IFRSs.

28 In simple terms securitization enables entities to raise external finance based on cash flow from a single asset or group of assets. This is achieved by allowing investors to buy the asset in the form of loans which are secured on the underlying asset and its associated income stream.

29 A special purpose vehicle (SPV) is a body corporate (usually a limited company of some type or, sometimes, a limited partnership) created to fulfill narrow, specific or temporary objectives, primarily to isolate financial risk, usually bankruptcy.

Other important issues have emerged, for example revolving around deferred tax liabilities in which businesses have to recognize their potential liabilities for tax if they sell assets that they have revalued. The taxation authorities devoted significant resources to solving these problems.

B.9.4 Lessons Learned

Box 5: Unintended Consequences of the use of IFRSs on Securitization*

Due to the relationship between tax and financial accounting, the United Kingdom has been in the forefront of IFRS-related tax issues. These have included issues affecting securitizations, under which assets which are pledged as security to market investors are held within bankruptcy-proof special purpose vehicles (SPVs). Under traditional UK GAAP the accounting profit of SPVs (on which SPVs were taxed) equated to their realized profits (the small retained margin on the overall transaction cash flows) consistently with their special purpose (bankruptcy-proof platform for holding assets). However under new IFRS rules, (specifically IAS 39) unrealized fair value profits of the SPVs could potentially be taxable if taxable profit equated accounting profit. Thus the introduction of IFRSs could make SPVs inefficient from a commercial point of view and was contrary to the central principles generally considered to be suitable for corporate taxation purposes (especially neutrality and tax capacity). This was a serious, unintended consequence for what had become a standard method of financing for all business sectors. To avoid this unintended outcome, the UK tax authorities focused significant resources culminating in regulations passed in December 2006 (the outcome of some four years of technical investigation and lobbying) resulting in the taxation of only the retained margin out of the transaction cash flows within the SPVs.

(*) Based on Stephen Shea, New rules promise smoother passage for securitizations, Financial Times, 11 January 2007.).

The lessons learned have been significant. For the UK, having developed and fine-tuned tax legislation based on financial accounting for the previous twenty years, the introduction of IFRSs necessitated a significant number of adjustments to accounting profit in order to arrive at the required taxable profit. Tax legislation will always need to make at least some adjustments to accounting profit in order to arrive at taxable profit. However, as IFRSs are unprecedentedly complex, the tax legislation that is introduced in order to adjust IFRS annual accounts is now also highly complex. In light of the introduction of IFRSs in the EU, the original merit in aligning tax accounting and financial accounting (objectivity, administrative simplicity, etc.) is overshadowed by this complexity. The UK tax authorities identified more than 200 policy-driven deviations from financial accounting to determine taxable profit. In practice, significant implementation issues have also emerged. Local stakeholders have identified the need for a deep pool of suitably knowledgeable individuals to address complex tax legislation requirements. Moreover, both financial accounting and tax accounting are still in an unprecedented state of flux such that even tax advisers who are intimately involved in the field are frequently unaware of the very latest detailed changes to tax regulations.

The key lessons from the UK experience are as follows: where a territory is contemplating a transition from tax accounting based on historical cost and accrual accounting to IFRSs, it needs to be appreciated that this is not purely a matter of intermediate level fiscal policy, but potentially has major macroeconomic implications. The first step should be for this to be drawn to the attention of the most senior policymakers at finance ministry level, rather than leaving everything to be dealt with in consultations between tax authority policymakers and the private sector. Such consultations are vital, but they need to be conducted within a clearly understood policy framework. In this way, it should be possible to formulate clear lines of policy which can guide the process going forward. Failing that, the process is most likely to end up with piecemeal and over-complex tax legislation affecting vital business areas (especially in the financial sector) leading to continuing vacillation and uncertainty in policy matters. The economic implications of these alternatives are self-evident.

C. Conclusions

Whatever the starting point in EU Member States, i.e. whether a Member State's tax accounting system belongs to Type 1, 2, 3, or 4, the pan-European survey above shows that the introduction of IFRSs and their growing influence on national accounting standards is leading to a need to appraise the appropriateness of the relationship between financial and tax accounting.

