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Accounting and taxation

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Introduction

The connection between tax and accounting is a complex topic with many dimensions. It is a very dynamic area. One explanation for this is changes within accounting on the international level. The most important change has been the adoption of International Financial Reporting Standards (IFRS) as the mandatory standard for consolidated accounts in listed companies within EU. But the introduction of IFRS also might affect financial accounting in unlisted companies. This creates a challenge for tax law and a need to revisit the theoretical and practical foundations for the use of accounting as a starting point for taxation of companies.

I will in this paper discuss the effects of IFRS on tax accounting.[1] I will do this in five parts. First, I will give some comments on delimitations and terminology. Second, I will discuss the idea of using financial accounting as a starting point for tax accounting, setting a frame for the analysis in the next three parts. After that I will discuss the use of IFRS in Member States (MS) within EU and the possible effects on tax accounting. In part four I reverse the perspective and look at actual and potential changes in tax legislation due to IFRS. Lastly, I will make some comments on future developments. I will touch upon the work on the Common Consolidated Corporate Tax Base (CCCTB) within EU and I will also say a few words regarding tax and accounting in Small and Medium-sized Entities (SMEs), a question of general interest in Europe.

When discussing the situation in MS, I will use examples from some countries, especially UK, Ireland, Finland and Sweden, slightly favouring the last country mentioned.[2] I have not made a systematic comparative study but I hope that the questions I raise together with the examples will be sufficient enough to form a basis for a general discussion of the topic.

Terminology and delimitations

First some words on the terminology I will use. When I talk about accounting I will differentiate between *financial accounting*, governed by accounting legislation and accounting standards (for example IFRS) and *tax accounting*, governed by tax

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[1] See regarding this topic Schön, W, International Accounting Standards – A “Starting Point” for a Common European Tax Base?, European Taxation (2004) pp. 426-440 with further references and Freedman, J, Aligning Taxable Profits and Acconting Profits: Accounting standards, legislators and judges, eJournal of Tax research, Volume 2, Number 1 (2004) pp. 71-99 with further references.

[2] The countries mentioned have some connection between financial accounting and tax accounting.

legislation. Financial accounting is for financial reports, tax accounting for tax returns. When I say that there is a *connection* between financial accounting and tax accounting, this means that a specific tax accounting question (for example income recognition or valuation of assets) is solved by Generally Accepted Accounting Practice (GAAP) in a country. This solution either follows from tax legislation or from court decisions. If a tax accounting question is *disconnected* this means that a specific question is solved by reference to a tax accounting rule in tax legislation or in case law which deviates from GAAP. GAAP will in this situation have no effect on tax accounting.

When talking about a connection between tax and accounting – what is or what can be connected? When defining a tax income concept there are two questions that have to be addressed – what should be taxed and when? The first question is generally viewed as an exclusive tax question. *What* is taxable income and what deductions should be allowed is matter for tax law. Principles and rules are usually set without regard to financial accounting as opposite to the question *when* an income should be taxed or a deduction allowed. In many tax systems principles of financial accounting have a direct or indirect influence on tax accounting.

There are some questions that are closely connected with the question when income should be taxed and expenses deducted. I am thinking about for example classification of assets and liabilities, deciding who is the owner of an asset etc. Those types of questions also have to be solved in financial accounting when drawing up the financial reports. Since the questions are similar to each other tax accounting might refer to national GAAP when solving them.

Accounting as a starting point for taxation

Accounting is a natural starting point for the taxation of companies. Both systems are aiming to identify an economic result of the business. Financial accounting principles and tax accounting principles are in many ways similar to each other but have different objectives.

Theoretical and practical motives for using financial accounting as a starting point for tax accounting

In tax theory, the definition of an income concept is very important in order to formulate a base for taxation. The Schanz-Haig-Simons definition of income is often used as a starting point. Income is defined as the increase in value of property rights available for consumption. But when looking into tax legislation there are few if any examples of countries using this concept consequently. Instead, other modified income concepts are used. The idea of using financial accounting as starting point for defining taxable income in companies is often motivated by a reference to that the financial accounts reflects “the (true) economic profit” of a company or something like that.[3] But there are also practical motives for using financial accounting as a starting point. One is basically that there is no alternative!

This will be put in focus when financial accounting changes. If for example historical cost is substituted for fair value as the main basis for valuation of assets in financial accounting, this will be difficult to handle for taxation for various reasons. The idea

[3] See also Schön, European Taxation (2004) p. 433.

of using financial accounting as a starting point for tax accounting is difficult to uphold regardless of the content of financial accounting. I believe that in most tax systems the idea is built on a number of explicit or implicit assumptions regarding the content of financial accounting and tax accounting that are similar to each other (historical cost, prudence etc.). Historically, the use of financial accounting as a starting point therefore has worked rather well. But developments in financial accounting create new challenges for tax legislators. This can be seen from the example of IFRS.

Connection between financial accounting and tax accounting

To what degree tax accounting is connected with financial accounting varies among countries. Accounting can be a practical starting point. Some countries, for example Sweden, UK and Ireland, have a *basic rule* in tax legislation that typically says that unless there is a specific tax rule, GAAP should be followed in tax accounting. The basic tax rule in other countries may be drafted in a different way. There might not be any explicit reference to GAAP (no formal connection). Instead, the basic tax rule might say something like that "tax accounting should clearly reflect tax income" etc.[4] What that is will be a matter of interpretation.

But the basic rule in tax legislation will not alone explain the relation between financial accounting and tax accounting in a specific country. The relation must be analyzed taking a number of factors into account:

- How many important tax accounting questions are covered by specific tax rules and what is left to the basic rule and is this rule connected to financial accounting or not (what is the scope of the basic rule vs. specific tax rules)?
- To what extent do specific tax rules deviate from financial accounting?
- To what extent are tax statutes interpreted in the light of financial accounting principles (with or without explicit reference to GAAP etc.)?
- How are gaps in tax legislation filled out (with or without explicit reference to GAAP etc.)?

