Successfully Connecting Financial Reporting and Tax

A&ACoP "KEEPING FINANCIAL REPORTING RELEVANT: FOCUS ON MICRO, SMALL AND MEDIUM ENTERPRISES"

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CFRR
Centre for Financial Reporting Reform

WORLD BANK GROUP
Governance

STAREP
Strengthening Auditing and Reporting in the Countries of the Eastern Partnership

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Objective of the session

» discuss the need for simplification of relationship between tax and accounting

» outline the key messages for consideration by policy makers for a better connection between corporate financial reporting and tax requirements

What is the fundamental difference between the tax law and the accounting law/accounting standards?

» the fundamental difference is the purpose for which these laws are written

» the purpose of the tax law - define taxpayers’ liabilities towards the state - profit/taxable income generated

» the purpose of the accounting law/accounting standards - define accounting principles for keeping accounting and preparing financial statements (true and fair view) – for economic/financing decisions

Exemple of difference: Measurement after initial recognition - Amortization

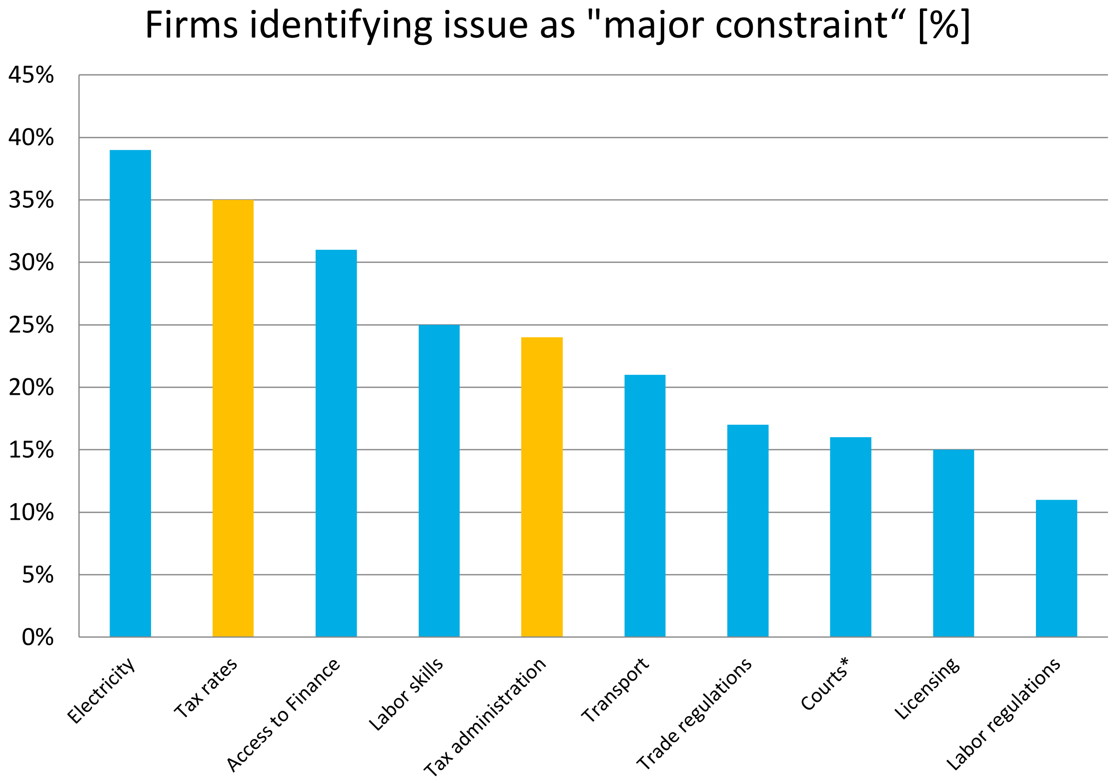
GAAP	Tax regulation	IFRS
Intangible or tangible assets - definite useful life period. Initial value is reduced by amortization over economic useful life based on: a) pace of technical and economic progress; b) legal or other limitations of useful life period; c) expected net selling price of a substantial residual of the item of property, plant and equipment upon liquidation	Intangible assets are amortized by flat rate, set forth in tax regulations. Maximum acceptable rates as per CIT Act are: a) Software licenses and copyrights – 50% b) Licenses for film projections, radio and television broadcasting – 50% c) Costs of completed development works – 100% d) Other intangible assets – 20% e) cooperative member's ownership right to living accommodation, a cooperative member's right to business premises and a right to a single-family house in a housing cooperative – 2,5%.	IFRS identify assets of definite and indefinite useful life. The latter are not amortized, but tested for impairment every year.