It appears that the higher the degree of relationship between financial and tax accounting, the more important and urgent it is to appraise the existing degree of relationship and/or to put in place measures to anticipate and manage the effect of changes in financial accounting on tax accounting. Accepting the status quo where there is a strong relationship may have detrimental consequences on a Member State.

In this Section, we noted that the degree of relationship between tax and financial accounting varies greatly across the EU. We surveyed nine EU Member States noting that the modernization of financial accounting standards, especially the influence of IFRSs, is having a significant impact on tax accounting in those Member States where there is a strong relationship between financial and tax accounting. Their experience suggests that there is a need to revisit the appropriateness of the relationship between financial and tax accounting. We draw on the lessons learned in these Member States to formulate the policy considerations in Section IV of this paper.

Section IV
Policy Considerations

The primary policy objective discussed in this Paper is the adoption of an optimal tax accounting system. In previous sections, we noted that there are a significant number of Member States where policy choices in the area of financial accounting will impact upon tax accounting, and vice versa. In this Section, we set forth a proposed approach for tax policymakers to develop an optimal tax accounting system within the constraints of international law, EU law, and existing practices.

This paper recommends a two-step process to achieve this objective, i.e.:

» first, to agree the overall policy objectives of financial and tax accounting; and
» second, to evaluate the appropriateness of the existing relationship between financial and tax accounting based on their respective objectives.

A. Overall Policy Objectives

A.1 Financial Accounting

Since the focus of this paper is around tax policymaking, we do not propose to delve into financial accounting policymaking in any significant detail. However, two points are worth noting:

» Financial accounting is a building block of a well-functioning market economy. As such, financial accounting policymakers should not be unduly constrained by externalities, including tax policy considerations, when deciding which financial accounting framework best serves the needs of their economy.
» Recognizing the importance of financial accounting, the EU and several Member States are increasingly requiring or permitting the use of IFRSs for the preparation of annual accounts and/or embedding IFRS concepts into their national accounting requirements.

The evolution of financial accounting is responsive to the evolution of the economy (and the evolving needs of users of financial information). It is an unavoidable externality for tax policymakers at both the EU and the national levels.

A.2 Tax Accounting

In an ideal world, rather than focusing the discussion on how to accommodate existing national tax accounting practices, policymakers would seek to enhance tax accounting with a view to developing an optimal definition of 'taxable profit'.[30] The principles generally considered to be suitable for tax accounting (refer to Section II.A.1) will be helpful in reviewing policy options to achieve an optimal definition of 'taxable profit'. They will also be helpful to policymakers who seek to enhance tax accounting within the constraints imposed by international tax law and the legacy of historical and political developments.

However, there will be times when these principles conflict with one another. This paper does not propose an absolute ranking of these various principles across all jurisdictions. Any ranking may change depending on the specific item to be considered (e.g., public policy may be the overwhelming principle when considering whether fines should be tax deductible) and the relative merits are a matter for each Member State to decide.

In undertaking this exercise, tax accounting policymakers have considerably more leeway than their counterparts in financial accounting, since EU law (the *acquis communautaire*) does not impose a framework for tax accounting (refer to Section I.B.3). However, as discussed in Appendix II, this may change as progress is being made with the Common Consolidated Corporate Tax Base (CCCTB) initiative. Monitoring developments in the CCCTB initiative is therefore important to tax policymakers in EU Member States.

A.3 Financial and Tax Accounting have Differing Objectives

The main purpose of corporate income taxes is to raise revenues for the government but there are other aims such as the redistribution of income, the re-allocation of resources, political objectives, etc. These objectives are captured in the principles discussed above and in detail at Section II.A.1.[31]

In this context, the determination of taxable profit is essentially a retrospective calculation of profits and losses which a company has made. Hence, when it comes to annual accounts, a tax system will be most interested in an company's income statement, and may be relatively unconcerned with its balance sheet (except in so far as movements in carrying values are reflected in the income statement).

Increasingly though, the primary focus of financial accounting, in particular IFRSs, is different. IFRSs are primarily concerned with the capacity of a

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30 This paper assumes that traditional measures of taxable profit will continue to be used, i.e. that there is little appetite in the EU to consider alternative taxation schemes (e.g., the neutral cash flow tax).