The key question within one country would be – how much do tax accounting in substance deviate from GAAP? Tax accounting often "mirrors" financial accounting to some extent regardless of if there is an explicit connection or not. The major differences can often be explained by the use tax incentives, tax rules aiming to simplify tax accounting or the application of the realisation principle in tax accounting to an extent that does not match the use of the principle in financial accounting.

I will take Sweden as an example. This country is often classified as having a strong connection between tax and accounting. But important types of assets – financial instruments and real estate – are taxed according to rules for capital gains, which means that the realisation principle will be applied both for profits and losses. There is no connection to GAAP in tax law for those assets. Other types of important assets (stock in trade, construction contracts, machines and equipment and buildings) are covered by specific tax rules. But those tax rules are either incomplete or have to be interpreted. The result is that those areas can be described as "mixed". The valuation

[4] Schön, European Taxation (2004) pp. 430-432.

is partly governed by disconnected tax rules, partly by GAAP. The basic rule in Sweden states that Swedish GAAP should be followed for tax accounting purposes unless there are specific tax rules. GAAP will be followed in tax accounting in some important areas, mainly income recognition and provisions.

It might be somewhat misleading to say that the main rule is to follow GAAP for tax accounting purposes in Sweden. Instead, one could say that there is a residual competence for GAAP to solve unregulated tax accounting questions. But many of the explicit tax rules in Sweden are rather similar to those that are applied in financial accounting. Differences can be explained by use of tax incentives, generous depreciation rules for fixed assets, simplification of accounting and application of the realisation principle. So when describing the degree of connection one must decide if this should be done only looking at the basic rule or at tax accounting in total. The answer will be different depending of how the question is formulated.[5]

The situation in one country can be compared to the situation in other countries. My general impression is that even though there are differences regarding the wording of the basic rule and the content of specific tax rules, interpretations by the courts etc., the situation might be roughly the same in many countries.[6] But the "mix" of GAAP/specific tax rules can be different and there might be important differences regarding details.

The impact of IFRS on financial accounting

It is the capital markets and their need for information that is the driving force behind developments in international accounting (IFRS). It is the listed companies that are in focus. The need for more comparable information from those companies has been strong for many years.

Focus is on the consolidated accounts. One reason why there has been a truly international development is that there is basically no tax consequences attached to consolidated accounts. Instead, the "pure" investor perspective can be used when writing international accounting standards.

Theoretical developments in financial accounting

A number of changes have been undertaken in IAS/IFRS during later years. Some of them are a result of changes in the theoretical approach to financial accounting. An important development has been the increased focus on using a *balance sheet approach* when solving accounting questions. Simply speaking, there has been a shift in accounting from a transaction-based approach to a value-based approach. A transaction-based approach starts with the historical cost of assets, measurement of those costs over time, demands that income should be realised by disposal of assets and emphasizes matching of income and costs. Focus is on the income statement. A value-based theory focuses on the balance sheet, what is an asset or a liability and how they should be valued. The later approach allows assets to valued at fair value and no principal distinction is made between realised and unrealised income. The value-based theory defines income as the increase in equity adjusted for payments to and from owners of the company, often called "comprehensive income". This

[5] See Norberg, C, and Thorell. P, Redovisningsfrågor i skattepraxis (2007) (forthcoming).
[6] See Schön, European Taxation (2004) pp. 430-432 with further references regarding this question.

approach is comer closer to the Schanz-Haig-Simons definition of income discussed above that the traditional transaction-based approach in financial accounting. In that sense, tax theory and financial accounting theory on the IFRS-level are coming closer to each other.[7]

A second development, as a consequence of the shift to a balance sheet approach, regards the definition and interpretation of what is an *asset* or a *liability*. An asset is something that is expected to generate future economic benefits, either through disposal or future cash flows. No distinction is in principle made between different types of assets. A liability is a commitment that is expected to be settled by the disposal of resources containing economic benefits. Examples of how this new approach affects financial accounting are changes in the definition of intangible assets (IAS 38) and the possibility to carry deferred tax claims as an asset in the balance sheet (IAS 12).

IFRS and EU

EU adopted IFRS as the mandatory reporting standard for consolidated accounts for listed companies with effect from 2005.[8] EU left the option to Member States to use IFRS for consolidated accounts in unlisted companies and for the annual accounts of companies. Changes in the Fourth (annual accounts)[9] and Seventh Company Directives (consolidated accounts)[10] also open the possibility to use IFRS accounting principles in unlisted companies in Member States within the framework of national accounting legislation and national GAAP.[11]

IFRS and accounting in member states

The number of listed companies that have to use IFRS for consolidated accounts have been estimated to around 7 000.[12] Its up to the MS to decide when IFRS should be used in consolidated accounts in unlisted companies and in the annual accounts of companies. There are a number of possible alternatives for MS. In order to understand the effects not only national legislation has to be taken into account. It is also necessary to take national GAAP into account. Since taxation is normally based on annual accounts I will not discuss consolidated accounts.

It is important to make a difference between the use of “full IFRS” and IFRS accounting principles within national GAAP. If a country requires or permits use of “full IFRS” this means that all IFRS-standards must be applied in a complete way, including valuation rules and all disclosure requirements. If a country chooses to incorporate IFRS accounting principles into national GAAP, this can be done in a selective way. Some valuation rules might not be adopted and disclosure requirements “softened”. The alternatives can be seen from the following tables. I include Sweden as an example.

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[7] In the same direction Schön, European Taxation (2004) p. 433.

[8] Regulation 1606/2002/EC concerning the application of international accounting standards, adopted on 19 July 2002 by the European Parliament and the Council (often called the IAS Regulation).

[9] Fourth Council Directive 78/660/EEC.

[10] Seventh Council Directive 83/349/EEC.