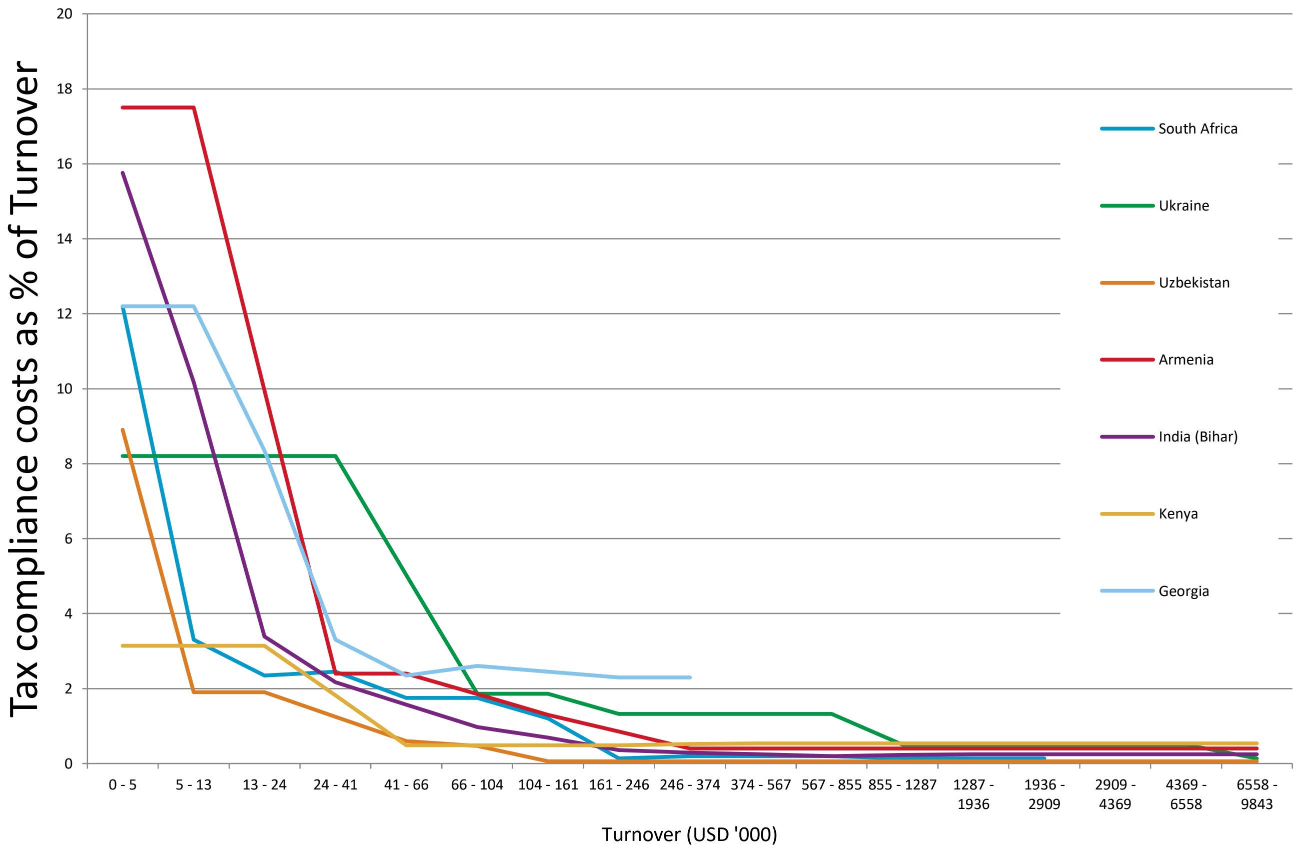
» Tax regulations do not envisage a concept of use period and useful life - they set specific amortization rates