31 This was nicely illustrated in the UK when the taxation authorities categorized the reasons for a departure from the accounting results, including public policy (e.g., not allowing a deduction for fines), transfer pricing, avoidance, tax neutrality, symmetry, realizability, etc.

company to generate profits in the future, stemming from the company's success (or failure) in 'capital maintenance,' as reflected in its balance sheet.

In Table 2, we have evaluated IFRSs against the principles generally considered to be suitable for corporate taxation purposes. We conclude that the accounting profit determined in conformity with IFRSs would require a significant number of adjustments to serve as a relevant tax base (taxable profit). As the UK example demonstrates (refer to Section III.B.9), this does not result in a more simplified system or a reduction in compliance costs.

Table 2: Evaluation of IFRSs as a Basis for Tax Accounting

Criteria	***Evaluation***
Neutrality[32]	IFRSs generally appear to meet the test of neutrality, i.e. IFRSs imply a certain degree of symmetry in the recognition of a transaction, meaning that positive and negative components of the tax base generally have a symmetrical treatment when they have a similar nature.
Simplicity	IFRSs are much more complex than most of the current financial accounting systems in the EU, above all in the crucial area of financial instruments. A move towards basing tax accounting on IFRSs is hardly likely to produce greater simplicity in the tax system concerned. The system will almost inevitably become more complex, either as a result of IFRSs being followed (leading to the complexity of IFRSs being incorporated into the tax system) or as a result of there being a need to introduce a host of detailed measures into the tax system to adjust out specific parts of IFRSs.
Enforceability	An enforceable system has to define with certainty which items are included in taxable profit and clearly limit taxpayer discretion in implementing accounting techniques that will affect taxable profit. In areas where IFRSs require fair value accounting (e.g., in the measurement of financial instruments), IFRSs run counter to the requirement of certainty.
Tax capacity (realization) and revenue position	IFRSs are not designed to meet the objectives of a tax accounting system (as clearly recognized in paragraph 6 of the IASB Framework). Significant adjustments to the IFRS-based profit or loss for the year would be needed in order to produce an acceptable outcome from a corporate income tax perspective.

32 It should be noted that the concept of 'neutrality' as defined within this paper is unrelated to the concept of 'neutrality' defined in the IASB Framework, i.e. "To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome."

Public policy	IFRSs are developed by the IASB, a private sector organization. Governments would need to cancel out an IFRS treatment and provide an alternative set of rules whenever they want to use corporate income tax as a policy tool. In turn, this would add to the complexity of the system.
Cost of reform	Evidence to date would suggest the transition to IFRSs can be potentially very problematic with significant identifiable cost in the time and education of all parties involved from the tax authorities to the tax preparers. While within this paper we have discussed the situation within a specific number of Member States, in practice each Member State should make available sufficient resources to investigate the specific consequences of making significant policy decisions on the (dis)association of tax and accounting policies based on the current situation within their Member State and the potential outcome of EU discussions on the CCCTB (refer to Appendix II).

B. Evaluating the Relationship between Financial and Tax Accounting

As noted in this paper, the policy elections regarding tax and financial accounting can hardly be made in isolation. The stronger the relationship between tax and financial accounting (e.g., Type 3 jurisdictions such as Germany) the more important it is to consider financial and tax accounting policy elections in tandem.

B.1 Appropriateness of the Relationship between Financial and Tax Accounting

While tax policymakers could establish systems to identify and, if relevant, cancel out the effects of financial accounting policy elections upon tax accounting (e.g., the introduction of fair value accounting), this paper recommends that they revisit the existing degree of relationship between tax and financial accounting in their jurisdiction. As evidenced by the case studies in Section III, accepting the status quo, particularly in Member States where there is a strong relationship, may have detrimental consequences, including:

» unintended consequences on the economy;
» unforeseen effects on tax collections;
» the development of a yet more complex tax accounting system; or
» the maintenance of a financial accounting system which may not be responsive to the needs of a modern market economy.