[11] Changes were adopted through the so called Modernisation Directive (2003/51/EC) and the so called Fair Value Directive (2001/65/EC).

[12] See for example http//:ip-online2.ibfd.org/tns/docs/html/tns_2006-09-25_ifa_1.html, downloaded 2006-10-05.

Table 1: IFRS in annual accounts of listed companies in Member States – the example of Sweden

LISTED COMPANIES	**YES**	**NO**
1. Has MS used the option to **permit** "full" IFRS in the annual accounts for listed companies (as an alternative to national GAAP)?		X
2. Has MS used the option to **require** "full" IFRS in the annual accounts for listed companies?		X
3. Have national legislatiors/standard setters **incorporated** IFRS accounting principles into national GAAP for annual accounts in listed companies?	X (in parts)	
4 a. If the answer to question 3 is yes are those principles **mandatory** for annual accounts in listed companies according to national GAAP (alternatives are not permitted)?	X (in parts)	
4 b. If the answer to question 3 is yes can a listed company in the annual accounts **choose** between IFRS accounting principles or other accounting principles within national GAAP (alternatives are permitted)?	X (in parts)	

Table 2: IFRS in annual accounts of unlisted companies in Member States – the example of Sweden

UNLISTED COMPANIES	**YES**	**NO**
1. Has MS used the option to **permit** "full" IFRS in the annual accounts for unlisted companies (as an alternative to national GAAP)?		X
2. Has MS used the option to **require** "full" IFRS in the annual accounts for unlisted companies?		X
3. Have national legislators/standard setters **incorporated** IFRS accounting principles into national GAAP for annual accounts in unlisted companies?	X (in parts)	
4 a. If the answer to question 3 is yes are those principles **mandatory** for annual accounts in unlisted companies according to national GAAP (alternatives are not permitted)?	Not decided but probably only in parts and only for certain types of companies	
4 b. If the answer to question 3 is yes can an unlisted company in the annual accounts **choose** between IFRS accounting principles or other accounting principles within national GAAP (alternatives are permitted)?	Not decided but very probable (unless mandatory according to 4 a)	

Sweden neither permits nor demands use of "full IFRS" for annual accounts. In accounting legislation, the use of fair value accounting is permitted but not mandatory for financial instruments to the extent fair value accounting is permitted under EU Directives (IAS 39). The use of fair value accounting for other assets in the annual accounts has been suspended in Sweden until 2009 due to uncertainty of the consequences for taxation and company law. This means that fair value might not be used for Property, Plant and Equipment (IAS 16), Intangible Assets (IAS 38), Investment Property (IAS 40) and Agriculture Products (IAS 41) in the annual accounts before 2009.

The actual effect of IFRS on annual accounts in Sweden is dependent on the content of national GAAP (within what is permitted in accounting legislation). In reality the decision is in the hands of the financial accounting standard setters Redovisningsrådet (RR) (listed companies) and Bokföringsnämnden (BFN) (unlisted companies). To sum up – companies will generally not be forced to apply IFRS accounting principles according to Swedish GAAP. It will instead be an option with some differences according to the classification of the company (listed/unlisted or size). Swedish GAAP will start from a transaction-based approach and allow use of a value-based approach.

From what I have seen in surveys the situation differs significantly in MS.[13] A number of countries require mandatory use of IFRS for annual accounts in financial institutions. Few countries require use of “full IFRS” for annual accounts in non-financial companies. Cyprus, Malta and Slovakia are reported as exceptions. “Full IFRS” is permitted as an option for annual accounts of companies in a number of MS, for example Denmark, Finland, the Netherlands and UK. Germany allows IFRS but also requires annual accounts to be drawn up according to national accounting law for taxation purposes. Use of “full IFRS” is prohibited for annual accounts of companies in for example Austria, France and Spain.

This overview raises a number of questions. Regarding countries where IFRS is mandatory for annual accounts one need to know is this requirement includes full disclosure. If this is the case it must create a heavy burden on SMEs. Also, the surveys I have seen have not taken national GAAP into account. But as can be seen from the Swedish example, knowledge about the content of national GAAP is very important when assessing the situation in a MS.[14]

IFRS is mandatory in consolidated accounts of listed companies. In a number of MS “full IFRS” is permitted for consolidated accounts of unlisted companies. The reporting in consolidated accounts has not or little impact on taxation. The development of national GAAP for annual accounts is, on the other hand, in a number of MS affected by institutional factors such as the connection to taxation and company law. The consequence is that differences between financial accounting principles applied in consolidated accounts and annual accounts might increase in some MS, especially those with a connection between financial accounting and tax accounting. Sweden is a clear example of this.

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[13] Information about planned implementation of the IAS Regulation in the EU and EAA can be found at: http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf. Latest available information is per 15 May 2006.

[14] The Big Four accounting firms publish information about IFRS vs. national GAAP, see the web-sites of the firms.

IFRS in member states from a tax perspective

Choice of financial accounting standards and the effects on tax accounting

How relevant is IFRS from a tax perspective? It depends on three things *assuming no changes are undertaken in tax legislation in a country*. First, to what extent financial accounting is connected to tax accounting in specific country. Second, if a MS chooses to use the “full IFRS” option for annual accounts of companies. Third, to what extent national accounting standard setters take IFRS into consideration when setting standards for national GAAP and what choices of accounting principles companies can make within national GAAP.

In countries where there is *no connection* between financial accounting and tax accounting, there should be no impact of IFRS on tax accounting, of course.

In countries where there is some degree of *connection* between financial accounting and tax accounting there are a number of alternative outcomes. If “full IFRS” is *mandatory* for annual accounts it will affect the tax accounting in connected areas. But since its very rare that “full IFRS” is required by Member States I assume that this a hypothetical situation. If the company has an *option* to either apply “full IFRS” or national GAAP the effect depends on the choice of the company and whether tax law recognizes IFRS as a tax base. But in substance the effects of IFRS might depend on to what degree national GAAP incorporates IFRS accounting principles.