» In practice, tax amortization rates may differ from accounting amortization rates

Key point 1: Simplify both tax and financial reporting requirements

Importance of tax & accounting simplification/alignment for MSMEs…





There is broad variation in MSME tax regime design

Region	# Countries analyzed	Countries operating presumptive regimes
European Union	21	8
Transition countries	19	16
The Americas	19	16
Africa	25	23

- From very simple patent taxes to full application of standard regime
- From high VAT registration threshold to no threshold at all
- From exemption of micro businesses to uniform treatment of all MSEs.
- From substituting income taxes only to covering social security contributions
- Inclusion or exclusion of small legal entities from presumptive tax regimes?
- From practically exempting most MSEs from tax audit to comprehensive audit coverage

Making it easy to comply

- Reducing tax and accounting compliance costs, especially for small and micro entities:
  - Simplifying accounting policies
    - e.g. simplified methods to account for inventories, depreciation by pooling of assets, provisions for receivables
  - Simplified accounting regimes
    - e.g. allowing “cash accounting” or directly expensing items which should normally be capitalized
  - Reduced filing & payment requirements
    - e.g. larger companies make more frequent tax payments, while smaller ones are required to make them less frequently

Making it easy to file

- Introducing or enhancing electronic filing systems
  - Possibility to make on line, real time filing
- Implementing single filing mechanisms
  - Tax and financial reporting information is filed in a single source institution

Some examples

Serbia: Achieved full implementation of electronic systems for VAT and social contributions

Belarus:
Reduced compliance time by changing its quarterly corporate income tax compliance structure from a calculation based on forecast to one based on actual results. Also some differences in expense recognition for VAT and income tax had been eliminated

Montenegro:
Taxpayers use of electronic payment systems caught up with their use of electronic filing system and majority of companies fully use the electronic platform for social security contributions

Tajikistan: Problems associated with introduced electronic system had been remedied

Key point 2: Reporting trends are moving towards greater transparency

More is being reported

- Various stakeholders are interested in a company taxes
  - e.g. media, government, tax, general public
- Transparent tax reporting can create trust and enhance a company reputation
  - Companies contribute to economies in which they operate by paying taxes (on profits, employment, etc.). Explaining this contribution can help stakeholders better understand the benefits provided by business
- A step towards integrated reporting
  - Trends emerge for reports to turn more strategic and look at the wider impact of business beyond the current focus on financial information
- Auditor reporting is becoming more informative – e.g. listed companies will need to report on Key Audit Matters (KAM)

Increasing (tax related) pressure for further transparency

» G20/OECD BEPS – Action 13

» Core documentation requirements covering:

i. A master file with high-level info on an MNE's global business operations and TP policy;

ii. A local file containing the detailed country specific transaction-based transfer pricing information;

iii. A global report providing Country-by-Country (CbC) information on key performance and input measures of an MNE's activities in all jurisdictions of the group's operations

» In addition, "4th tier" – transfer pricing disclosures, sometimes with independent sign-off requirement (Denmark, India)

Key point 3: Financial statements are useful tools for tax analysis

Importance of financial information for administering/ monitoring international tax compliance

- Availability of financial information is critical for implementing the Arm's length principle (ALP):
  - *"Simply put, the application of a principle that relies on a comparison of the conditions in controlled transactions with the conditions in comparable uncontrolled transactions is extremely difficult, if not impossible, where the requisite information is not available or does not exist."*

A glimpse at the challenge: Combined review of several common commercial databases in 2015