B.1.1 Unintended Consequences on the Economy

Financial accounting, in particular IFRSs, is changing to address the evolving needs of users of financial information. As discussed in Section I.B.4, the EU decided in 2002 to embrace IFRSs for consolidated accounts of publicly traded companies. In addition, some Member States require or permit the use of IFRSs in annual accounts. Finally, other Member States have adopted IFRSed national accounting standards. As a consequence, changes in IFRSs directly or indirectly influence Member States' financial accounting systems.

In Member States where there is a strong relationship between tax accounting and financial accounting, amendments to IFRSs and/or national accounting standards may have a knock-on effect on the determination of taxable profit. As the UK experience with securitization demonstrates (refer to Section III.B.9.3 above), unless that knock-on effect is anticipated and possibly cancelled out, an innocuous change to financial accounting may threaten an economic activity.

B.1.2 Unforeseen Effects on Tax Collections

Likewise, there may be unforeseen effects on tax collections. This is particularly the case where a Member State requires or permits the use of IFRSs in annual accounts (as opposed to IFRSed national accounting standards), since changes to IFRSs become automatically applicable, i.e. the Member State has no control over changes to financial accounting requirements.

In such circumstances, if the strong relationship between financial and tax accounting is maintained, it is also important to establish a system to capture changes to IFRSs in order to anticipate and possibly cancel out the effect these changes may have on taxable profit and, hence, tax collections by the Government.

B.1.3 Development of a Complex Tax Accounting System

One point which emerges clearly from the above is that it is almost inconceivable that IFRSs could be adopted wholesale and without qualification as a basis for the determination of taxable profit. Rather, if a tax accounting system is to be aligned to any degree with IFRSs (financial accounting), this will almost inevitably involve selecting certain features of IFRSs which provide a workable basis for computation of taxable profit.

The resulting tax accounting system will almost inevitably become more complex, either as a result of IFRSs being followed (leading to the complexity of IFRSs itself being incorporated into the tax accounting system) or as a result of there being a need to introduce a host of detailed measures into the tax accounting system to adjust out specific parts of IFRSs.

B.1.4 Maintaining an Ill-Adapted Financial Accounting System

The three points above are predicated on the assumption that financial accounting is permitted to meet the evolving needs of users of financial reporting. In other words, it assumes that tax accounting does not hinder developments in financial accounting. However, as several case studies show, some Member States give preference to tax policy (tax accounting) over financial reporting (financial accounting). In those instances, in order to avoid tax consequences (where there is a strong relationship between tax and financial accounting) these Member States decide not to modernize their financial accounting system.

This policy decision, while maintaining the status quo from a tax accounting point of view, may well result in maintaining a financial accounting system which is ill-adapted to the evolving needs of users of financial reporting. For example, it may maintain recognition and measurement principles for the preparation of annual accounts which do not result in a true and fair view because they fail to present fairly and truly certain transactions a company enters into (e.g., business combinations).

In that context, it is noteworthy that Member States with a small degree of relationship between financial and tax accounting, were generally more open to requiring or allowing companies to use IFRSs for the preparation of their annual accounts as permitted by Article 5 of Regulation (EC) No 1606/2002. Table 3 illustrates this trend, categorizing the Member States included in our pan-European survey (except Estonia) based on the typology described in Section III.A.

Table 3: Relationship between Financial and Tax Accounting and Use of IFRSs for Annual Accounts

Relationship between financial and tax accounting	Use of IFRSs not permitted	Use of IFRSs permitted	Use of IFRSs required
Type 1 [33]			
Type 2			
Type 3	Belgium France Germany Luxembourg	United Kingdom	
Type 4		Denmark Poland The Netherlands	

B.2 Policy Decision about the Degree of Relationship

As a consequence, this paper recommends that, right at the outset, significant consideration be given to the macro-economic implications of associating or disassociating tax and financial accounting. This decision should only be made after considering these implications at the highest level within the relevant government agencies and a thorough consultative interaction between these agencies and the relevant private sector advisers and interest groups.