A similar situation is present when “full IFRS” is *disallowed* but national GAAP has incorporated IFRS accounting principles. The impact of IFRS on tax accounting depends on which options a company can choose between when drawing up the annual accounts also taking into account if the question is connected or not in tax accounting. If no other aspects than taxes have to be taken into consideration it is probable that companies will opt for accounting principles that are the best from a taxation standpoint.

Lets take Sweden as an example. As I have said above, national accounting standard setters in reality has the final word regarding to what extent IFRS accounting principles must be used in annual accounts in Sweden. Redovisningsrådet has published a standard (RR 32) for the annual accounts in listed companies as part of national GAAP. The starting point is that IFRS should be applied also in the annual accounts unless prohibited by Swedish legislation. But RR 32 makes a number of exceptions from this main rule allowing companies to use alternative accounting principles. Many of the exceptions are explicitly motivated by the connection between tax and accounting. Examples of exceptions that have tax implications in Sweden:

- classification of items in financial reports (i.e. no deferred tax liabilities in balance sheet, instead untaxed reserves are shown to full amount)
- all leasing contracts are classified as operational leases
- income from construction contracts and service contracts may be accounted for using completed contract method instead of using percentage of completion method
- accounting for pensions
- expenditures for development (IAS 38) need not to be capitalized
- most parts of IAS 39 is optional due potential tax effects or uncertainty of tax effects

This example shows that in countries with a connection between tax and accounting national GAAP might neutralize the potential impact of IFRS on tax accounting. It also shows, quite expected, that deviations from IFRS in national GAAP is often driven by tax effects. In the end, the effects are dependent on the content of accounting legislation and what degree of freedom national accounting standard setters have. This will set the frame for which options that available for companies. In Sweden the IFRS-question today seems to be a non-question! The accounting standard setters, not the tax legislator, have taken care of the potential problems. The expected outcome is that few if any (listed) companies will opt for IFRS accounting principles in annual accounts and only because other aspects than tax effects are more important.

It would be interesting to compare the Swedish situation with other countries where there is a connection between tax and accounting with regard both to choice of valuation principles for annual accounts and actual choices made by companies. Maybe it is relevant to think of two types of countries; "IFRS-countries" and "national GAAP-countries".

Changes in tax legislation

The discussion above assumed that no changes where made in tax law because of IFRS. But of course IFRS might force or inspire the tax legislator to think things over. So I will address the IFRS-question from a tax point of view.

I think that the key question is how tax systems handle the shift from a transaction-based approach to a value-based approach in financial accounting from a tax perspective. Should unrealised profits be taxed and deduction for unrealised losses be allowed? Or to put the question on a more theoretical level – should tax accounting move from a transaction-based approach (based on "old accounting" theory) to a value based-approach (based on "new accounting theory") and in that sense move closer to the Schanz-Haig-Simons definition of income?

There are of course arguments for and against. The main argument in favour is that a use of IFRS as a tax base moves tax accounting closer to the "real economic income" of companies. The arguments against are numerous. Fair value accounting is highly subjective. It is not easy to control for tax purposes. Another argument is that the use of IFRS will lead to a situation where (unrealised) income is taxed which in turn will affect the liquidity of companies. A third argument is that IFRS-standards are complicated and difficult to understand. A fourth argument is that the complexity of standards and the high number of subjective judgements that have to made will increase the risk of tax disputes.[15]

The question is "hot" in a number of countries. There are basically two alternatives. The first one is to distance taxation from IFRS and stay with a transaction-based approach for tax purposes. The second one is to move taxation closer to IFRS (value-based approach). The question can be approached in different ways. I will give some examples from MS to illustrate this.

[15] See for example Knutsson, M, Internationella redovisningsstandarder – ingen lämplig grund för företagsbeskattning, Skattenytt (2005) pp. 510-518.

Timing differences from a tax perspective

In some countries the introduction of IFRS in financial accounting has brought up questions about the alignment of financial accounting and tax accounting at a general level. One effect of using IFRS in financial accounting could be an increased number of *timing differences* between financial accounting and tax accounting. This will for example happen when assets are carried at fair value in the financial accounts but at historical cost for taxation purposes. Another typical situation is when tax rules on depreciation of fixed assets are not aligned with depreciation in the annual accounts.

In financial accounting timing differences give rise to deferred tax assets and liabilities (IAS 12). They shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.

In for example Sweden and Finland, tax law requires companies to show the full amount of tax depreciation of certain fixed assets in the annual accounts in order to get a deduction. The difference between "economic" depreciation and tax depreciation will be shown as an untaxed reserve in the annual accounts. The untaxed reserve is from an economic point of view part deferred tax, part equity. The equity part is shown as a (realised) profit under IAS 12 but not when accounted for as an untaxed reserve. From a company law standpoint, the equity part is in principle available for distribution when IAS 12 is applied but not when the "untaxed reserve-model" is applied in the financial accounts.

In Finland, a government committee has analyzed the IFRS-related questions both from a tax and company law standpoint. Three questions were in focus; depreciation of fixed assets, fair value accounting and impact on dividends available for distribution. In Sweden, a government committee has evaluated timing differences from a tax perspective when assets are valued at fair value in the financial accounts.

A common starting point in both countries seems to be that the equity part of timing differences should not be available for distributions to shareholders, even though they are in principle realised profits from a financial accounting standpoint. It is not enough that a deferred tax liability is shown in the financial accounts. The tax policy standpoint seems to be that profits distributed or available for distribution should be taxed at the company level, meaning that corporate tax should be paid before distribution. This basically means that the definition of income in financial accounting is not accepted for tax purposes.