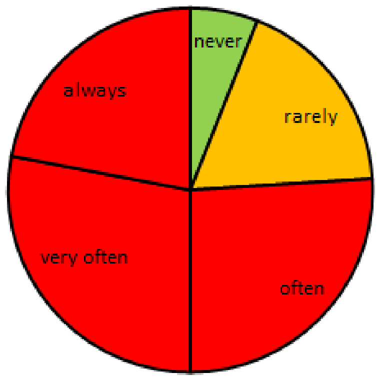
# of independent records with revenue and net margin information	Countries	# of Economies
=<10	Afghanistan (AF), Albania (AL), Algeria (DZ), Andorra (AD), Angola (AO), Anguilla (AI), Antigua and Barbuda (AG), Armenia (AM), Aruba (AW), Bahamas (BS), Barbados (BB), Belize (BZ), Benin (BJ), Bhutan (BT), Brunei Darussalam (BN), Burkina Faso (BF), Burundi (BI), Cambodia (KH), Cameroon (CM), Cape Verde (CV), Central African Republic (CF), Chad (TD), Comoros (KM), Congo (CG), Congo, Democratic Republic of (CD), Costa Rica (CR), Côte d'Ivoire (CI), Cuba (CU), Curaçao (CW), Djibouti (DJ), Dominica (DM), Dominican Republic (DO), East Timor (TL), El Salvador (SV), Equatorial Guinea (GQ), Eritrea (ER), Ethiopia (ET), Fiji (FJ), Gabon (GA), Gambia (GM), Georgia (GE), Gibraltar (GI), Grenada (GD), Guatemala (GT), Guinea (GN), Guinea Bissau (GW), Guyana (GY), Haiti (HT), Honduras (HN), Kiribati (KI), Korea, Democratic People's Republic of (KP), Kosovo (KV), Kyrgyzstan (KG), Lao People's Democratic Republic (LA), Lesotho (LS), Liberia (LR), Libya (LY), Liechtenstein (LI), Macao (MO), Madagascar (MG), Malawi (MW), Maldives (MV), Mali (ML), Mauritania (MR), Micronesia, Federated States of (FM), Monaco (MC), Mongolia (MN), Mozambique (MZ), Myanmar/Burma (MM), Namibia (NA), Nauru (NR), Nicaragua (NI), Niger (NE), Palau (PW), Papua New Guinea (PG), Paraguay (PY), Rwanda (RW), Saint Kitts and Nevis (KN), Saint Lucia (LC), Saint Vincent and the Grenadines (VC), Samoa (WS), San Marino (SM), Sao Tome and Principe (ST), Senegal (SN), Seychelles (SC), Sierra Leone (SL), Sint Maarten (SX), Solomon Islands (SB), Somalia (SO), South Sudan (SS), Sudan (SD), Suriname (SR), Swaziland (SZ), Tajikistan (TJ), Tanzania, United Republic of (TZ), Togo (TG), Tonga (TO), Turkmenistan (TM), Tuvalu (TV), Uganda (UG), Uzbekistan (UZ), Vanuatu (VU), Vatican City, State/Holy See (VA), Yemen (YE), Zambia (ZM)	106
10-100	Azerbaijan (AZ), Bahrain (BH), Belarus (BY), Bolivia (BO), Botswana (BW), Ecuador (EC), Ghana (GH), Iran, Islamic Republic of (IR), Iraq (IQ), Jamaica (JM), Kenya (KE), Lebanon (LB), Marshall, Islands (MH), Mauritius (MU), Moldova, Republic of (MD), Montenegro (ME), Morocco (MA), Nepal (NP), Nigeria (NG), Palestinian Territory (PS), Panama (PA), Qatar (QA), Syrian Arab Republic (SY), Trinidad and Tobago (TT), Tunisia (TN), United Arab Emirates (AE), Uruguay (UY), Venezuela (VE), Virgin Islands (British) (VG), Zimbabwe (ZW)	30

Combined review of commercial databases, October 2015

How is it dealt with in practice (Tax and TP practitioners)?