In this paper, we have shown that a strong statutory relationship between financial and tax accounting may have negative consequences, resulting in financial and/or tax accounting systems failing to achieve their objectives. However, a few additional considerations may help policymakers in evaluating the appropriate degree of relationship between tax and financial accounting given the circumstance of their Member State:

- the Member State's current situation (historical/tradition and economic);
- the case for associating tax and financial accounting,

B.2.1 The Member State's Current Situation

The case for (dis)associating tax and financial accounting must be viewed with the current situation in mind. It is unlikely that a Member State will want to start from scratch and develop a brand new tax accounting system based on what is considered to be the optimal tax accounting system. Arguments for disassociating can be skewed in some Member States when considering the

33 Refer to the typology set out in Section III A.

strong tradition of association. The consequences of (dis)associating tax and financial accounting are not the same for all Member States.

Practical implementation issues should be considered. The lessons learned by other Member States can offer key insights to the process of disassociating financial and tax accounting. Evidence to date would suggest that this is a complex and difficult process requiring significant resources from tax authorities, tax practitioners, and tax preparers. The transition to a new regime can be potentially very problematic with significant identifiable cost in the time and education of all parties involved from the tax authorities to the tax preparers.

B.2.2 The Case for Associating Tax and Financial Accounting

"The case for alignment is simple and *prima facie* attractive. It is based on the view that the alignment brings simplicity, cuts compliance costs, and reduces avoidance."[34] This paper contents that this argument becomes less relevant when financial accounting, as it relates to annual accounts, is influenced by IFRSs.

To sum up, the lessons learned from the nine Member States we surveyed would suggest that one should be very cautious about broad-brush discussions of tax accounting and IFRS. When it comes to the hard reality of drafting tax accounting rules based on IFRSs, all of the major issues arise out of points of detail on technical accounting matters. Consequently, unless such points of detail are ever present in policy discussions (and even in high-level policy discussions), there will be a danger of missing the issues which will turn out to be most important in practice.

Policymakers should insist that any presentations that are made to them on tax and IFRSs should always contain specific references to specific technical issues in specific accounting standards. It follows from this that a combination of different types of expertise is absolutely crucial and indispensable in order to be able to identify IFRS-related tax issues and work out how to resolve them. This requires a combination of:

» accounting experts with a genuine working knowledge of IFRS;
» tax experts; and
» commercial experts with genuine working knowledge of the areas of business that are affected by the tax measures under discussion.

34 Freedman, Judith, *Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges*, eJournal of Tax Research Vol. 2 No.4 – 2004, p. p.74.

While this paper discussed the situation within a specific number of Member States, in practice each Member State should make available sufficient resources to investigate the specific consequences of making significant policy decisions on (dis)associating tax and financial accounting based on the current situation within their Member State and the potential outcome of EU discussions on the CCCTB.

In this Section, we have set forth a proposed approach for tax policymakers to develop an optimal tax accounting system within the constraints of international law, EU law, and existing practices. In that context, we recommended a two-step process, including: (i) agreement on the overall policy objectives of financial and tax accounting; and (ii) an evaluation of the appropriateness of the existing degree of relationship between financial and tax accounting based on their respective objectives.

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Appendix I

Planned Implementation of Regulation (EC) No 1606/2002 in the EU and EEA[35]

	Austria	Belgium	Cyprus	Czech Rep.	Denmark	Estonia	Finland	France	Germany
Status of the implementation of IAS	Final law	Final Law	Final law, see note 1	Final law	Final law	Final law	Final law	Final law	Final law
***Article 5(a) of the IAS Regulation* – Listed Companies** **1.** Will you use the option to **permit** IAS in the **annual accounts** for listed companies?	No	See note 2	No	No	Fin. entities: Yes Other entities:Until 2009: YesAfter 2009: No	No	Yes	No	Yes, see note 3
2. Will you use the option to **require** IAS in the **annual accounts** for listed companies?	No	See note 2	Yes	Yes	Fin. entities: No Other entities: Until 2009: No After 2009: Yes	Yes	No	No	No
***Article 5(b) of the IAS Regulation* – Other Companies** **1.** Will you use the option to **permit** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes, all companies	Yes, all companies	No	Yes All types of companies	Yes, all companies	Yes, all companies	Yes, all companies	Yes	Yes, all companies

35 Extract of the implementation tables available at http://ec.europa.eu/internal_market/accounting/ias_en.htm#options; current as of May 2006.