Regarding *timing differences due to tax incentives* there seem to be three alternatives. The first one is to require the full amount of untaxed reserves to be shown in the financial accounts and by that making then unavailable for distribution. That is the present solution in Sweden and Finland. The second one is to disconnect taxation from financial accounting and instead make changes in company law making the equity part of untaxed reserves unavailable for distribution. The third option is to make the tax rules less generous. The last option has been suggested in Finland, but it has been critized.[16]It not clear what the Swedish committee will propose.

There are four possible solutions from a tax policy standpoint regarding *timing differences due to fair value accounting*. The first one is simply to accept timing differences. The second one is to change the tax base to IFRS which means that fair value will be used for also for tax accounting purposes for certain assets. That has been proposed in Sweden, but it has been heavily critized.[17] A third alternative is to change company law in order to make profits attached to timing differences unavailable for distributions. That was the proposal in Finland, but is has been stopped.[18] In Sweden, this proposal could not be put forward since it was outside the scope of the committee. Instead, the Swedish committee reluctantly put forward its fair value-taxation alternative. A fourth possibility is to tax companies when dividends are paid out in equivalence of differences between tax income and book income. Sweden actually already has such tax rule, but restricted to financial instruments held for trading in financial institutions.[19] Apart from the technical difficulties in assessing what parts of dividends that can be deemed to be a result of timing differences, legal objections can also be raised against such tax rules. The main argument is that is may be viewed as a withholding tax under the EU Parent/Subsidiary Directive (2003/123/EC).[20] That explains why neither Finland nor Sweden has proposed this alternative. For the moment the outcome in both countries is unclear.

My personal view is that the real problem might be increased differences between tax income and book income if one uses IFRS to define the latter.[21] It might not sit well with tax legislators that increased profits could be distributed without tax payments in listed companies. Deferred taxes are not enough. But tax legislators seem to be ambivalent towards to what income concept to use as a tax base and also somewhat unsure what it really means to use accounting as a starting point for taxation. What accounting – national GAAP or IFRS? If national GAAP is actually used in most companies the questions mentioned above seem to be rather superficial – assuming that companies can opt not to apply IFRS principles in the annual accounts. It is then somewhat misleading to compare profits based on IFRS principles in consolidated accounts with tax income.

Basic tax accounting rule

Due to the adoption of IFRS, some countries have changed the wording of their basic tax accounting rule. For example in the UK, the rule in the Finance Act was changed

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[16] Andersson, E, Redovisning, beskattning, aktiebolagsrätt: nya koordinationsproblem, Svensk Skattetidning, Svensk Skattetidning (2006) pp. 687-699.

[17] For the proposal, see SOU 2005:53. Regarding the critique, see Melbi, I, Beskattning när tillgångar värderas till verkligt värde – kommentar till ett delbetänkande, Skattenytt (2005) pp. 614-619.

[18] Andersson, Svensk Skattetidning (2006) pp. 687-699.

[19] 17 Ch. 21 § of the Swedish Income Tax Act (1999:1229).

[20] Compare the decision of the ECJ in C-294/99 Athinaiki Zythopoiia.

[21] In Sweden, the idea that corporate tax should be paid when profits are available for distribution in companies is said to be founded on the principle of economic double taxation of profits, see for example SOU 2005:53. But that must be mistake. What if profits in companies only are taxed once? The “principle” should be expressed as that corporate tax should be paid when profits of the company are available for distribution. It is not a matter of double taxation, it is a matter of timing.

in 2004. The Act now refers explicitly to International Accounting Standards (IAS). Section 50 of the Finance Act 2004 defines generally accepted accounting practice as:

(a) in relation to the affairs of a company or other entity that prepares accounts in accordance with international accounting standards ("IAS accounts"), generally accepted accounting practice with respect to such accounts;

(b) in any other case, UK generally accepted accounting practice.

The effect in UK will be that companies that chooses to use IFRS for annual accounts also will taxed according to this.[22] But it is important to remember that this only will have an impact in tax accounting matters where financial accounting has “the final word”.[23] The practical effect will also depend on how many companies that choose to use the IFRS-option for financial accounting purposes.

A similar change has been made in Ireland. Tax legislation now makes an explicitly states that taxable profits should be calculated using GAAP, defining GAAP as either Irish GAAP or IFRS.[24] The questions raised for UK are also relevant when looking at changes made in Irish tax law.

The question is on table also in other countries where there is a connection between financial accounting and tax accounting. In Finland, IFRS may be used as an option when drawing up annual accounts of individual companies as an alternative to national GAAP. The connection between financial accounting and tax accounting is formally not as strong in Finland as for example in Sweden, but the principles for tax accounting set down in Finnish tax legislation is in substance equivalent to financial accounting principles for many questions. This has lead to uncertainty of the tax consequences of using IFRS when drawing up the annual accounts.[25]

In Sweden, a government committee is thinking things over.[26] It has been said that one the alternatives the Swedish committee is thinking about is a complete disconnection of financial accounting from tax accounting for a number of reasons, for example the impact of IFRS on tax accounting. This would mean a change in the basic tax accounting rule. It is an important question of course but as I have said above the development of national GAAP in Sweden has made IFRS a non-question. So it is not obvious in my view that a change is necessary in Sweden for reasons related to IFRS. It is not clear what the proposals of the Swedish committee will be.

It would be interesting to hear if there are similar questions raised in other countries regarding the basic rule in tax accounting.

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[22] See Freedman, J, eJournal of Tax research, (2004) pp. 71-99 and also Freedman, J, Accounting Standards: A Panacea?, Tax Journal, 18 October (2004) pp. 9-10.

[23] See regarding this in the UK, HM Revenue & Customs: Accounting Standards – the UK tax implications at http://www.hmrc.gov.uk/practitioners/int_accounting-index.htm, downloaded 14 March 2007.

[24] Grimes, L and Maguire, T, The Adoption of International Financial Reporting Standards for Tax Purposes by Ireland, European Taxation (2006) pp. 577-582.

[25] Andersson, Svensk Skattetidning (2006) pp. 687-699.