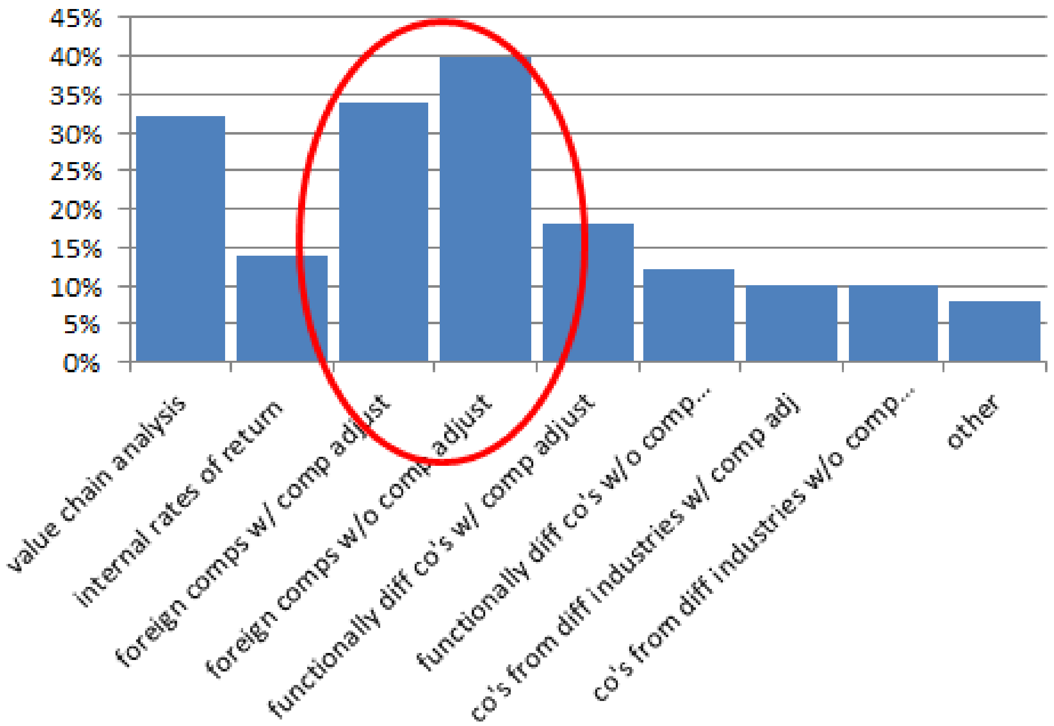
» Selected results of survey of over 50 transfer pricing practitioners, covering 25 countries in the EECA region:

How often do you face difficulties obtaining information on domestic comparables?



Is there any guidance/law on use of foreign comparables?

Approaches adopted/observed in absence of information on domestic comparables?



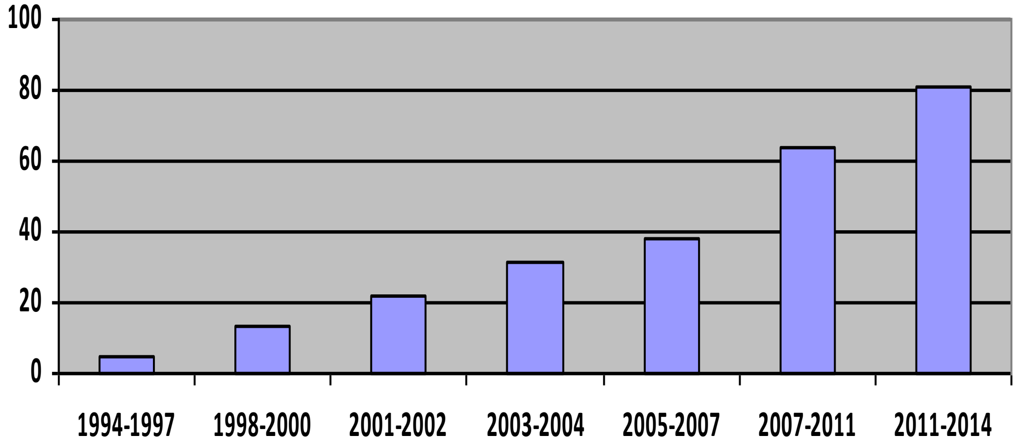
Example 1: Using financial information to understand tax treaty effects