	Austria	Belgium	Cyprus	Czech Rep.	Denmark	Estonia	Finland	France	Germany
2. Will you use the option to **require** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	No	Yes, for credit institutions	Yes, all companies	No	No	Yes. Credit institutions, insurance undertakings, financial holding companies, mixed financial holding companies, investment firms	No	No	Yes, companies, which have filed for a listing
3. Will you use the option to **permit** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No	See note 2	No	No	Yes, all companies	Yes, all companies	Yes, all companies, see note 4	No	Yes, all companies, see note 3
4. Will you use the option to **require** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No	See note 2	Yes, all companies	No	No	Yes. Credit institutions, insurance undertakings, financial holding companies, mixed financial holding companies, investment firms	No	No	No

Notes:

1. Cyprus: Compliance with IAS has been mandatory since 2003.
2. Belgium: To be examined with tax and legal aspects.
3. Germany: For purposes of information only. Financial statements that are in line with national accounting law will continue to be required for purposes of profit distribution, taxation and financial services supervision.
4. Finland: Application of national law will be mandatory for insurance companies in annual accounts for a transition period.
5. Czech Rep.: Yes, effective from the first accounting period following after Accession Treaty comes into force, for companies mentioned above.

	Greece	Hungary	Ireland	Italy	Latvia	Lithuania	Luxem-burg	Malta	Nether-lands
Status of the implementation of IAS	Final law	Final law	Final law	Final law	Final law	Final law	Final law and law proposal, see note 6	Final law, see note 7	Final law
***Article 5(a) of the IAS Regulation* – Listed Companies** **1.** Will you use the option to **permit** IAS in the **annual accounts** for listed companies?	No	No, see note 8	Yes	No	No	No	Yes	No	Yes
2. Will you use the option to **require** IAS in the **annual accounts** for listed companies?	Yes	No	No	Yes, except for insurance, see note 9	No, see note 10	Yes	No	Yes	No
***Article 5(b) of the IAS Regulation* – Other Companies** **1.** Will you use the option to **permit** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes, see note 11	Yes, all types of companies within the scope of Act of Accounting	Yes, probably all types	Yes, except for small enterprises	Yes, all types	No	Yes	No	Yes, all types
2. Will you use the option to **require** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	No	No	No	Yes, some companies, see note 12	Yes, banks, insurance enterprises, other supervised fin. inst.	Yes, for banks and their controlled fin. institutions	No	Yes	No

	Greece	Hungary	Ireland	Italy	Latvia	Lithuania	Luxem-burg	Malta	Nether-lands
3. Will you use the option to **permit** IAS in the **annual accounts** for other companies? If yes, what type of companies?	Yes, see note 11	No, see note 13	Yes, all bar companies not trading for gain	Yes, except for insurance. , small enterprises and required companies	No	No	Probably yes, probably all types	No	Yes, all types
4. Will you use the option to **require** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No	No	No	Yes, some companies, see note 14	Yes, banks, insurance enterprises, other supervised fin. inst.	Yes, for banks and their controlled fin. institutions	No	Yes	No

Notes:

6. Luxembourg: final law for banks and insurance companies.
7. Malta: Compliance with IFRSs has been mandatory for all companies since 1995.
8. Hungary: The application of IFRSs for informal purposes is permitted, and the listing rules in some cases require the application of IFRSs. Nevertheless the companies are obliged to prepare annual accounts according to the Accounting Act. Changing of position is not anticipated until the tax and legal issues are solved.
9. Italy: Listed insurance enterprises must comply with IFRSs only if they do not draw up consolidated accounts.
10. Latvia: Companies listed in official list have to prepare separate IAS annual accounts for listing purposes only.
11. Finland and Greece: Companies, which are audited by certified auditors.
12. Italy: Supervised financial companies; companies with financial instruments widely distributed among the public; insurance companies.
13. Hungary: It is permitted to apply IFRSs for informal purposes; however the companies are obliged to prepare annual accounts according to the Accounting Act. It is not anticipated to change position before the tax and legal issues are solved.
14. Italy: Supervised financial companies; companies with financial instruments widely distributed among the public.