[26] Utredningen om sambandet mellan redovisning och beskattning, see directives for the committee Dir. 2004:146.

Specific tax rules

Tax legislators might look at specific tax accounting rules in the mirror of IFRS. Even though tax rules might formally disconnected from financial accounting ideas of copying IFRS for tax purposes might “pop up”.

The most important IFRS-related issue has been taxation of *financial instruments*. In Ireland new tax rules have been put into legislation.[27] Financial instruments held in trading accounts are to valued at fair value for taxation purposes. In Sweden, a company can choose to value financial instruments at fair value or historical cost for tax accounting purposes.[28] This means that the legislator has copied IAS 39 but made it optional. This rule only applies to financial institutions and companies trading in financial instruments. All other companies are taxed according to capital gains rules (realisation principle).[29] The step to tax financial instruments at fair value might seem like a big change in Sweden, but might not be so radical since the rules are restricted to instruments held for trading. Finland is dwelling on this problem and other fair value-related problems, as I understand it.[30]

Ireland also has adopted new tax rules in tax legislation for *leasing*. As I understand the new rule, the meaning is that the legal form of the transaction, not the economic substance, is the base for taxation. This means that if a company applies IAS 17 in the annual accounts for leasing transactions, taxation will be disconnected from financial accounting. Ireland also has set in new tax rules about the situation when a company applying IFRS enters into transactions with an associated company applying Irish GAAP. The tax rules are aiming at disallowing unmotivated tax advantages due to use of different financial *accounting principles within a group* (asymmetrical timing of losses and profits in intra-group transactions).[31]

In Finland, new tax rules have been proposed regarding a number of IFRS-related accounting issues. Regarding revenue the proposal is that revenue recognition according to IAS 11 also will be accepted for tax purposes in IFRS-companies. But no losses might be deducted before the loss is realised, which is a clear deviation from IFRS. For inventories the proposal is to align tax accounting with IAS 2. For business combinations a complete disconnection from financial accounting is proposed, meaning that intra-group restructurings can be done at tax values regardless of how assets are valued in the financial accounts. Lastly, the proposal is to keep the no-deduction rule for companies when issuing options till employees without cost. According to IFRS 2, the fair value of the option should be taken as a cost and an increase in equity. But this accounting cost is not viewed as a cost for tax purposes, since the company has not paid anything for the options.[32]

The overall conclusion from the examples mentioned is that IFRS-related questions have been dealt with using a piece-meal approach. Even within one country there is

[27] Grimes, and Maguire, European Taxation (2006) pp. 577-582.
[28] 17 Ch. 20 § of the Swedish Income Tax Act.
[29] See Norberg, Skattefrågor vid värdepappersinnehav i finansiella företag, SOU 2005:99 bilaga 3, pp. 409-438.
[30] See Andersson, Svensk Skattetidning (2006) pp. 687-699.
[31] Grimes, and Maguire, European Taxation (2006) pp. 577-582.
[32] Andersson, Svensk Skattetidning (2006) pp. 687-699.

no clear principle for adopting IFRS or not as a base for a tax accounting rule. It is interesting to hear what the experiences are in other countries.

Interpretation of tax law

Assuming that few tax systems have a complete set of tax accounting rules in legislation many questions of tax accounting will be left to tax authorities or tax courts to solve. The impact of financial accounting when filling out gaps in tax law and when interpreting tax legislation varies.[33]

In countries where financial accounting or economic analysis of transactions may affect the interpretation of tax law it is of course interesting to see if there are any signs of IFRS-impact in tax case law. It is not always easy to identify such impact because in many situations national GAAP will be similar to IFRS. Tax courts also can "borrow" views from financial accounting without explicitly referring to financial accounting, IFRS etc. I will give an example from Sweden.

One such question has to do with the principle of substance over form. This principle in accounting means than if there are differences between the legal form and the economic substance of a transaction, the latter should govern accounting. The principle is described in the IASB Framework and has formed a base for IFRS. One clear example is leasing (IAS 17). In tax law, legislators and courts often have to address the question if leasing transactions should be taxed according to legal form or economic substance. In for example Sweden, there are no rules in tax legislation defining who should be viewed as the owner of assets for tax purposes. This therefore has to be decided in case law. In most cases on leasing the courts have based their decision on the legal form. But in three cases decided in 1998 that involved complex cross-border leasing arrangements, the Administrative Supreme Court of Sweden instead in reality based its judgements on the economic substance of the transactions.[34] No references were maid to financial accounting etc., but when analyzing the decisions it can be seen that the court´s arguments have a close resemblance to IAS 17.[35]

Future developments

IFRS as a starting point for common tax base in the EU

A question that has attracted a lot of attention during the last years is the work within EU on a Common Consolidated Corporate Tax BASE (CCCTB).[36] In short, the idea is to reduce compliance costs for companies operating across the Internal Market,

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[33] See for example regarding UK Freedman, eJournal of Tax research (2004) pp. 71-99 and regarding Sweden Norberg and Thorell (2007).

[34] RÅ 1998 ref. 58 (I-III).

[35] See Norberg and Thorell (2007) for an analysis.

[36] This policy was established in 2001 (COM(2001) 582 of 23/10/2001) and confirmed in 2003 (COM(2003) 726 of 24/11/2003). A public consultation was held in 2003 concerning the use of International Accounting Standards as a possible starting point for a common EU tax base. The underlying document was a Consultation Document (The application of International Accounting Standards (IAS) in 2005 and the implications for the introduction of a consolidated tax base for companies´ EU-wide activities), February 2003. In July 2004 a non-paper on the common tax base (A Common Consolidated EU Corporate Tax Base, 7 July 2004) was presented by the Commission and discussed at the informal ECOFIN Council meeting, 10 and 11 September 2004.

resolve transfer pricing problems, simplify international restructurings and avoid many situations of double taxation. The goal is to create a common tax base and not to link CCCTB with any proposal to harmonize tax rates. If the work with CCCTB is successful it would mean greater transparency in the tax base and that tax competition would go through tax rates. A Working Group (CCCTB WG) has been working with the technical aspects since 2004. The members are experts from the European Commission and Member States and also experts from business and academia. In 2006 the Commission issued a Communication on CCCTB on the progress made by the working group.[37] The main conclusions from the Communication are:

- The CCCTB shoulf be simple and uniform with as few exceptions as possible.
- The tax base should be consolidated and optional for companies.
- The rules for calculating the CCCTB should be self-standing and not formally linked to the international accounting standards (IAS/IFRS).

