The Tax Base for CCCTB: The Role of Principles

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Abstract[§]

The European Commission is working on a proposal for a Common Consolidated Corporate Tax Base (CCCTB). A draft Directive is expected to be published during the course of 2008. The proposal aims to tackle some fundamental problems encountered as a result of lack of corporate tax harmonisation, especially in the areas of cross border losses and transfer pricing. There are several difficulties that must be tackled to make the proposal workable, not least the question of formulary apportionment of the consolidated profits of the corporate group as between Member States. This paper does not attempt to discuss the entire range of issues to which the CCCTB gives rise, important though they are, but focuses on the question of the tax base itself.

The CCCTB project presents an opportunity to rethink the tax base. For the purposes of this paper it is assumed that there will be no radical re-appraisal of the way in which we tax corporations for the time being, but that the tax base will continue to be based on a concept of 'profit'. This paper supports the use of International Financial Reporting Standards (IFRS) as a starting point in ascertaining profit. It acknowledges that some deviations will be necessary from IFRS for tax purposes and suggests that these deviations should be explicit and based on autonomous tax principles. Partial convergence gives rise to issues about the relationship between accounting and tax principles. Conceptual clarity is needed to manage the questions that will arise and appropriate institutional mechanisms need to be developed to deal with the task of interpretation and regulation of the evolving relationship between accounting developments and tax law.

If the CCCTB is to be successful it must provide a comprehensive and autonomous set of rules. In fact it must be a Comprehensive Common Consolidated Corporate Tax Base (***C***CCCTB or C4TB) In view of the complexity of the issues arising in creating and applying the rules for a tax base, it is impossible to produce a Directive that will cover every necessary detail. Instead it needs to refer to IFRS as at the date of the Directive and to contain a set of tax principles as well as setting out institutional arrangements capable of managing the relationship. National tax law and national accounting standards are an inappropriate default for a C4TB. Thus the Directive should provide both a reference point for determining the scope of the tax base and a constitutionally valid framework for interpretation and application of the Directive and its implementing legislation in Member States.

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I. INTRODUCTION

The question of the introduction of a Common Consolidated Corporate Tax Base (CCCTB) for the European Union (EU) raises theoretical, political and practical issues. CCCTB is proposed as a tool of harmonization in order to promote efficiency and competitiveness within the EU but it also presents a unique opportunity to consider the system for the taxation of companies from first principles. The working groups of the Commission have produced many detailed papers which deserve close attention. This chapter is intended to step back from these details to consider the role of principles in the formulation, drafting and application of a CCCTB.

The scope of this chapter is confined to a discussion of the question of how best to achieve a harmonised tax base. No attempt is made here to evaluate the CCCTB more widely. We take it as given that for these purposes the objective is to tax corporate profits under a corporate tax similar to that currently imposed by most Member States (MS) in the European Union.[1]

II. WHAT IS A PRINCIPLE?

For the purposes of this discussion we take principles to be the fundamental tenets or primary assumptions forming the basis of a chain of reasoning.[2] They will apply at three stages in formulating and implementing a tax system: first the policy stage of setting the overall tax objectives, second at the design and legislative stage of determining the tax structure and setting the rules and, third, at the stage of interpreting and applying the tax rules. At the first stage the principles are a *source* of the law: concepts that are involved in determining the policy objectives and structural characteristics of the tax system. At the second stage the principles may be narrower and more specific in scope and will guide the design of the tax structure and thus the drafting of operational rules. They may be included in the legislation itself as a guide to interpretation of the detailed rules, so that at the third stage they act as general reference points for resolving detailed issues and interpreting and applying the rules in specific circumstances.

Two points should be made clear. First, principles can and do conflict and may need to be weighed against each other by those designing the system.[3] Choices will need to be made in the context of selection of tax structure and base: we are not dealing with absolutes and constraints may impose compromises. There may be discussion about optimal methods of

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[1] It is outside the scope of this chapter to discuss alternative regimes for taxing corporations such as a cash flow tax, or the complete abolition of corporation tax and its replacement with other forms of revenue. For a discussion of more radical proposals for corporation tax see Auerbach, Devereux and Simpson, Taxing Corporate Income and Griffith, Hines and Sorensen, International Capital Taxation, both in Blundell et al (eds) *Reforming the Tax System for the 21st Century: The Mirrlees Review (2008).*

[2] Online Oxford English Dictionary accessed January 2008.

[3] There is an extensive jurisprudential literature on the roles of rules and principles which goes beyond the scope of this paper but is discussed further in the tax context in Avery Jones, Tax Law: Rules or Principles? *British Tax Review* 1996 p. 580; Braithwaite, Making Tax Law More Certain: a Theory" 31 *Australian Business Law Review* 2003 p. 72; Freedman, Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle *British Tax Review* 2004 p. 332 (p.353). Principles based drafting has been discussed in Australia and the UK but there is controversy over its implementation in both jurisdictions - see Pinder, Australian Treasury *The coherent principles approach to tax law design* (2005);. HMRC, *Simplifying anti-avoidance legislation: A progress report on the anti-avoidance simplification review* (2008). Civil law systems and European Community legislation are seen as being more principles based than common law systems but this is doubtless an over-simplification.

taxation, but once a political choice has been made, principles can be applied accordingly, even if there is not universal agreement about the structure chosen.

Second, we do not claim that principles will give a clear answer in every case of difficulty, though this is not an argument for ignoring them. Neither do we suggest that principles should replace detailed rules, nor that they render such rules unnecessary. We do recognise, however, that rules can never provide for every eventuality, so that they will always need interpretation. Principles contained in the legislation can give guidance and help to legitimise the inevitable process of interpretation. They can provide a legislatively validated framework for determination of a default position without which the issues would either be left to the discretion of administrators or the judiciary, or where in the case of CCCTB there would be a need to refer to national law. In our view a default to national law is inconsistent with a European common tax base, making it essential that principles are made explicit so as to act as ‘gap-fillers’.

So, by definition, principles do not provide detailed answers to every question, but only guidance. Far from giving unacceptable discretion, however, such principles would provide boundaries for the exercise of discretion by the administration and the courts. The extent to which matters can be left to interpretation, and by whom they should be interpreted, raises constitutional and practical issues which are discussed further below.

III. PRINCIPLES IN THE CCCTB CONTEXT

Our concern is with the tax base which, it has been predetermined, is profit. What is understood by profit conceptually is a primary principle. In designing and legislating the tax base to reflect that understanding, secondary “tax principles” will be used as criteria to guide that process. At the same time, because of the nature of the tax base, consideration has to be given to “accounting principles”, for it is these that determine the substance of what is measured as profit in a commercial context. One of the issues at the heart of the CCCTB debate is whether, and if so to what extent, accounting measures of profit can be used as a measure of the tax base, or whether an autonomous tax measure of profit is required. In considering that question an understanding of accounting principles is required, but the issue will be concluded by reference to the primary principle of profit definition and the application of the criteria that are tax principles. Provided a clear decision is taken at the outset in a legitimate way, consistent with principles, to either adopt or reject a particular accounting principle for tax profit definition purposes there seems no reason not to adopt the accounting principles so agreed upon in defining the tax base. Given that complete convergence of tax and accounting rules is unlikely to be desirable, but that accounting rules and concepts will undoubtedly be used to some extent, clarity about the relationship between the two sets of rules and how differences are to be determined in cases of doubt is essential.

In 2001, European Commission staff took the view that a common base of tax accounting rules might be developed as a result of the need to develop such principles independently from financial accounting. In their view, the harmonization of accounting standards across the EU (and more widely) meant that there would be no prospect of fully matching tax and financial accounting in the future. They considered that,

> To the extent that tax accounting will develop independently from financial accounting, MS will be obliged to find autonomous rules for tax accounting purposes. In looking for such rules there is an opening for co-

ordination and co-operation to start with common base rules, instead of each of the MS trying to pursue individual solutions.[4]

Thus initially the impetus for the CCCTB project was that the tax base and accounting standards would be diverging and an autonomous measure of tax profits, derived from tax principles, would be needed. This divergence is indeed occurring in some MS as their national accounting standards are being more heavily influenced by International Accounting Standards, so that they feel a need to provide special tax rules where they had previously followed accounting practice. In other cases, as in Sweden, it appears that it is the differences between the financial accounting found in consolidated accounts under IFRS and the financial accounting in annual single company accounts under national accounting standards that is increasing[5]

Subsequently the ground shifted a little. In 2003[6], the Commission identified two possible approaches. One was that the CCCTB could use the IFRS approach, which starts with a common accounting position and seeks to define what adjustments would be required to achieve the tax base. The alternative was said to be to reach agreement in isolation on tax principles. This latter route was rejected on the basis that it 'risks becoming a long drawn out exercise which fails to provide a pragmatic and workable solution'.

The route chosen was to use IFRS as a starting point, but not one upon which tax accounts would be dependent. This was for three reasons. First, IFRS will not always be appropriate for tax purposes given the different objectives of tax and financial accounting.[7] This issue is dealt with in more detail below. Second, IFRS change over time and are promulgated by a non-governmental organisation not under democratic control. There is therefore a constitutional issue about their incorporation by reference into a Directive because the CCCTB will have to satisfy the varying legal requirements for imposing taxation in all the MS.[8] Third, not all MS permit the use of IFRS for individual company accounts. Many companies will start from accounts prepared in accordance with different forms of national Generally Accepted Accounting Practice (GAAP) and will then have to modify their accounts to fit in with CCCTB. This third point means that pure dependence is impossible, but it does not mean that CCCTB cannot be based on IFRS, since modifications to the national tax base (that is both specific national tax rules and national GAAP) will be needed for CCCTB purposes in any event in order to create a single European tax base.