	Poland	Portugal	Slovakia	Slovenia	Spain	Sweden	UK	Iceland	Liechten-stein	Norway
Status of the implementation of IAS	Final law	Final Law	Final law	Final Law	Final law	Final law	Final law	Final law	Final law	Final law
Article 5(a) of the IAS Regulation – **Listed Companies** **1.** Will you use the option to **permit** IAS in the **annual accounts** for listed companies?	Yes	Yes, except for banks and financial institutions	No	Yes	No	No	Yes	Yes, for the years 2005 and 2006	Yes	Yes
2. Will you use the option to **require** IAS in the **annual accounts** for listed companies?	No	Yes, after 1/1/2007 if they don't prepare consolidated accounts, see note 15	No	No	No	No	No	Yes, from 2007	No	No
Article 5(b) of the IAS Regulation – **Other Companies** **1.** Will you use the option to **permit** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes, 1) companies having filed for admission to public trading; 2) any parent comp. being a subs. of another parent u/t preparing	Yes, all types	Yes	Yes, all types of companies which decide to use IFRSs for at least 5 years	Yes, all types	Yes, all types	Yes, all types of companies except for the charity sector	Yes, for medium sized and big companies from 2005	Yes, all types	Yes, all types

	Poland	Portugal	Slovakia	Slovenia	Spain	Sweden	UK	Iceland	Liechten-stein	Norway
	its cons. acc. in line with IAS									
2. Will you use the option to **require** IAS in the **consolidated accounts** for other companies? If yes, what type of companies?	Yes, banks	Yes, for banks and financial institutions in 2006	Yes, all types16	Yes, for banks and insurance companies	No	No	No	No	No	No
3. Will you use the option to **permit** IAS in the **annual accounts** for other companies? If yes, what type of companies?	Yes, 1) companies having filed for admission to public trading; 2) companies whose parent u/t prepares its cons. acc. in line with IAS	Yes, companies within the scope of consolidation of an entity who applies IFRSs	Yes, all companies of public interest	Yes, all types of companies which decide to use IFRSs for at least 5 years	No	No	Yes, all types of companies except for the charity sector	Yes, for medium sized and big companies from 2005	Yes, all types	Yes, all types

	Poland	Portugal	Slovakia	Slovenia	Spain	Sweden	UK	Iceland	Liechten-stein	Norway
4. Will you use the option to **require** IAS in the **annual accounts** for other companies? If yes, what type of companies?	No	No	No	Yes, for banks and insurance companies	No	No	No	No. If the consolidated groups are permitted to use IAS in their consolidated accounts (according to question 1 in 5(b)), the annual accounts of each subsidiary are required to use IAS from 2007	No	No

Notes:

15. However, assurance companies, banks and financial institutions may comply with the requirements by preparing IFRS figures as additional information to their Statutory Accounts 16 Slovakia: Application of IAS for preparing consolidated accounts for all companies (listed and non-listed) from the year 2005.

Appendix II
The Common Consolidated Corporate Tax Base

As discussed above, Regulation (EC) No 1606/2002, requiring publicly traded companies to prepare their consolidated accounts in accordance with IFRSs from 2005 signified an important step towards the harmonization of financial accounting in the EU. The much publicized harmonization of financial accounting also coincided with the intensification of the debate as to whether the EU should harmonize tax accounting across its Member States and whether IFRSs could provide a starting point for this harmonization process eventually leading to a 'common consolidated corporate tax base' (CCCTB). [36]

The CCCTB may influence the options available to tax policymakers in EU Member States regarding their tax accounting system either directly (if it were adopted and required, as opposed to permitted) or indirectly (e.g., it would influence generally accepted practices in the EU).

A. The Rationale for the CCCTB

The basic concept of a CCCTB was outlined in September 2004 by the European Commission in a non-paper, *A Common Consolidated EU Corporate Tax Base*. The non-paper outlines that the fundamental concept would "provide companies with establishments in at least two Member States with the possibility to compute their group taxable income according to one set of rules, those of the new EU tax base." The initiative seeks to reduce the tax-related compliance costs of such companies and effectively tackle the "tax obstacles that are currently still hindering companies in developing their EU-wide activities, e.g. as resulting from transfer pricing rules, the lack of cross-border loss compensation." The non-paper emphasizes that the lack of a CCCTB within the EU is a serious competitive issue in light of the Lisbon[37] objectives and that without such a tax base other global economies would continue to hold a distinct competitive advantage.