For the meeting with the CCCTB WG on 12 December 2006 the Commission Services prepared a working paper on progress to date and future plans for the CCCTB, which summarises the work carried out by the Working Group in the various areas covered by the CCCTB.[38]

The objectives of the CCCTB WG are:

- 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 idea of having a CCCTB contain both a political side and a technical side. Concerning the political level the opinions are divided, depending on among other things the views of tax cooperation vs. tax competition and if the latter should be transparent or not. I leave the political side of the project with this comment.

Regarding the technical side I will limit my comments mainly to the question of financial accounting (IFRS) as a base for CCCTB.[39] The current position of having no formal link to IFRS is based on the following line of thinking. It is clear that there

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[37] Communication on the progress to date and next steps towards a Common Consolidated Corporate Tax Base (CCCTB) (COM/2006/157), 5 April 2006.

[38] CCCTB/WP/046/doc/en.

[39] The CCCTB and IFRS as a starting point for taxation have been discussed by a number of authors, see for example Spengel, C, International Accounting Standards, Tax Accounting and Effective Levels of Company Tax Burdens in the European Union, European Taxation (2003) pp. 253-266; Schön, W, European Taxation (2004), pp. 426-440; Freedman, J, eJournal of Tax Research (2004) pp. 71-99; Andersson, K, En gemensam konsoliderad skattebas för företag i EU, Svensk skattetidning (2005) pp. 5-17; Cerioni, L, The Possible Introduction of Common Consolidated Base Taxation via Enhanced Cooperation: Some Open Issues, European Taxation (2006) pp. 187-196; and Endres, D, The Determination of Corporate Taxable Income in the EU Member States (2006).

are different starting points in Member States for tax accounting (national GAAP or IFRS). Because of that it is difficult to have a formal link between IFRS and CCCTB. The rules governing CCCTB will be applicable regardless what starting point there is at national level. According to the Communication from Commission, IFRS will therefore be used only as a tool in designing the base because they provide a common language and some common definitions. The CCCTB legislation should therefore be a self-standing document containing all the necessary definitions for determining taxable profits.[40]

The work for CCCTB WG is basically to draft a tax law from scratch using what can used in IFRS when designing the content. The effects of CCCTB will depend on to what extent IFRS is followed for tax purposes.[41] The challenge is to come up with solutions from a tax standpoint that people can agree on. The product might in the end in some parts come rather close to IFRS but in parts deviate in a material way.

Some of the issues that not yet have been addressed by the CCCTB WG include fundamental issues such as whether a Profit and Loss method or a Balance Sheet method should be used when calculating taxable income. One could say that the first method is closer to what I used today in MS for tax accounting purposes and the second one is closer to IFRS.[42] If the first alternative will be chosen this would mean that a fundamental component in IFRS would not apply. Another fundamental aspect is the use of fair value for assets. It seems that there is an agreement that unrealised profits should not be taxed but the opinions seem divided on issue whether unrealised losses should be taken into account.[43] Another important question that not yet has been addressed is the administrative and legal framework of CCCTB.

The idea of using IFRS as a tool-box for CCCTB because of its common language and definitions is both understandable and quite natural. It is a way of overcoming the lack of common tax accounting language. It also might be added that another attractive feature of IFRS is that the product is rather comprehensive, containing nearly 50 standards covering nearly all material financial accounting questions. The problems start when trying to design a tax law and deciding when to follow IFRS or not. IFRS can only can serve as a tool-kit some questions, mainly timing questions and some questions regarding consolidation. What should be taxed and deducted is matter of “pure” tax considerations.

One problem that will have to be addressed is now interpret CCCTB and how to fill out gaps in the CCCTB if there is no formal link to IFRS. It is not clear what

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[40] COM/2006/157, 5 April 2006.

[41] A number of unpublished research papers have addressed the effects of using IFRS as a tax base in Member States, for example Jacobs, O, Spengel, C, Stetter, T and Wendt, C, EU Company Taxation in Case of a Common Tax Base – A Computer-based Calculation and Comparison Using the Enhanced Model of the European Tax Analyzer, Discussion Paper No 05-37, Centre for European Economic Research (ZEW) (2005); Haverals, J, IAS/IFRS in Belgium: Quantitative Analysis of the Impact on the Tax Burden of Companies, Université Libre de Bruxelles, Solvay Business School, Centre Emile Bernheim, Research Institute of Management Sciences, Working Paper: WP-CEB 05-011 (2005); and Ebenhartinger, E, and Klostermann, M, What if IAS/IFRS were a Tax Base?, New Empirical Evidence from an Austrian Perspective, Working Paper No 1, Wirtschaftsuniversität Wien (2006).

[42] CCCTB/WP/046/doc/en, paragraphs 13-16.

[43] CCCTB/WP/046/doc/en, paragraphs 52-54.

interpretational data that should be used when interpreting CCCTB. Could IFRS (including the IAS Framework) serve as inspiration also for interpretation (at least in some parts) even though there is no formal link? One question is for example if the principle of substance over form will have any impact on the interpretation of CCCTB, for example when deciding who is the owner of an asset for CCCTB purposes. This might be an important question since CCCTB cannot be based on legal form of a specific country.