» Reported Returns Comparing Similar Entities with Affiliates in a Low-Tax Treaty Partner to Those Without

Notes: Data sourced from BvD's Orbis Database (September 2015). Only companies with complete information from 2006-2014 selected. Four hundred and eighty-nine companies' treaty partner affiliates were matched on fixed assets with MNE subsidiaries non-affiliated to this specific treaty partner.

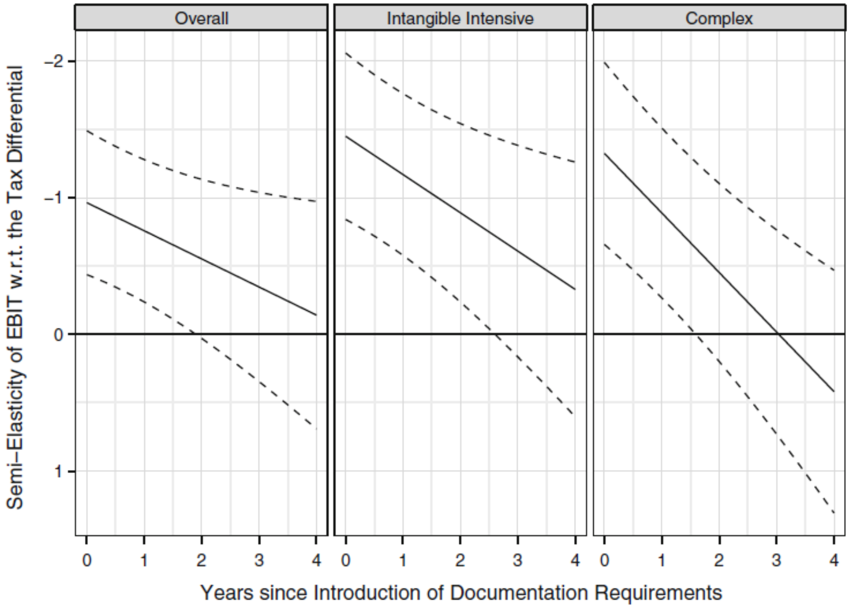
Example 2: Measuring the global effect of anti-abuse provisions

- The number of countries introducing, or updating, documentation requirements continues to increase:
  - During the period 1994–2014, the number of countries with "effective" transfer pricing documentation rules increased from 4 to more than 80



Source: International Transfer Pricing: From Implementation to Application (World Bank Group, *forthcoming*)

- We have some evidence on their effectiveness:



Mitigation effect for selected groups. The figure is illustrates the estimated elasticity of taxable profits with respect to the tax differential as a function of the presence of documentation requirements. The *first panel* shows the effect of documentation requirements for the whole sample. The *second (third) panel* present the effect for intangible intensive (highly complex) subsidiaries with an average level of complexity (intangible intensity). The *solid line* is the expected value. The *dashed lines* are 95 % confidence intervals

Source: Beer and Loeprick. 2015
"*Global profit shifting: Drivers and the Effect of Countermeasures*" ITAX

Key point 4: Introducing IFRS/IFRS for SMEs calls for better understanding of accounting matters by tax authorities

Effects of introducing Global Standards

» IFRS has introduced a new area of complexity in the financial and tax relationship:
  » Objectives of IFRS differ fundamentally than those of tax accounting
  » IFRS change over time and this imposes the need to capture these changes and their effect on taxable profit
  » IFRS have some complex accounting requirements that would lead to further complexity of the tax system
  » Level of IFRS expertise, i.e. number of accountants and tax professionals with a working knowledge on IFRS issues should increase
» The case for alignment where possible - brings simplicity, cuts compliance and reduced avoidance. But policymakers should also consider the practicalities.