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36 Refer to http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm for additional information.

37 The European Council met in Lisbon in March 2000, to discuss the achievements of the EU since the adoption of the Maastricht Treaty in 1992. Following the Lisbon meeting, the Council issued the Lisbon Agenda, which comprised a ten-year strategy for transforming Europe into the world's leading knowledge economy. For additional information on the Lisbon Agenda, refer to Gielen, van der Plaats, Hirata, Tranter (2007), op. cit, p 13.

B. Determination of the CCCTB using IFRSs

The harmonization of financial accounting provided a starting point for discussions on a CCCTB within the EU. Although the fundamental purpose of IFRS consolidated accounts is not to support computations prepared for taxation purposes but rather to meet the needs of investors as providers of risk capital to an entity,[38] there is a general recognition that IFRSs provide the only 'common' financial reporting framework across the EU. In this context, the European Commission established a Working Group to examine from a technical perspective the definition of a common consolidated tax base for companies operating in the EU, to discuss the basic tax principles, to discuss the fundamental structural elements of a common consolidated tax base, and to discuss other necessary technical details such as a mechanism for 'sharing' a consolidated tax base between Member States.

The objective of a CCCTB was and is politically sensitive within the EU. Some Member States consider tax law to be outside the remit of the European Commission and to be an exclusively national issue. This view is sometimes supported by Member States which have gained a competitive advantage within the EU by holding domestic corporate tax rates low. However Member States were encouraged to join the Working Group by signaling that participation in the Working Group does not commit to implementing a CCCTB.

The Working Group has, up to the end of 2006, met on nine occasions. The primary technical focus at this stage is in the harmonization of individual companies' tax bases across the EU, a major step forward in itself. The European Commission denies that the harmonization of tax rates is under consideration but this is seen by some as a likely second stage. The basic principle expressed is that harmonizing the rules for calculating the corporate tax base does not require an overall harmonization of the tax administration. The Working Group has discussed in detail how the CCCTB could be developed and the technical committees have worked through complex issues. For example, in 2006, areas such as taxable income and revenue recognition were discussed drawing on principles set out in IAS 18, *Revenue*.

However, because IFRSs are not required or permitted to be used in preparing annual accounts of companies in all Member States (see Appendix II), IFRSs are only useful to a certain point in developing a CCCTB. The European Commission has stated that the rules governing the content of the CCCTB will be applicable "whether, at the national level, the starting point for companies preparing their tax accounts is accounts prepared in accordance with

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38 Refer to *Framework for the Preparation and Presentation of Financial Statements,* International Accounting Standards Board, paragraph 6.

IFRSs or national accounting standards." In addition, the European Commission has stated that 'IFRSs will therefore be used only as a tool in designing the base because [IFRSs] provide a common language and some common definitions.' Also, the European Commission emphasized that a number of IFRS recognition and measurement principles, which do not suit the CCCTB, will not be imported into the CCCTB. Further, the European Commission is not proposing to establish a direct and formal link to the constantly changing IFRSs.

The Working Group recently reiterated that "the CCCTB is an important contribution of the taxation policy to the achievement of the Lisbon objectives." The Working Group noted that the key advantages of the CCCTB include: (i) reducing compliance costs for companies operating cross-border; and (ii) simplifying and modernizing the tax environment leading to increased growth and competitiveness of EU enterprises. The European Commission reiterated that any CCCTB would not "interfere with Member States' sovereignty on tax matters, and in particular on their freedom to set the tax rates that best fit their domestic policies in terms of public expenditures, provision of services and financing of the social systems." The European Commission emphasized that the "creation of a common tax base will not remove fair tax competition among Member States, but would probably make tax competition more transparent." A comprehensive Community legislative measure regarding the CCCTB is expected by the end of 2008.