Tax accounting in SMEs

Lastly, some words on tax accounting in SMEs. Most enterprises within EU are small. One idea regarding regulation policy for those enterprises that are common within the EU is the need for simplification.[44] Compliance costs are often viewed to be too high. One step in this direction is to simplify tax and accounting rules for SMEs. For example in Sweden, some steps have been taken to align financial accounting with tax accounting for the smallest firms (sole proprietors). This has been done by changing Swedish GAAP, allowing the use of simplified tax accounting rules for those firms also for financial accounting purposes. A consequence of this is that Swedish GAAP in the future will have different financial accounting standards for different enterprises, depending on the size of the enterprise and if its listed or not. The enterprises will be divided into four classes.[45]

This development has altered the idea in Sweden that all enterprises should be taxed using the same tax rules. The major change in viewpoint is that financial accounting in small firms basically serves no other real function than as a base for taxation. It will be interesting to see if this is the first step in a series of reforms in Sweden aligning financial and tax accounting even closer than today or if the committee dealing with the connection between tax and accounting will choose another path. It will very much depend on whether IFRS is viewed as an important question or as a non-question and if all companies should have the same tax rules or not.

In contrast, the development at the international level should be noted. IASB has published a draft IFRS for SMEs in 2007.[46] The aim of the proposed standard is to provide a simplified, self-contained set of accounting principles that are appropriate for smaller, non-listed companies, based on full International Financial Reporting Standards (IFRSs), developed primarily for listed companies. The adoption of IFRS for SMEs will be a matter for each country to decide according to IASB. One should note that even if the key word is simplification, the draft standard for SMEs covers 252 pages.

The IASB draft standard for SMEs is built one the same idea as IFRS in general, which is to provide good quality financial information for investors. Since this is an IASB-product no aspects of tax and accounting are taken into consideration. It is because of this very probable that not every country can or will adopt the complete standard. The ultimate degree of implementation will depend on institutional factors

[44] This argument is of course not only for small firms. It is also one the arguments for introducing CCCTB.

[45] Financial accounting standards will be set by BFN, www.bfn.se.

[46] IASB, Exposure Draft, International Financial Reporting Standard for Small and Medium-sized Entities (15 February 2007).

in specific countries, especially the connection between financial accounting and tax accounting.

Conclusions

The idea of using financial accounting as a starting point for tax accounting is based on both theoretical and practical motives. But apart from the idea to tax "the real economic income" of companies, the theoretical foundation is rather vague from a tax standpoint. Tax accounting in many countries has not developed independently from financial accounting. Instead, there has been a reciprocal influence, in many countries also mixed with influences to and from company law. The effect has been that both financial accounting and tax accounting has developed around some common principles (historical cost, realisation, prudence etc.). The details in national GAAP might differ from rules for tax accounting, but the definition of income will be built on the same approach.

When financial accounting starts to develop in the lines of IFRS, with an income concept built on a balance sheet approach allowing fair value accounting, this can change the content of national GAAP in a significant way and therefore also indirectly affect tax accounting in a country. But as has been shown, to what degree there will be any major changes in national GAAP depends on legislators and standard setters. Since this is a tricky question, a commonly endorsed alternative is to allow the companies to choose accounting principles. As can be seen by some examples this might in the end mean that the potential impact of IFRS on annual accounts in MS will be significantly reduced. With regard to countries where there is a connection between financial accounting and tax accounting, the result might be that potential negative tax effects of using IFRS for tax accounting will not a real problem. The companies can opt to use other accounting principles within GAAP.

The development of IFRS also may have an impact on tax legislation. There are some examples of this in "connected countries". Some examples have been mentioned, namely the changes in the basic tax rule in countries to include IFRS as part of the definition of GAAP as an alternative to national GAAP. The effect of this change is that tax law in those countries accepts that different accounting bases can be the starting point for taxation – in other words another option. The examples mentioned here indicate that tax legislators have difficulties in taking a clear position on what starting point that should be used for taxation purposes. Instead the message is – we accept the accounting base chosen by the company even though the bases are not equal and the choice is not tax neutral.

Other examples I have talked about have dealt with changes in specific tax accounting rules due to IFRS. The impression from those few examples are that there seem to be a piece-meal approach, sometimes copying IFRS, sometimes disconnecting financial accounting from tax accounting.

Sweden and Finland have tried to take an overall tax view on timing differences in the light of IFRS. So far no new comprehensive tax legislation has been adopted. But what is interesting with the Swedish and Finnish proposals is that they illustrate the difficulties tax legislators will encounter when trying come up with tax accounting principles (or a tax income concept if one would like to express that way) in an accounting environment affected by IFRS.

There is some irony to all this. When financial accounting in the form of IFRS is moving towards an income concept that is closer to a theoretical all-inclusive tax income concept (Schanz-Haig-Simons), tax legislators are trying to decide if this is the right way to go or if "old accounting theory" – often expressed in the form of national GAAP – should form the starting point for tax accounting. Adding to the difficulties is the fact that company law also must be taken into account.

The same questions appear at the international level, which can be seen when looking at the development of the CCCTB. This product will be optional for companies, a typical solution also used in specific countries as shown before when things are getting tricky.

One could say that a choice not to formally connect CCCTB to IFRS gives an indication that the income concept of IFRS will not work as a starting point for taxation, even though financial accounting built on IFRS will show the "real economic income". Instead, in taxation the view of what is "real economic income" will reflect the "old accounting theory" at least in some parts. This goes both for CCCTB and many specific countries.

The overall impression is that this is an area of tax law that is under change. The solution for the moment is allow options and letting the companies decide at least to some extent when to be taxed. It very much boils down to a cost-benefit analysis from the companies. The tax issues are difficult and complex. But over time the work performed regarding CCCTB, regardless of if it will be implemented or not, will not be wasted. It can form a common base for formulating tax accounting principles both at the international level and in specific countries, in a world of constant change in financial accounting.