With IFRS as only a starting point, there has to be a basis for adjusting it to a tax base. Although autonomous tax principles may not provide a complete solution, they will guide the adjustment and interpretation process. The creation of a completely new tax base offers opportunities for a proper consideration of the relationship between tax and accounting with the interaction being clearly thought out and implemented.[9] This contrasts with national tax systems which have relationships between tax and accounting rules that have developed over

[4] EU Commission staff working paper *Company Taxation in the Internal Market* (2001) p.324.
[5]Schoen, International Accounting Standards – A "Starting Point" for a Common European Tax Base? 44 *European Taxation* 2004 p.426; Schoen – The Odd Couple: A Common Future for Financial and Tax Accounting? *58 Tax Law Review* 2005 p. 111; Norberg, Kari Tikka Memorial Lecture: Accounting and Taxation, in Lang and Vanistendael (eds) Accounting and Taxation (2007) p.9
[6] European Commission Communication, *Internal Market without Company Obstacles* COM (2003) 726.
[7] For discussions of these differences see Schoen, *European Taxation* 2004 p.426; Schoen *58 Tax Law Review* 2005 p. 111; Freedman, Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges *eJournal Tax Research* 2005. p.7 .
[8] CCCTB/WP\001Rev1 23 November 2004 para 33. The issue is discussed further below.
[9] On the need for conceptual clarity in the case of partial convergence see Freedman, Financial and Tax Accounting: Transparency and "Truth" in Schoen (ed) *Tax and Corporate Governance* (2008) p.71

time that are sometimes conceptually unclear. The CCCTB Working Paper on General Tax Principles (the 'Principles WP') [10]dealt with general principles for the design and assessment of tax systems. These it listed as vertical and horizontal equity; efficiency and neutrality; effectiveness; simplicity, transparency and certainty; consistency and coherence; flexibility and enforceability. It concluded that these principles are of varying value in considering the structural elements of a tax base. They are indeed abstract and may not always provide concrete answers. Nevertheless, as we shall see, these principles do provide an important framework for thinking about the tax base, and for evaluating the accounting solution to profit measurement.

The Principles WP then dealt with specific accounting principles. These were listed as understandability, materiality, substance over form and prudence. The WP assumed that the tax base will be grounded in an accruals basis and considered issues of recognition and measurement. The paper concluded that these principles are more useful than the broader general principles in formulating the structural elements of the tax base. Nevertheless the Commission has not so far developed them into a formal statement or code. To some extent they are already contained in IFRS and the accompanying International Accounting Standards Board (IASB) Framework, but the framework contains further principles and is more comprehensive.[11]

However the tax base is formulated, we consider it important that the principles upon which that formulation is based are made explicit in the Directive and not left to be inferred from the legislation on a case by case, or jurisdiction by jurisdiction basis. This is the more so when the subject matter of the rule making such as "profit", is itself notoriously difficult to define, and when, as in the case of taxation rules, the audience is recalcitrant. There is no reason to suppose that the use of principles is inappropriate in a tax context and indeed wide principles in the preambles of the VAT Directives have proved to be very important, and interpretation in accordance with them has been held to be within the principle of legal certainty.[12]

The CCCTB Tax Base Working Group argued in its paper on the possible elements of a technical outline (Tax Base WP)[13] that unless uniform treatment is explicitly provided for in the CCCTB legislation the tax base would be computed by reference to national GAAP.[14] It is not clear whether this is intended to refer to national accounting practice only or is assuming that this is the same as national tax rules (which of course is not the case in some jurisdictions and in some instances) [15]. One way or the other this could lead to national tax rules re-emerging in cases where there is no explicit provision in CCCTB, although the precise relationship between national GAAP and national tax law within this suggestion is unclear. This would seem to be unfortunate and contrary to the high level principles of harmonisation and simplification which underlie the very proposal for a CCCTB. The aim of stating principles in the legislation should be to avoid the need for this default position and to ensure that the CCCTB is a comprehensive 'standalone' piece of legislation (albeit possibly by

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[10] CCCTB/WP\001Rev1 23 November 2004

[11] IASC, *Framework for the Preparation and Presentation of Financial Statements* (adopted 2001).

[12] Farmer/ Lyal. *EC Tax La w* (1994) p 90. For example see the discussion by Arden LJ of the principles of avoidance of non-taxation, avoidance of double taxation and the prevention of the distortion of competition in the Sixth VAT Directive in 27 January 2006, [2006] EWCA Civ 29 *R&C Comrs v IDT Card Services* [2006] STC 1252 citing ECJ 17 November 1993, C-73/92 *EC Commission v Kingdom of Spain* [1993] ECR I-637.

[13] CCCTB/WP057annotated\doc, 20 November 2007.

[14] Tax Base WP, para 9.

[15] Suppose, for example, there was an issue about whether a payment by a company should be defined as a distribution or as interest. Further suppose that CCCTB was silent as to the relevant definitions. Would this be left to national GAAP, or national tax law if there was a statutory overlay to the accounting rules?

reference to accounting standards with necessary adaptations made clear).[16] The Commission Services has now acknowledged that this might be an aspect of the proposal which needs further consideration and that 'including a set of clear general tax principles to be referred to in the directive rather than defaulting to external rules' should be examined further'.[17]

To summarise, the CCCTB is intended to create a new, unified tax base. As such, it is essential that it provides a comprehensive and autonomous set of rules. In view of the complexity of the issues arising in creating and applying the rules for a tax base, it is impossible to produce a Directive that will cover every necessary detail. Instead it needs to contain a set of principles. The role of these principles should be twofold. They should provide both a reference point for determining the scope of the tax base through a legislative statement of the central concept which encompasses the substantive nature of the tax base, and a constitutionally valid framework in the form of criteria for interpreting and applying the provisions of the Directive and its implementing legislation in MS.

IV. CCCTB OBJECTIVES

Our concern is with the principles to be applied in formulating and regulating the tax base, but in the interests of clarity we begin by setting our discussion in the context of policy objectives which have been, or will have been, determined prior to detailed consideration of the tax base.

We assume that the CCCTB is consistent with an objective of raising tax revenues for MS, but that it also has the specific objective of achieving this in a way that promotes efficiency and competition within the EU.[18] It is understood that the tax base will be profits.[19] Further it is taken as given that the tax unit will be the company, extended where applicable to a group of companies, and that the tax rate structure will be that applied by each MS to the share of the tax base deemed by the CCCTB to be attributable to companies within their jurisdiction. These objectives will be taken as given in discussion of the principles applicable to consideration of the tax base: other approaches might require a different application of principles. The principles are essentially normative standards applied in designing the tax system, and are well known: those of neutrality, horizontal equity and constitutional equity including certainty. They represent criteria against which the structure and its legislation can be judged, given the objective.

V. Tax Principles

5.1 Neutrality

Neutrality reflects a general proposition that all the transactions that are substantively within the tax base should be taxed equally, otherwise choices between transactions will be distorted and cause economic inefficiency. However, it is possible that some objectives of the tax system might themselves be explicitly non-neutral. The objective of a tax might be to

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[16] As suggested by Business Europe in Tax Base WP, annotation to para 9.
[17] EC 4th March 2008, Summary Record by the Chair of meeting held in Brussels on 10-11 December 2007, CCCTB/WP/64
[18] EC 7th July 2004, European Commission Non-Paper- Commission Non-Paper to informal Ecofin Council, 10 and 11 September 2004 *A Common Consolidated EU Corporate Tax Base* . http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCTBWPNon_Paper.pdf
[19] See footnote 1 above.

encourage or discourage certain types of behaviour, an objective the essence of which is intentionally to distort economic decisions. In such cases, the neutrality criterion is subordinate to the policy objective.

In a world that is characterised by open economies, neutrality has become a significant issue with regard to the supply and location of capital. The jurisdictional limitations with regard to the tax base and the tax unit are significant in this respect. This affects what is to be included in the tax base and there are relevant principles which may be considered. Where a tax base includes the return to capital regardless of where it arises, there will be no discrimination as to where a resident invests (capital export neutrality); where the return is taxed only in the nation state where the capital is invested, regardless of the residence of the corporate owner of capital, there will be no discrimination as to who invests in that state (capital import neutrality). Capital ownership neutrality (CON) must also be considered. Tax systems satisfy CON if they do not distort the ownership of capital assets, which promotes global efficiency whenever the productivity of an investment differs based on its ownership. A regime in which all countries exempt foreign income from taxation satisfies CON, as does a regime in which all countries tax foreign income while providing foreign tax credits. [20] A decision as to how to balance these principles and apply them to CCCTB will determine how the relevant transactions are recognised in the tax base, but will not be subject to further scrutiny against the neutrality criterion in this chapter.

By defining the tax unit as the company (although under the CCCTB it might effectively be the group) the CCCTB formally limits the incidence of the tax and discriminates against one particular medium through which business is conducted. It taxes an intermediary, which raises both structural issues as to the relationship between the corporate tax and the personal tax, as well as empirical questions as to where the effective incidence of the tax actually lies. The neutrality implications of these issues are outside our terms of reference. The definition of the tax unit also raises a further question: is the company to be regarded as an independent legal entity separate from those who have a financial interest in it, or is it identified with a particular financial interest? Typically the company is not considered as an entity the profits of which are taxed, but rather as a financial interest group, equity shareholders, whose profits constitute the tax base. The consequence, as is well recognised, is that one form of finance becomes cheaper relative to the other because interest payments are allowed as a cost of earning profit whereas dividend payments are not. This lack of neutrality then requires tax avoidance rules to protect the tax/no tax boundary.

Similarly the choice of rate structure has neutrality implications. A broader base allows a lower tax rate for the same level of tax revenue. In the case of company taxation there is usually a proportional rate of tax, so a broader base will mean a lower rate of tax at the margin and therefore fewer disincentives to invest. However the CCCTB determines only the base, not the rate structure; it is not clear whether, if the CCCTB adopted a tax base different from the typical corporate tax base of the MS, a MS could levy a differential tax rate. A proportional rate structure also means that, subject to proper provision within the tax base, risky investment will not be discriminated against since the rate of tax recovery for losses will not depend, as it would under a progressive rate structure, upon the quantum of profits. We can only assume that the rate structures of MS will be proportional.

5.2 Equity, objectivity and certainty

[20] Andersson on behalf of UNICE, Comments on CCCTB/WP\001- General Tax Principles January 22, 2005. Desai and Hines, 'Evaluating International Tax Reform' 56 *National Tax Journal* 2003 p.487.