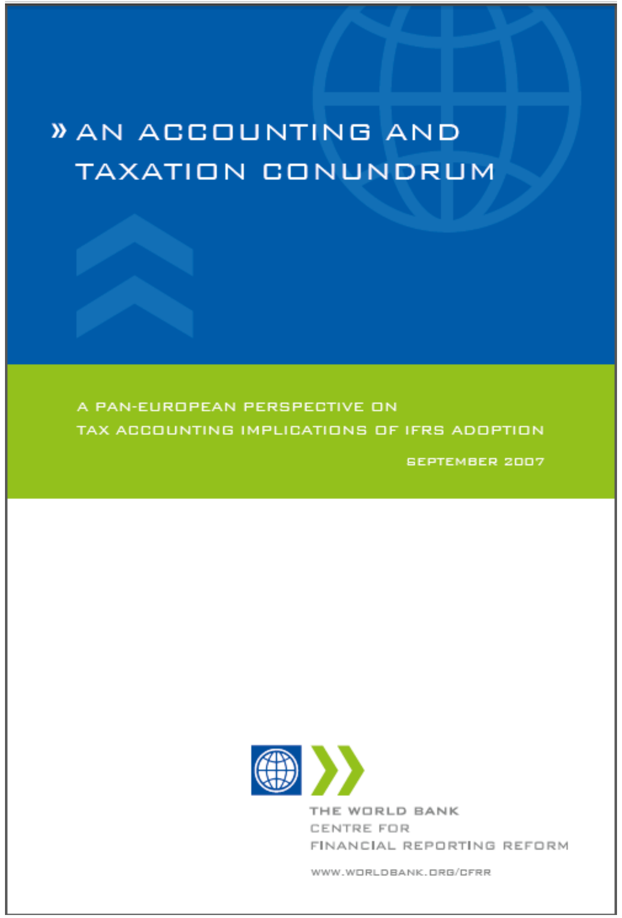
“An Accounting and Taxation Conundrum”

» This CFRR Resource discusses the adoption of a optimal tax accounting system and **sets out an approach to assist policymakers** in reviewing the tax accounting system in place

» Analyzes the **tax implications of IFRS adoption** on EU members states

» It also **highlights lessons learned** in member states with different tradition which can be useful outside the EU

» www.worldbank.org/cfrr



Analytical publication - Kazakhstan

» http://siteresources.worldbank.org/EXTCENFINREPREF/Resources/4152117-1277976014693/7214669-1295446446795/7677205-1350467773492/KZ-Jerp-Tax&acounitng-report-June2012-final-eng.pdf

Common Consolidated Corporate Tax Base (CCCTB)

- The Common Consolidated Corporate Tax Base is a single set of rules to calculate companies' taxable profits in the EU
- With the CCCTB, cross-border companies will only have to comply with one, single EU system for computing their taxable income, rather than many different national rulebooks
- Companies can file one tax return for all of their EU activities, and offset losses in one Member State against profits in another
- The consolidated taxable profits will be shared between the Member States in which the group is active, using an apportionment formula. ach Member State will then tax its share of the profits at its own national tax rate
- CCCTB project was re-launched by the Commission in October 2016. it is supposed that it will be implemented through a two-step process and will be mandatory for the largest groups in the EU

- *Additional details*: https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en

Conclusions

- In general, the closer alignment of tax and financial reporting rules helps to improve the incentives for businesses to apply more transparent and qualitative financial reporting standards
- In particular, the closer alignment of tax rules with SME financial reporting standards helps improve the quality of financial information, facilitate tax administration and reduce the cost to SMEs of doing business
- The relevant authorities need to establish a tax reconciliation process addressing the potential problems arising in situations where taxpayers apply various accounting standards as the starting point for calculating taxable profit, i.e. IFRS, IFRS for SMEs, NASs

Questions?