Equity is concerned primarily with the position of the tax unit in relation to the tax system. The horizontal equity criterion is very much a reflection of neutrality in that it is considered that those who are equal before tax should be equal after tax. As with neutrality, the judgement of equality is based upon the perception of the tax base and comparison between taxpayers is intended to be objective. The tax base therefore has to be susceptible to objective measurement; objective in this sense does not mean accurate or correct, but unbiased and verifiable.

Equity can also be regarded as a matter of the constitutional relationship between government and taxpayer – that the laws imposing the charge to tax should be clear (so that the taxpayer can engage in transactions with certainty as to the tax consequences), and should be applied equally to all taxpayers. Unlike horizontal equity this notion accepts the legal form as the basis of equality. Thus, in terms of constitutional equity as opposed to horizontal equity, if only companies are taxed on income there is no inequity as between companies and other forms of business; there would only be inequity if some companies were not taxed.

These criteria may conflict with each other, so that priorities have to be established or pragmatic compromises embraced; and they may be difficult to apply in practice, so whilst recognising the principles we have also to be aware of any constraints limiting their application.

5.3 Realisation

"Realisation" is often invoked as a tax principle, particularly in the context of a tax on income. The term is in fact a rule that has developed either as a manifestation of other principles or as a solution to otherwise intractable measurement problems. In part it reflects a notion of ability to pay, but this term in itself is ambiguous. In a general sense, ability to pay is analogous to taxable capacity, of which the tax base is an index. In another sense it infers a literal meaning of being able to meet a tax liability out of cash generated within the tax base. In this latter sense it is a liquidity issue.

However realisation has also been a recognition rule applied in accounting and used for company law purposes in limiting what can be distributed to shareholders as profit. As such, it is a rule born of prudence: a response to uncertainty. The very purpose of accounting during the period that this rule was developed was to report on the stewardship of companies and on the amount distributable as profit to shareholders. The requirement that distributable profit be realised was developed as a response to uncertainty in the particular context of maintaining capital as a form of creditor protection. By requiring that only realised profits could be distributed as dividend, creditors were protected against the distribution of estimated profits which might not be realised, and which, once distributed, could not be recovered from shareholders.

How far should these considerations be regarded as principles of taxation? The question is particularly pertinent now because accounting, as represented by IFRS, has moved to placing greater emphasis on providing information for investor decision-making, and less on measuring distributable profit. The certainty threshold, previously set by realisation, has been lowered in the interests of relevant information, leading to a greater acceptance of valuations unconfirmed by market transactions. This can be seen as a move away from realisation or, to some extent, as changing the definition of what realisation means. [21] Given that tax has a different purpose this may be a point at which some divergence should occur.

[21] So, for example, in the UK the Accounting Standards Board decided that the linking of prudence to realisation had become out of date and they did not wish to redefine realisation but asserted that the principle would apply

For tax purposes, rather than relevance of information, the first consideration is the level of certainty and objectivity that is required in measuring the tax base both to justify the levy of tax, and to meet the horizontal equity criterion. What realisation means in this context, and whether it is required in all circumstances is open to debate, but that debate should be conducted in the specific context of the tax principles of certainty and objectivity.

Second, there is the issue of liquidity. The liquidity or cash flow argument turns on the assertion that to tax an unrealised gain would force realisation. Any tax liability can give rise to cash flow difficulties and may require borrowing to finance it. An income or profits tax, in contrast to an expenditure tax, requires that tax should be paid on income even if it has been saved and reinvested. In some cases, unrealised gains may be viewed as equivalent, that is within the concept of profit as a matter of principle. Further if the tax liability does have to be financed by realisation this does not always require realisation of the complete asset, but only that sufficient to meet the tax liability. In some specific cases of unrealised gains, liquidity problems could require pragmatic solutions which would need to be specified by the legislature: but they would by definition apply only to gains and not to losses, which suggests that liquidity is inappropriate as a principle for defining gains and losses in general.

Third there is a question as to whether taxable income should be synonymous with distributable income for company law purposes, which is required to be based on 'realised' profits. On one argument, just as a dividend paid to shareholders is a distribution, so is a payment of tax to government. The difference, of course, is that tax can be repaid in the event of profit not in fact being realised, whereas a dividend once paid cannot be recovered. In practice it seems that there are differences between MS over what is distributable for company law purposes. [22] The degree of deviation has been found in a major study conducted on behalf of the European Commission to be determined by differing national interpretations of the realisation principle.[23] This in itself suggests the difficult of using such a principle as the basis for a CCCTB. Further there is a substantial body of opinion that suggests that the protection of creditors is best effected through solvency requirements in addition to a balance sheet test.[24] Solvency would not be an acceptable constraint in measuring tax liability (as opposed to ability to pay based on liquidity), and so if the insolvency test were to triumph. would suggest that there is no *prima facie* reason to require identity between the measure of profits for company law and for tax purposes. If taxable profits are to diverge from distributable profits, however, it is essential that any legislative expression of the underlying concept of profit should clearly state that it is not intended to be constrained by the definition of distributable profit for company law purposes.

'unless it is possible to be reasonably certain that, although a gain is unrealised, it nevertheless exits, and to measure it with sufficient reliability' Accounting Standards Board FRS 18 para 28 and Appendix IV, para 20.

[22] Despite its flexible definition of what is realised, the UK requires a number of adjustments from accounting profits to reach distributable profits.: KPMG feasibility study of an alternative to the Capital Maintenance Regime of the Second Directive and the impact of the adoption of IFRS on profit distribution" (2008) at p. 322.

[23] See DG Internal Market Services, "Results of the external study on the feasibility of an alternative to the Capital Maintenance Regime of the Second Directive and the impact of the adoption of IFRS on profit distribution", and the associated feasibility study by KPMG, 2008 at p. 8, http://ec.europa.eu/internal_market/company/capital/index_en.htm. This reports that 19 of the 27 MS already apply IFRS to determine distributability, with 8 of these also applying additional tests to ensure that 'unrealised' profits are not distributed.

[24] See DG Internal Market Services "Results of the external study on profit distribution", and associated KPMG feasibility study 2008.

Finally, it is suggested that limiting taxable profits to realised profits reduces the volatility of tax liabilities for the taxpayer and tax revenues for government. In some circumstances this must be true: an unrealised gain or loss in one year matched by a loss or gain, realised or not, in the following year will give greater volatility. Equally, however, bunching all gains or losses in the period in which realisation takes place, rather than recognising them as they arise, will itself result in volatility. On the other hand, the issue is certainly more pertinent in the case of some assets than others: those, such as some derivatives the value of which lies only in the risks they cover, will be inherently more volatile than assets the value of which lies in returns which are risky. Thus whilst volatility might be a significant issue in some cases, it is questionable as to whether it is of sufficiently general application to justify realisation as an overarching principle. There is a practical question, however, connected to this question of whether recognising unrealised losses would, in an economic down turn, increase government's difficulty in managing the economy: at a time when tax revenues were already reduced, recognition of unrealised losses and the associated tax repayments could further accentuate this.

On the other hand, we should recognise that there are significant problems associated with limiting the taxation of profit to realised profits. This results in the effective postponement of tax and the "lock-in effect" whereby economic decision making is distorted in favour of second-best assets already held at the expense of optimal assets, acquisition of which requires realisation of owned assets and payment of any consequent tax liability. It thus conflicts with the neutrality principle[25]. It can also constrain the way in which loss relief is given, again impinging upon the neutrality required of that relief[26].

None of the considerations above in themselves seem to justify realisation as a principle of taxation which should necessarily govern the measurement of the tax base in all circumstances. It has developed as a pragmatic solution to certain issues, and it may still have that role in certain circumstances. However we conclude that we should in the first place determine taxable profits according to our fundamental understanding of the concept; if we find that we are constrained in applying the results by reference to other criteria, then realisation may in some circumstances provide a useful benchmark.

5.4 Constraints

How far the objective of a tax can be achieved, and how far the neutrality and equity criteria can be applied will depend upon what is administratively possible. In particular this will limit just how far it is possible to measure profit accurately, or measure it with sufficient certainty and objectivity to justify taxing the resultant sum at an acceptable level of both compliance and enforcement cost. Consequently it might well be impossible to achieve the ideal as regards neutrality and equity, with administrative compromise requiring modifications in the application of the central definition of the tax base.

Within the EU there are the formal constraints embedded in the Treaty of Rome laying down the fundamental freedoms. The fundamental freedoms are constraints on what is feasible, particularly with respect to cross border transactions and their taxation. The CCCTB by its nature should overcome these problems, but care needs to be taken in provisions for those entering or leaving a group for CCCTB purposes.

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[25] This conflict does not in itself preclude realisation being considered a principle, because any principles might in some cases conflict and have to be prioritised.

[26] See p.252 below.

Within the administrative constraint we can also consider competitiveness; that is, that the system should not discourage companies from operating within the tax jurisdiction. In part the capital export/import neutrality issue will affect this, but so too will the ease of complying with tax administration. The CCCTB is aimed specifically at minimising the administrative burden, and, within the EU, resolves the capital export/import question. The definition of the tax base could be compromised, however, by the need to be internationally tax competitive. For example, if it were suggested that, in order to preserve neutrality as between debt and equity finance, debt interest should not be deducted in computing the tax base, it would almost certainly be argued that this would make the EU jurisdiction unattractive. A consequent reduction in tax rates, if MS applied them, could outweigh this, but consideration of this is outside the scope of CCCTB.

VI. Principles and the Tax Base

In addressing the issue of the tax base we consider three broad and connected issues:

a. The conceptual and substantive understanding of profits.
b. The accounting measure of profits.
c. Legislating the tax base.

Both neutrality and horizontal equity suggest a broad and general tax base so that distortions are not unintentionally caused by the exclusion of some, but inclusion of other, similar transactions from the base, and so that inequities do not arise because taxpayers in identical positions before tax are in different positions after tax. This suggests that any underlying concept of profit should be broad based, and it requires that all transactions perceived as being within the tax base are in fact captured by its legislative definition; otherwise some transactions will unintentionally escape taxation thereby creating economic distortion, inefficiency and horizontal inequity.

Constitutional equity requires that any tax be validated by government and not subject to the whim of administrators, or the discretion of the taxpayer. Whilst the CCCTB will clearly have to satisfy the varying legal requirements for imposing taxation in all the MS,[27] there is the more general difficulty that the need for validation has tended to suggest that tax legislation should take the form of highly detailed and prescriptive rules. However quite apart from the voluminous nature of that type of law, and the compliance difficulties that it brings, it also suffers from lending itself to literal interpretation and, as part of a feed-back process, leads to a recalcitrant audience learning the language and taking appropriate avoiding action. Constitutional equity thus conflicts with neutrality and horizontal equity and a balance has to be struck.

The Tax Base WP contains discussion and comment on the relative merits of legislating through the Directive (which at some level is a necessity) and through Comitology. This discussion reflects two very different, but not necessarily competing, views. The first is that any tax requires constitutional authorization. The second is that detailed prescription may not be the best way of legislating effectively. We accept the first without reservation, but, especially with the authors' experience of very detailed UK tax statutes, are concerned to explore whether more general rather than more precise legislation might provide a more robust definition of the tax base, and to what extent accounting standards, modified as necessary, could be incorporated into the legislation by reference, subject to some form of on-going scrutiny as to their continuing suitability for tax purposes.

[27] CCCTB/WP\001Rev1 23 November 2004 para 33.

What is required is legislation where the default position is that a transaction is within the tax base unless explicitly exempted. The definition of the base should be general, the exemptions detailed and protected, so that unintended distortions are minimised and horizontal equity realised. Further, the definition of the tax base should be supplemented by reference to principles which would inform the interpretation and application of the tax provisions. Where the legislation is general rather than detailed there will inevitably be gaps left by the Directive. Principles would provide a validated framework within which to implement legislation. They would make clear the basis on which the legislation would be interpreted and applied so ensuring constitutional equity as regards the taxpayer, and neutral and horizontally equitable outcomes from the operation of the system.

Certainty in this context should not be construed as meaning accuracy or correctness, or understood as requiring that tax can be levied only on certain outcomes. We shall see that estimation is inherent in the approach to periodic profit measurement identified with accounting, and is unavoidable. What has to be limited in this context is the opportunity for taxpayers to exercise discretion with a view to reducing their tax liability.

The certainty that taxpayers do require comes from the consistency of the tax system over time so that they can reach a post tax equilibrium within which they can act. Changes will inevitably take place to the tax system, and the definition of the tax base, but constitutional equity suggests that these should not be retrospective, and that there should be adequate transitional arrangements accompanying changes[28]. Transitional provisions, although tedious in legislative terms, are vital in this respect.

In the case of the CCCTB, as we have seen, a major issue is how far there needs to be a set of autonomous rules defining the tax base, or whether and to what extent, accounting principles as reflected in IFRS could be relied upon. This raises the fundamental issue of validation: should the tax base be computed according to rules promulgated by a private body not subject to democratic controls (the IASB)? Is it acceptable that tax law should be altered automatically by any future pronouncements of the IASB? The answer to this issue, of course, is that extant accounting standards, and any subsequent revisions, would be used, or not, following review of their fitness for purpose. It is this review process by an authorised body which would give their application for tax purposes constitutional validity.[29]

There is also a neutrality question to be considered. It is in the nature of companies that they report to their shareholders, and in many cases to the financial markets generally. Ideally this information contributes to an efficient market. It is inevitable that the data underlying that information will provide the basis for measuring the tax base. The neutrality issue is one of whether, if the accounting output is followed for tax purposes, this will distort the information available to the market because of companies reporting so as to minimise tax liabilities. This is considered in more detail later in this chapter.

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[28] This is reflected in the principle of the protection of legitimate expectations. See for example *Marks and Spencer v C&E Comrs* (Case C-62/00) [2002] STC 1036.

[29] IFRS are already subject to an adoption process within the EC. The Accounting Regulatory Committee and the European Financial Reporting Advisory Group advise not only on adoption but also attempt to influence the IASB during the development of the standard. Nevertheless the final endorsement tends to be an all or nothing process (subject to a carve out agreed at one time for IAS39). A parallel advisory committee would be needed for tax purposes. This would endorse only those parts of the IFRS appropriate for tax purposes. This would provide a double check and further approval could be required by Council and the European Parliament in the case of major changes and new standards.

VII. The Definition of Profit

The tax base has to be measured. Although it is therefore a calculus, and rules of that calculus can be set down, that in itself provides no inherent reference point by which those rules can be adjudged to be adequate, or more pertinent, whether they apply to particular transactions or events not expressly enumerated in legislation. What is therefore required, as argued above, is an overarching definition or conceptualisation of what it is that the tax base represents. The principle, or concept, of profit therefore needs to be explicit in any directive implementing the CCCTB; detailed rules as to the calculation of profit can be the subject of implementing legislation scrutinised under the Comitology procedure.[30]

The concept of profit is not itself a matter of fact; it is an abstraction which reflects the purpose for which it is undertaken. The purpose in this case is to provide a base according to which taxable capacity can be measured. This is very specific; it means that the definition, and the rules that follow from it, should result in a tax base which meets the neutrality and equity criteria. The process of measuring profit will be constrained by administrative feasibility, but nevertheless the importance of the central concept as a reference point remains; the rules of measurement can still be required to adhere to it unless departure is justified either by the specific needs of tax policy or because of administrative constraints.

A general definition of company profit would be a variation of one of the generally recognised and well-known definitions of personal income as set out by Haigh, Simons and Hicks. [31] These are in fact *measures* of personal income. Income is measured as consumption plus saving, and since saving represents consumption foregone, income is a measure of the potential consumption arising in a period. The conceptual underpinning is thus that income is a measure of how much a person could consume in a period whilst remaining as well off at the end of the period as at the beginning.

These measures can be undertaken either *ex ante* (budgeted) or *ex post* (reported). For our purposes it will be assumed that reported income will form the basis of any final tax liability. This will provide as much certainty as is possible within the context of periodic reporting. These definitions may be adapted to give a definition of company income, or indeed any business income where the business is regarded as an entity separate from the person running or owning it (whatever its legal status). For personal consumption we substitute the distribution or withdrawal of profit from the entity (as a necessary prelude to consumption); and although all the terms in the basic definitions import a positive meaning (as does the word income itself) we can allow accumulation to encompass its negative, depletion, and distribution to cover its reverse, capital introduction. Thus a company's profit for a period can be measured as being the amount it has distributed during a period, less any introduction of

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[30] EC Explanatory note on the Comitology procedure CCCTB/WP062 (2007).

[31] "Income is the *money-value of the net accretion to economic power between two points of time*" (Haigh, The Concept of Income – Economic and Legal Apects, in Haigh (ed), *The Federal Income Tax*, (1921), reprinted in Musgrave and Shoup (ed) Readings in the Economics of Taxation (1959) p 54 (p59)
"Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in value of the store in property rights between the beginning and end of the period in question….. The essential connotation of income, to repeat, is - gain to someone during a specified period and measured according to objective market standards." (Simons, *Personal Income Taxation*, (1938) p 49.)
"Income ….equals the value of an individual's consumption *plus* the increment in the money value of his prospect which has accrued during the week; it equals consumption *plus* capital accumulation" (Hicks, *Value and Capital*, (1946) p 178.)

capital, plus or minus the change in value of its economic capital. Conceptually we are measuring how much a company *could* have distributed in a period whilst maintaining the economic capital that it held at the beginning of the period.

To make that definition operational, for whatever purpose, three further issues need clarification:

a. The period over which the measure is undertaken. This is generally accepted as being a year, and for our purposes it is suggested the year over which a company chooses to measure its profits is also the "tax year". The administrative question then becomes that of determining the rate at which tax is levied for any given "tax year", given that each company may have a different tax year.
b. What is understood by capital accumulation, or what is required to ensure that opening capital is maintained. Of the three issues this can be the most problematic and wide-ranging. It raises, firstly, the fundamental question of what is understood by capital in the specific context of a company or business: is it simply a monetary equivalence, or purchasing power (as opposed to a monetary measure), or is it a productive capacity or service potential (measured in money terms)? Secondly it raises the issue of valuation: whether a particular concept of capital requires a particular basis of valuation. We discuss this below.
c. Whether, as questioned above, the profits are those of the company as an economic entity, or the equity shareholders as those with the residual financial interest in the company. This will determine whether contributions of capital extend beyond share capital to debt finance, and whether both interest and dividends are excluded in computing profit.[32] Ideally it would seem that that interest should not be deductible, so that there is no tax incentive in favour of debt finance.[33] An alternative would be to allow a deduction for the cost of all capital, debt and equity, at a risk free rate of interest.[34] This would reduce the tax base by allowing the cost of equity capital, but would increase it in so far as nominal debt interest exceeded the risk free rate. This would almost certainly require an increase in what would otherwise be the corporate tax rate. Thus it would not only be an explicit tax on the rewards to risk taking, although the present deductibility of interest has a similar effect, though to a lesser extent, but the higher rate would discriminate against service and other less capital intensive businesses. Further, since by exempting the risk free return only risky profits would be taxed, tax revenues would be more risky. A full discussion of alternative forms of corporation tax is outside the scope of our chapter.

VIII. Accounting Principles- General

[32] It also has implications for the consistent treatment of share-based payments: is a share option issued to an employee (and diluting the interests of existing equity shareholders) a cost to the company and/or a cost to shareholders?
[33] Debt interest within the corporate sector would then have to be exempted from double corporate taxation; this would then mean making some allowance for the service element involved in payments of bank interest.
[34] This broadly follows the ACE proposals of the IFS, though that does not suggest limiting nominal debt interest. The system has significant advantages from the perspective of defining the tax base in that timing issues become irrelevant.

We consider here the output of the accounting process in general terms and the problems inherent in periodic profit measurement in order to consider whether in principle the content of reported accounts is a suitable basis for CCCTB.

It is important to note first that personal income as referred to above is generally only measured in those terms for some regulatory purpose. By contrast, business profit in general, and corporate profit in particular, is measured notwithstanding regulation as part of the ongoing review of progress or performance of the business. What is measured as profit is thus very much determined by accounting principles and conventions, so that in a very real sense accounting provides the substance of what is meant by profit for that purpose.

As noted above, profit measurement is a purpose-based activity. According to accounting principles the objective of accounting is to provide general purpose accounting statements meeting the information needs of a variety of users. Although general purpose reports, the statements are considered as being especially the concern of investors, current or potential, who are assumed to make investment decisions. What is common to all users is that each values accounting statements according to their information content in relation to the decisions they are to make. In that context the qualities needed of accounting information can be inferred: information has to be understandable and relevant to the users of the statements, and to be relevant has to be reliable, that is, free from material error or bias; when deciding between alternatives it has to be comparable. These qualities are not identical to the tax principles of neutrality, equity and certainty, but in many respects they are consistent with them, and consistent with the need for objective measurement of the tax base.

The standard output of the accounting process is a balance sheet and profit and loss account. These statements capture in summary form all the transactions of the accounting entity with a third party. This is not to say that the profit and loss account will necessarily produce a profit figure that accords with the central concept of profit outlined above, or that any such figure is automatically suitable for taxation. Nevertheless, that all an entity's transactions are accounted for does suggest that the accounting output can be taken as a starting point in the knowledge that there are no systematic exclusions which would render it unsuitable as a data base from which a comprehensive tax base which is both neutral and equitable can be computed.

Accounting remains problematic, however. At the heart of its problems is the artificial separation of a productive continuum into a series of periods, with a measure of profit being made for each period. At a trivial level, the way profits are calculated as between each period will make no difference – over the life of a business or project any stream of periodic profits, however measured, will have the same economic value. But the whole point of periodic measurements is that they are made during the continuum before its completion. Their purpose might be to act as some guide as to progress to date, or the future progress, of the continuum, or, as in our case, their purpose might be to measure taxable capacity at any particular stage in the continuum, in which case the period in which the profits fall may be very important, due to availability of reliefs, changes in tax rates and other reasons.

The accrual basis of accounting is central to the way periodic profits are measured. It recognises transactions and events when they occur and not when cash is received or paid. This is entirely consistent with a central concept of income that includes accumulation of capital value, and is not limited to the cash flows inherent in consumption or distribution. It means that at the end of any period we establish (i) whether there is capital in the form of assets less liabilities, and (ii) a value of that capital.

Accounting establishes whether or not capital exists by determining whether there are assets, (defined as resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity), and liabilities (obligations of the entity arising from past events settlement of which is expected to result in an outflow of assets from the entity).Comparison of the measure of assets and liabilities at the end of the period with those at the start will determine the amount of capital accumulation for the period; this, adjusted for distributions and capital contributions will give the measure of profit for the period.

Although this is conceptually consistent with the definition of profit, it is in fact what might be termed an indirect measure of profit. A direct measure of profit, and the one we are familiar with in the context of taxation, involves the summing of certain transactions in the accounting period:

a. income - the increase in economic benefits in the form of an increase in assets or decrease in liabilities other than those relating to capital contributions to the entity, and
b. expense – the decrease in economic benefits in the form of a decrease in assets or increase in liabilities other than those relating to distributions or capital repayments by the entity.

Both approaches give the same measure of profit providing any changes in the measurement of assets are included in the profit and loss account. However both simply reflect or describe a calculus used in measuring profit; neither provides a conceptual understanding of what profit, as measured, is.

Because the measurement of transactions is not limited to cash flows, the time at which the underlying transactions are recognised becomes significant. So, too, does the question of estimates and the reliability or certainty of those estimates because the nature of the accrual process is that the effects of transactions that have taken place are allocated across accounting periods, and account may also be taken of transactions which have not occurred at the accounting date. Whether or not this process is reliable enough is determined by the perceived information needs of the users of accounts, and it is relevance to their concerns which determines how transactions are allocated and measured over time.

The measurement of transactions and thus of income, expense, assets and liabilities is initiated by recording them at their legally contracted price, or historic cost.[35] Where the transaction results in an asset or liability, this will represent their carrying cost; where it does not, this will be the measure of income or expense. Thereafter the measure of assets or liabilities might be adjusted to reflect a change in either the future economic resources attributable to the asset or liability, and hence a change in the cost of the transaction attributable to them, or the price at which the asset or liability is recorded.

A change in the cost attributable to an asset or liability, typically a reduction in the cost of an asset, will represent an expense. When that expense is recognised will generally[36] be determined by when the income generated by the consumption of the economic service potential of the asset is recognised. When income is recognised is generally based on certainty

[35] Where there is no such price or cost, the fair value of the asset exchanged in the transaction has to be established.

[36] If the reduction in the future economic benefits expected to flow from the asset is not matched by income generating transactions, the reduction is considered a loss and charged in the same way as an expense.

of the transaction and reliability as to its measurement. In some cases, long term contracts for example, this issue of income recognition is particularly problematic, and different conventions for recognition are applied in order to improve the relevance of the measure of profit to investors. Within limits, the relevance of information is more important than its reliability or certainty. This may be an area where tax and accounting will diverge.

Measuring the reductions in the cost attributable to assets raises very different issues from measuring price changes attributable to assets or liabilities. Measurement of inventories is conventionally at the lower of cost or net realisable value. This is not an exercise in re-pricing, neither is it an asymmetric approach to revaluation;[37] rather it is a question of allocating cost. The accounting model requires that when an asset will no longer provide future economic benefits its carrying cost should be de-recognised; that is, the cost is recognised not in the balance sheet as an asset, but as an expense in the profit and loss account. When inventories are valued at the lower of cost or net realisable value, the realisable value is only being taken as a benchmark against which to measure how much cost can be retained as the measure of the asset.

Depreciation represents a process of allocating the cost of an asset over its useful life, and applies to non current assets and intangible assets. By contrast an impairment adjustment applies to any asset and is recognition that an asset has lost its expected economic benefits without generating compensating inflows; it is equivalent to the write down of inventories to net realisable value, except that the benchmark is its recoverable amount - the higher of net realisable value or value in use.

The process of re-valuation or re-pricing is very different. It raises fundamental questions as to the relevance of the information given by the value of assets and liabilities, and, subject to that, the nature of capital. The accounting treatment depends very much on the asset or liability in question. Assets, the costs of which are expected to be recovered by use in the business rather than a sale transaction, could be re-valued according to either their replacement cost or their realisable value, and the values might be very different. The first is consistent with a view of capital as being a store of service potential; if the market price changes, without any change in the physical service potential, then there has been no real increase in capital and no increase in potential future distributions. The rationale for re-measurement would be to indicate the current cost of using the asset and the amount of the value change would not be included in profit.[38] Alternatively a change in replacement cost might indicate a market wide change in the future financial benefits expected to flow from its use by the company. A reduction in value would be covered by the impairment measure and would represent a loss as argued above; but if there were an increase reflecting an increase in the financial flows attributable to future use of the asset, to include that change would not be consistent with an *ex post* transaction based measure of profit. It would recognise now the profit due to be measured in the future, and its future use would reduce that increase in profit accordingly.

By contrast, to value assets in use at their realisable value is to equate capital with a fund of money or, if adjusted for inflation, purchasing power. Assuming that such a value had an acceptable level of certainty attached to it, that in itself would not be sufficient to justify including it in the measure of profit. Only if there would be no consequent liabilities attaching

[37] The comment of the MS at para.77 Tax Base WP that these write-downs are asymmetric appears to be incorrect.
[38] However, a proportionate amount could be added back as the asset is depreciated; the result would be to give the same total profit figure but in a more informative way. Accounting does not do this under IRFS.

to the hypothetical realisation could it be said that there had been an accumulation of capital that could be distributed. It is inadequate to claim that an amount equal to the increase in value could be borrowed against the security of the asset and distributed, because under the conditions described borrowing could only be repaid out of the proceeds of realisation and these first would have to fund the consequent liabilities. Accounting does not recognise these consequent liabilities because it is based on a fundamental assumption that the business will continue as a going concern.

It is the case that accounting does include the gains or losses arising on revaluation in profit in some instances, generally those involving investments. Provided there is sufficient evidence from deep and active markets to evidence the value, so that the profit measure is considered reliable enough, inventories of traders are measured at fair value at the end of any period. Any unrealised gain or loss is thus captured in the profit measure. This differs from the conventions applicable to the sale of goods and services, where the sale needs to be completed for revenue to be recognised. The different treatment can be justified both by the nature of the hypothetical transaction and the reliability of measurement: the market price (net of selling cost) indicates the price at which the holder could most probably have realised the asset without further work or expense on his part. Where financial instruments are designated as being for profit and loss, then other entities also include gains and losses on valuation in their profit. Similarly holders of investment property may opt between whether to hold properties and depreciate the cost of the building or revalue the building and land. In none of these cases does the inclusion of unrealised profits or losses seem inconsistent with the underlying concept of profit as discussed above, so that if it is wished for CCCTB to diverge for practical reasons this will need to be made explicit in the Directive.

The standard on financial instruments also includes accounting for liabilities as well as assets. As we have talked of assets held for use, so in this context the standard talks of instruments held to maturity. These are generally required to be measured at amortised cost using the effective interest rate method, an approach which accrues all the costs of the liability evenly across the periods to maturity.

The effect of the accounting measure of profit is to maintain the capital of the entity at its original monetary value (subject to any losses), unless assets other than financial instruments or investment properties are revalued. In that case the measure of capital includes that change in value, but any uplift is excluded from the calculation of profit. As such there is no fundamental conceptualisation of what is understood by capital, whether service potential or purchasing power. Conceptualising capital as purchasing power, as opposed to money, would require some form of indexation of the opening capital.[39]

Finally, provision for future expenditure is recognised. Provisions are a particular example under the accrual system of recognising expense in advance of a later underlying transaction. A level of certainty is required before provisions may be recognised, in part to prevent the build up of secret reserves (which can be released when the published results would otherwise appear poor). They are admitted not only where there is evidence of a legal obligation, but also where there a constructive obligations based upon the evidence of past behaviour making it more probable than not that the expense will be incurred. Contingent liabilities and assets, not evidenced by an existing legal obligation or dependent on future events not within the control of the company, are not recognised.

[39] Interestingly, the proposal to give an allowance at the risk free rate of interest on capital would automatically ensure that for tax purposes the effects of inflation are recognised in aggregate because the money interest rate is inclusive of the inflation rate.

The continuity between accounting periods is central to the accrual concept. This requires not only consistency of accounting policies but recognition that estimates can be wrong and subject to subsequent adjustment; changing estimates with retrospective effect is not permitted. However correction of prior year errors and the effects of changes in accounting policies are applied retrospectively. This is an issue on which tax and accounting may need to diverge for practical reasons.

IX. Accounting Standards.

Before reviewing how far the content of accounting standards could, where appropriate, be applied in operating the CCCTB it is important to understand their nature and purpose.

In the case of companies, the information conveyed by accounting statements is being communicated by one party to another, with the communicating party having a vested interest in how that information is used. Thus company management has an interest in how shareholders interpret the information they are given. The combination of this, and of there being no obvious or non-problematic methodology for measuring periodic results, has led to the development and promulgation of accounting standards. These standards are often aimed at accounting avoidance, whereby relevant information is either withheld or misrepresented. In particular this might mean delay in the recognition of expenses or acceleration in the recognition of income so as to bolster profits for reporting purposes - the opposite to tax induced behaviour and thus creating a tension. [40] It can be seen from this that that the objectives of tax and accounting regulators will not necessarily co-incide. Thus there may be differences not only in the substance of accounting and tax law approaches but also in the way they are applied and enforced. In the CCTB context, where there are such differences they need to be recognised and dealt with explicitly and transparently. [41]

Compliance with accounting standards, where they exist, is what is now understood by the term GAAP. Where they do not exist, the term means little more than all the possible and various accounting practices currently operational in any defined situation. In formulating standards, the standard setters initially tended to provide an *ex post* rationalisation of what was done in practice. As accounting standards have developed, though, the need for a conceptual framework to underpin the creation of consistent solutions to a range of problems has been recognised and developed.[42] Compliance with standards generally advances the comparability and consistency of accounting reports, and, compliance with individual standards will limit (though not always standardise) the methodologies used in those situations where they would otherwise be discretionary. Whilst the result might not be the same as compliance with a single set of tax accounting rules, the question is whether the

[40] It is argued by some , particularly in the context of the debate on book-tax conformity in the USA, that this tension means that requiring the same figure for financial accounting and tax is likely to produce a good balance in the case of listed companies at least. This brings problems of its own, however. For the US debate see. Desai, The Degradation of Reported Corporate Profits, 2005 available at SSRN: http://ssrn.com/abstract=758144 ; Hanlon and Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues (2005) NBER Working Paper No 11067;* Plesko and Mills, Bridging the Reporting Gap: A Proposal for more Informative Reconciling of Book and Tax Income, 56 *National Tax Journal 2003 p. 4*.
[41] Freedman, Financial and Tax Accounting: Transparency and "Truth" in Schoen (ed) *Tax and Corporate Governance* p.71
[42] IASC, *Framework for the Preparation and Presentation of Financial Statements* (adopted 2001).

resultant range of measures would be limited enough to justify their application in measuring the tax base. In the particular context of CCCTB, the question is whether a variety of MS GAAPs can be used, or whether there should be conformity to a single GAAP (IFRS). Alternatively, should a single set of autonomous rules be developed specifically for the purpose of the CCCTB.

In the first place it has to be emphasised that although it is recognised that governments are one of the users of accounting statements, standards are not generally formulated with a view to computing tax liabilities. This is at once both a strength and a weakness as regards their suitability for tax purposes. That standards are not set with tax purposes in mind means that they can be regarded as objective in that their aim is not to reduce tax liabilities.[43] On the other hand, in ignoring the tax purpose, standards may be inappropriate to that purpose. Therefore how far, if at all, accounting standards can be relied on for tax purposes must be determined by the needs of tax policy in general and of the CCCTB in particular.

In general neutrality and equity suggest that differences between MS should be as few as possible, and the particular nature of the CCCTB project surely demands this. It is worth noting that a central requirement of IAS 27, the standard dealing with consolidation for accounting, is that "Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances". Consolidation without prior adjustment to IFRS from national GAAP could be rather like aggregating transactions in different currencies. This is the thrust of much of this chapter – that a CCCTB makes little sense without standardisation, whether it is based upon an external set of conventions such as IFRS, or an internal set of tax provisions. So, whilst MS GAAP must inevitably be the starting point, standardisation has to be the end point.

We agree with the Commission that IFRS provide a suitable starting point. This is for three reasons. First, standards identify those areas where the solutions to periodic reporting are problematic; they may or may not provide an acceptable solution for tax purposes, but if they do not, they at least point to those areas where specific tax rules will almost certainly be required. Second, the very purpose of the international standards setting process is to bring about convergence of national accounting standards to a set of enforceable global accounting standards. Third, they are currently applied in some MS where compliance with IFRS is required for listed companies and may be adopted voluntarily by others. A number of MS are moving their own national GAAP towards IFRS, such as Germany, or even converging with it as in the UK.[44] IFRS will be used increasingly world wide and, as such, make a suitable initial basis for a tax base that is being designed for use some time into the future.

X. Legislation and Accounting Standards

The uses to which accounting standards might be put in formulating the tax base are various and will range from compliance to complete rejection. We have already advocated that there should be a legislative principles-based expression of the tax base against which the inclusion or exclusion of any transaction can be measured. Reliance on accounting standards could act as a source of secondary principles to provide a default position where no explicit rules were set out. It is important to point out, however, that accounting standards do not always operate

[43] In a rare reference to tax, IAS 2 Inventories states in rejecting LIFO as a basis of valuation, that the use of LIFO is often tax-driven in that it seeks to charge costs at the most recent prices.
[44] Schön, 44 *European Taxation* 2004 p.426; Norberg , Kari Tikka Memorial Lecture in Lang and Vanistendael (eds) Accounting and Taxation p.9.

like legal rules. They may offer options between treatments as opposed to one treatment, and this might prevent them from achieving the requisite horizontal equity for tax purposes. In such cases, it might be necessary for the CCTB to provide more prescriptive treatment than does the standard.

One possibility would be that the legislation could adopt the whole or part of the standard (as at the date of the Directive) by reference. Alternatively, a general reference could be made to IFRS as a starting point and then clarity would require that standards excluded from application for tax purposes should be explicitly enumerated.

One of the advantages of legislating by reference to standards, rather than legislating directly, is that the standards would remove a layer of rules for MS to interpret (or misinterpret) and incorporate into national legislation. Issues could still arise, however, as to whether the meaning of the standards was the same when used for financial reporting as it was for tax purposes. This would be the case even if the CCCTB Directive did not refer to IFRS in every aspect or adopt it automatically: to the extent that IFRS was followed there would be issues about the meaning of provisions. It would be important for divergences to be explicit. As one of the authors has argued elsewhere, when dealing with two different rule systems and attempting to partially converge them, clarity of the relationship is of great importance.[45] Subject to express exceptions, it would be desirable for the interpretation of adopted or referenced IFRS to be on the basis of their meaning in financial reporting but there could be areas where this could cause difficulties. In order to ensure consistency of interpretation and awareness of potential problems in applying IFRS for tax purposes (such as conflicts with tax principles), it would be desirable to set up a regulatory committee which, under the Comitology procedure, could decide on the application of IFRS in relation to CCCTB according to criteria to be laid down by Regulation. [46]

We also propose setting up an advisory committee to monitor accounting developments, adoption of standards by the EU and interpretations of IFRS in relation to CCCTB, as they emerged. This would be equivalent to the advisory committee exercising this function in relation to the application of IFRS to companies within the EU (the European Financial Advisory Group – 'EFRAG').[47] Arrangements would be needed for consultation and co-operation between these two committees, including some overlap in membership. If a new IFRS was in whole or in part inappropriate for tax purposes, this committee could advise that an express exception would be needed for CCCTB. Where an issue of interpretation arose, the committee could make representations to the International Financial Reporting Interpretations Committee of the IASB (IFRIC).

Even with such a committee in place, problems of uniform interpretation and application across MS could remain where accounting rules, whether autonomous or IFRS based, depend on legal definitions, with regard to property for example, which differ as between MS. This could be avoided to some extent by dealing with such matters in the CCCTB with precision. Thus the recognition of revenues from long-term contacts could avoid a test of completion such as the time that title in property passes, and adopt instead a test based on a substantive

[45] Freedman, Financial and Tax Accounting: Transparency and "Truth" in Schoen (ed) *Tax and Corporate Governance* p.71.
[46] This would be similar to the Accounting Regulatory Committee established under Regulation 1606/2002 for the purpose of deciding on the application of IFRS to the EC for accounting purposes: see CCCTB/WP062 (Comitology Procedure) 2007 and the chapter by Lyal in this book, Comitology and the CCCTB. The authors are grateful to Richard Lyal for information supplied subsequent to the Vienna conference on this matter.
[47] The EFRAG is an ad hoc advisory committee composed of persons nominated by accounting and business organisations,

definition of completion. In this way, as far as possible, CCCTB needs to be explicit about divergences from IFRS or support those divergences with specific rules.[48] These divergences need to be considered in the light of the tax principles underlying the CCTB.

A further role of the CCCTB legislation would be as a control of the residual discretion left by standards. This discretion can range from that inherent in some of the estimates required under the accrual approach to profit measurement, such as the rate of depreciation, to a point at which compliance is overtly optional. This is another area where the principles underlying CCCTB will need to be applied, and where legislation will be needed to ensure that the liability to tax does not become discretionary, for to allow such beyond certain limits would offend all principles of constitutional equity.

In this context legislation could use the standards as limiting benchmarks for those cases where there is no necessary right or wrong treatment in principle for tax purposes, but where it is thought limits rather than prescriptive rules might be appropriate. Thus, knowing that for tax purposes the taxpayer will prefer to recognise revenues later and costs earlier than might otherwise be the case, the relevant legislative provision might be no more than a requirement that expenses should be recognised no earlier and revenues no later than permitted by IFRS . This could then leave the company free to choose between options on administrative grounds, without threatening the tax base or offending equity, and would not distort the provision of information. Alternatively the legislation might simply refer to a method of measurement adopted in an accounting standard. Thus there might be a requirement to measure the expense or income of loan finance according to amortised cost using the effective interest rate method.

A prior question would be whether a company should be taxed according to the requirements of accounting standards only if it reports according to those standards. Where a standard requires a singular accounting treatment of transactions, and that treatment is considered appropriate in principle for tax purposes, clearly the financial accounting and tax must match and be in compliance with the standard. Where a standard permits alternatives,[49]however, and both are acceptable for tax purposes, can a company report to investors on one accounting basis and compute for tax purposes on another acceptable but more tax advantageous basis? It is arguable that there is economic advantage in the communication of relevant information, and that standards generate that quality of information. If so, it may not be economically efficient to create a tax incentive to publish second-best information. Therefore, where an accounting standard allows alternative bases of recognition, one view is that the taxpayer should be able to report for tax purposes on the most advantageous basis, regardless of the basis used for general publication.[50] Even if conformity was not required, administrative costs might drive a company to report on a tax minimising basis, but this is an unavoidable consequence of accounting standards that allow choice.[51] Whether it is decided to insist on conformity or not, this decision should be made clear in the Directive and not left to national legislatures, otherwise it could create confusion in markets and a distortion between different jurisdictions.

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[48] Interactions between two systems will always be problematic and the interface between them needs to be carefully managed and monitored. For a further discussion of this see Freedman, *eJournal Tax Research* 2005 p.7.

[49] Such, for example, as the option for the fair value or cost model for investment properties under IAS 40, or the ability to assign financial instruments as being for sale under IAS 39.

[50] See Hanlon, *NBER Working Paper No 11067 2005* but others, e.g. Desai, would argue that this might give opportunities for avoidance.. Desai, SSSRN 2005.

[51] Even if there were a set of independent tax rules, where one matched an accounting alternative this could lead to a company adopting an accounting alternative for tax reasons in order to minimise administration costs.

XI. Issues for Tax Accounting

The CCTB working documents have made it clear that IFRS will indeed be a starting point for the tax base. It is then necessary to consider adaptations according to the principles we have enumerated above.

11.1. Exclusions

The first issue is whether any transactions reflected in the profit and loss account should be excluded, or exclusions from the accounts included. General exclusions from accounting profits for the purpose of the tax base would include:

a) Transactions not undertaken for a business purpose. The principle of a general restriction relevant here is that transactions that in effect provide the benefits of distribution, that is personal consumption, should not be deducted in calculating what is available for distribution. This is essentially a problem for closely held companies where there is identity between shareholders and managers. Equally important is that such items should be disclosed so that they can be included in personal income.[52]

b) Particular categories of transaction inherently close to the borderline in (a) above. Business entertainment expenses would be an example.

c) Transactions excluded on policy grounds. Examples would include bribes and fines, and if capital import neutrality is an objective, foreign profits - either those repatriated in the form of dividend or all foreign earnings.

d) Transactions excluded to prevent double corporate taxation of profits. This would include domestic dividends within the EU and could extend to gains on equity instruments if they are seen as a right to future profits which will themselves be taxed. In that sense the exemption would be consistent with the exemption of domestic dividends. On the other hand changes in equity prices arise from more than just expectations as to future profits. The common compromise on this issue is to exclude gains or losses on participation holdings, usually defined as such by reference to the size of the holding, thereby limiting the tax charge to portfolio holdings the purpose of which is in part to exploit market volatility.

e) Transactions related to activities excluded from the tax base. Thus if foreign profits are excluded from the tax base then any finance costs associated with those activities would not be recognised in measuring the home tax base[53]. On the other hand, where the rationale for the exclusion is to avoid double taxation, then it would not be appropriate to exclude underlying expenses (for example interest on debt financing domestic equity holdings) from the tax base.

11.2 Anti-abuse measures

[52] See para. 25 of Tax Base WP and comments.

[53] In these circumstances the position would be the same as if the shareholders had borrowed to invest directly in the foreign subsidiary.

Further limitations will also be needed in order to limit tax avoidance. These will arise wherever there is a boundary between what is taxable/allowable and not taxable/allowable. In particular, if the structure of the tax discriminates between debt and equity finance, what is recognised as debt, and what equity finance, will need to be controlled and transactions not necessarily accounted for according to their legal form. This will need to be dealt with explicitly in the Directive.[54]

More generally, provision will be required for re-measuring transactions between connected or related parties at arm's-length value as opposed to transacted price[55]. Where the tax base is consolidated, this will be irrelevant for intra group transactions, but the related party threshold is usually significantly lower than the group threshold and so is likely to have general application.

11.3 Timing

Subject to these general adjustments to an accounting measure of profit, the issues are essentially those of whether the allocation of transactions as between periods is appropriate. Although the view taken on this will mean excluding transactions in whole or in part from one period, it will also mean including them in others. The issue is thus one of the timing[56] of tax liabilities.

As regards the allocation of transactions between periods, the general criterion of equity requires that discretionary treatment of transactions is kept to a minimum so that no taxpayer obtains a tax advantage (later recognition of revenue or earlier recognition of expense) as compared with another simply on account of a choice made with a view to reducing tax liability as opposed to properly measuring profit. In so far as is compatible with administrative constraints and cost, these elements of discretion should be removed.

11. 3.1 Timing -depreciation

An important example is depreciation. The standard sets out the principles upon which the cost of depreciated assets should be ascertained and depreciation calculated but does not attempt to be specific as to rates and classes of asset. A tax system might wish to set rates for specific assets in order to prevent the adoption of aggressive depreciation policies aimed at postponing tax.[57] However it should also be recognised that the same asset might have a different rate of economic depreciation according to the entity using it and the use being made of it. In such a case the imposition of a uniform set of rates, whilst superficially attractive, would in fact offend the neutrality criterion and the rules defining classes of assets would in themselves almost certainly create distortions. Protection of the tax base can be achieved by strict monitoring of compliance with the standard, but if this is considered inadequate, a range of maximum rates could be established (adoption of which would still need to be justified within the terms of the accounting standard, though in practice the maxima for tax purposes might well become the norm for financial reporting).

[54] See CCCTB\WP\028\doc\en para 17. It has been noted by the sub-group on taxable income that this will need to be dealt with when anti-abuse provisions are discussed. The UK, for example, has a raft of complex anti-avoidance provisions in this area which would need to be overridden by the CCCTB Directive in order to ensure harmonized treatment under CCCTB.

[55] IAS 24 covers the disclosure, but not measurement, of related party transactions. Specific tax provisions suggested (para. 78 Tax Base WP) suggest a test broader than a percentage shareholding and advantage could be taken of the disclosures required by IAS 24.

[56] As mentioned above , this timing problem could be avoided by a move to an ACE or a cash flow tax but these are not discussed further in this chapter..

[57] As suggested in the Tax Base WP (paras 66-72).

What is crucial is that expense which is capitalised (carried as an asset) for accounting purposes and is subsequently depreciated, should be recognised within the tax system. The danger of legislating for categories of assets is that the process of legal categorisation excludes some assets from any category. Therefore, if there are to be separate tax depreciation rules, there should be a fail-safe provision allowing accounting depreciation (unless specifically excluded) where it does not fall within legislated categories.

11. 3.2 Timing - provisions

One aspect of modern accounting standards that leads to doubts as to their suitability for tax purposes is the concentration on the balance sheet, with the profit and loss account as a residual. In measuring the tax base the emphasis is very much the other way round, but we have seen that both approaches give the same result. The reason for this approach is to restrict the ability of managers to carry forward expenditure rather than charge it against profits, and it is considered a more rigorous test of whether to allocate expenditure to a current period or to carry it forward to a later period to ask whether the expenditure represents an asset as defined in the standards.

Similar rigor is seen in the limits for recognising provisions. The IFRS seeks to impose a level of objectivity before provisions may be recognised, in part to prevent the build up of secret reserves (which can be released when the published results would otherwise appear poor). Provisions are admitted not only where there is evidence of a legal obligation, but also where there a constructive obligation based upon the evidence of past behaviour. One's instinctive reaction to the recognition of provisions for tax purposes is that they represent an opportunity for tax relief in advance of actually incurring the expense. However this is in the nature of accrual accounting; there is little argument that capitalised expenditure should only be recognised as consumed as opposed to when the expense is incurred, but this is effectively a mirror image of provisions. Where there is a difference is in the objectivity of the measure. Capitalised expenditure has been incurred through a transaction and thus is objectively measurable, although the measure of its consumption is less objective. Provisions lack this objectivity, and whether provisions based on constructive obligations as opposed to only legal ones is considered objective or certain enough must be open to doubt. The other aspect of provisions that present difficulties is their timing, relating to existing obligations settlement of which will be in the distant future being particularly problematic. The accounting solution is to discount in order to recognise the time value of money where this is material. This again gives rise to concerns as to objectivity. An alternative to this might be only to recognise provisions for future expenses expected to arise within a fixed time scale, but recognising them then in full.

Alternatively different conditions for recognition might be applied in different cases. Thus in the case of employee benefits, recognition of pension liabilities might be limited to cash payments, either into a fund or in payment of pension, simply to prevent excessive provisions and the build up of untaxed reserves. The default principle should be one of objectivity, however, and should probably require a legal obligation.[58]

[58] As suggested in Tax Base WP para 32. However Essers in his chapter in this book, The Precious Relationship between IAS/IFRS and CCCTB with respect to Provisions and Liabilities, makes a strong case for accepting the IFRS treatment of provisions, arguing that it is in fact more stringent than the requirements accepted by MS.

11. 3.3 Timing - valuation and realisation

The other characteristic associated with the balance sheet approach of IFRS is a greater concentration on the value of assets and liabilities, as opposed to their cost. The rationale for this is that greater information value is given with regard to financial position and profit or loss as a measure of performance. Relevance takes precedence over certainty. The valuation basis used is “fair value”, defined as “the amount for which an asset could be exchanged between knowledgeable, willing parties to an arm’s length transaction”, which usually means market value determined by appraisal.

In fact, only in very limited circumstances are valuation changes reflected in the accounting profit under IFRS. Usually gains are transferred directly to equity and only enter profit and loss on final derecognition of the asset or liability[59], whereas losses are recognised in profit and loss. We have discussed above in section VIII the question of valuing assets held for use in the business and concluded by reference to the underlying definition of profit, without any recourse to a realisation principle, that generally there is no case for including value changes, whether gain or loss, in the measure of profit; unless there is impairment which requires that the carrying cost should be written down.

Fair value changes are included in accounting profits under IFRS in respect of unrealised gains or losses on investment assets, either financial instruments or investment properties. Even then, it should be emphasised that this is only in certain circumstances. Inclusion in the accounting profit is only admitted where there is evidence of market price from an active market, and there is sometimes more certainty and objectivity about these values than many other estimates admitted in profit calculation.

Under IAS 39 financial instruments representing trading inventory are required to be valued with the gain or loss being included in profit. There seems in principle no reason to treat portfolio investments any differently, but whether or not they are so treated in the financial accounts depends on how they are designated. The tax result would in this case be optional and could effect how the assets are reported. It would therefore be appropriate to legislate one way or the other as to the taxation of this class of asset, although perhaps what should be considered in this context is whether recognising gains and losses only in respect of quoted investments as opposed to others would distort investment decisions.

The problems of volatility and liquidity often cited as difficulties in following fair value accounting for tax purposes are discussed above in association with the tax principle of realisation. It should be noted that there are differences of opinion amongst the accounting regulators, business users and the profession about the way in which fair value accounting should develop for the future and the extent of its application now, particularly at a time of financial crisis, when accounting standards as currently applied can have some curious consequences. [60] It might be that the extent to which fair value accounting is appropriate for accounting purposes needs to be reviewed. This does not relate to differences in principle between tax and accounting but rather issues about whether fair values fulfil the purposes of accounting adequately.

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[59] Where a fair value model is applied a change in value is not reflected in the profit and loss account, though any subsequent depreciation or impairment measure will reflect it. It is thus a model aimed at maintaining capital at fair value. If applied for tax purposes this would create distortions as between capital intensive businesses and others, allowing the former to create untaxed reserves.

[60] See for example Sir Mike Rake, Financial Times October 11 2007, ‘Moving to fair value is going to require a high degree of subjectivity, which will mean less direct comparability’. A European Parliament Economics Committee report issued in April 2008 notes that the ‘fair value’ principle can lead to unrealistic valuations in some circumstances. Financial Times March 14, 2008 ‘AIG calls for ‘fair value’ review.

11.3.4 Problems with realisation basis and losses

Notwithstanding that assets held for use are not subject to tax on changes in their value, taxing any changes only on realisation gives rise to the problem of "lock-in" outlined above. To counter that, reinvestment relief is often given within tax systems in respect of realised gains on fixed assets[61]. However this would seem to be relevant to a very limited class of asset, essentially property, where there is only limited depreciation.

Where gains are only taxed on realisation there is also an incentive to realise losses in order to gain immediate tax relief, but to hold assets showing a gain so as to postpone tax charges. As a consequence some systems ring fence gains and losses on the disposals of assets (capital gains/losses) and allow capital losses only to be set against capital gains. This ability to "cherry pick" losses is of course most readily available just where there is an active market in the asset. Therefore exempting participating holdings from the tax base and subjecting portfolio holdings to immediate taxation on the accrual of any gain or loss may in fact then remove the need to restrict the set off of losses and thereby generally provide a more efficient treatment of losses.

The way accounting deals with periodic losses depends on the financial transactions consequent upon previous periodic profits. If previous periods' profits have been distributed then losses are carried forward and set against any subsequent profits. Alternatively, if they have been retained, then losses are immediately set against cumulative profits. The issues for tax policy are whether relief for losses should be given, and, if so, when. Neutrality requires that loss relief is given, otherwise risk taking is discriminated against, and ideally relief should be given as losses arise. Immediate relief can be achieved by allowing set off against previously taxed profits, the carry back usually being limited to a short period of say one to three years. The alternative to carry back is to allow losses carried forward to be up-rated by interest. Where unrealised gains have been taxed some relief could be afforded where there is a subsequent decrease in value: in these circumstances it could be possible to carry back the loss for as many periods as unrealised gains have been recognised and taxed.

The set-off of losses is a particular advantage, and concern, of the consolidation process under CCCTB. Under consolidation no relief would be given for losses arising prior to establishment of, or entry to, a group. This requires that assets be revalued at date of entry. Accounting consolidation would provide such values providing the threshold were the same as that triggering accounting consolidation (which it is not). However, it would seem inconsistent with our previous arguments with regard to revaluation to expect that a subsidiary would be charged tax on any uplift in value of assets in use on joining a group.[62] It would therefore seem appropriate that on entry to a group these assets should be transferred for tax purposes at the lower of tax written down value and fair value. Consistency would then suggest that the same rule should apply on leaving a group.

11.3. 5. Exchange differences

The CCCTB would require measurement of all transactions in euros. Exchange differences will arise either in respect of transactions and balances with MS whose national currency is

[61] This can be limited to gains above cost rather than gains above the tax written down value of depreciating assets. The pooling of assets suggested in the WD would make no such distinction.
[62] The group boundary would be equivalent to a jurisdictional boundary so any reinvestment relief would be unavailable.

not the euro, or in respect of foreign operations outside the EU. The methodology of IAS 21 could be applied to the computation of the CCCTB so that the standard would apply to transactions and balances as and when recognised for tax purposes.

11.3.6. Materiality and substance over form

Two general issues with regard to accounting need further consideration: materiality and the substance over form principle, since both permeate the final output of accounting reports without being limited to specific standards.

Materiality is a threshold below which certain transactions need not be subject to the full rigor of an accounting standard if the transaction is relatively small in the context of the reporting entity. Such a threshold is commonly applied in most areas of administration, including tax.[63] To allow a company to be excluded from the requirements of a standard on the basis of size is acceptable for financial accounting but might not be so for tax purposes due to the principle of equity. Administratively it might be appropriate to set some general exemption levels, but subject to that, materiality should not be relevant for tax purposes and where applied by any entity for accounting purposes it should be disclosed to the tax authorities.

Reporting according to the substance or economic reality of a transaction rather than its legal form is seen as prerequisite to reporting "faithfully" on transactions. In part this is an inevitable consequence of artificially allocating transactions between time periods, because that very process can create an artifice different from legal form. Although the result of accounting according to substance might not be appropriate in any case for tax purposes, it does not follow that it is inappropriate just because it does not follow legal form.

The question of substance is never far from any discussion of tax avoidance. This is because a measure of avoidance is whether transactions with the same economic effect (by reference to the tax base) are being taxed differently for no obvious policy reason. In other words, accounting according to substance may be consistent with the principles of both neutrality and equity. Thus measuring the cost of the grant of a share option to an employee by reference to the dilution of shareholder wealth is essentially the application of substance in the interests of obtaining a measure of cost which is comparable to similar transactions with a different legal form. Accounting for substance might also be used as a defence against avoidance.[64]

Often legislation itself will acknowledge the inadequacies of setting conditions which rely on legal form by developing further tests which aim to reflect the economic substance required of the legal form. Thus in the context of the CCCTB, an example would be the use of voting rights to determine whether or not there is a group relationship. The test of control may well be extended beyond formal voting rights to conditions reflecting shares of profit in any distribution or assets on a winding up. This, however, is different from the accounting application of substance: the extended definition still relies on formal legal rights, whereas accounting would represent transactions outside the legal form. Of course, the very process of

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[63] See for example para. 26 of Tax Base WP.

[64] Recently in the UK the sale of a number of years rental income for a single sum was held not to be taxable as income, though the accounts showed the sum as income over each of the years in question by ignoring legal form and reporting economic substance. This resulted first in additional legislation covering the particular transaction, and later in wider anti avoidance legislation based on GAAP and its treatment of finance arrangements according to economic substance rather than legal form. This is due to change again shortly to move to even more principles based legislation.

consolidation, which is at the heart of CCCTB, is itself an example of accounting according to substance rather than form.

By definition, the effect of accounting according to substance rather than form cannot be predicted. Therefore for tax purposes disclosure of transactions accounted for according to economic substance and not legal form should be required, with a power to require recalculation of profit according to legal form if it is considered that the resultant effect on profit measurement is not consistent with the underlying definition of the tax base. On the other hand, it might be that the principles set out in the Directive and the express wording of the legislation would make it clear in a given case that the intention was to tax on the basis of economic substance rather than legal form. This might be the case particularly in respect of some of the anti-abuse provisions which might benefit particularly from being drafted on the basis of principles.

The distinction between finance and operating leases in accounting is an example of the application of economic substance in order to ensure that the financial position of the lessee is fully disclosed. Whether there is in fact any need to distinguish for the purposes of taxation seems arguable, and it might well be preferable to require that all lease payments and receipts are recognised as an expense or revenue on a straight-line basis over the lease term in the lessee's and lessor's accounts respectively with the asset being depreciated in the accounts of the lessor. However, if it is considered desirable (in order to protect the tax base) to limit the benefits of depreciation allowances, the accounting solution may prove the right one for tax purposes. [65]

11.3.7. Continuity and consistency

We noted in the outline of accounting principles that the continuity between accounting periods is central to the accrual concept. However we saw that although prior estimates could not be changed retrospectively, changes in accounting policies and corrections of errors could. This would be unacceptable for tax purposes because, possibly excepting error, tax computations once agreed are closed. Therefore for tax purposes continuity is equally important because otherwise parts of transactions, whether revenues or expense, may be omitted from the tax base. The solution however would differ from that applied for accounting and would be of general import because it has to be recognised that accounting standards are not static.

Changes in accounting policy would be treated in the same way as changes in estimates. However consistency across time periods is of the essence when measuring periodic profits. A set of autonomous detailed rules for CCCTB would generally achieve this automatically, but if reliance is placed on IFRS with greater choice for each individual tax unit within well defined boundaries, then consistency has to be a central principle. Changes in accounting policies without financial reporting justification and with a tax avoidance purpose or benefit would not be recognised.

Furthermore, acknowledging that there would be no tax balance sheet, all pre-existing provisions accepted for tax should be reviewed in each period in order to establish whether continued provision is justified.[66].Changes in estimates[67] would be adjusted in the taxable profit.

[65] It would need to be considered whether it went far enough. The UK has legislation based on accounting but going further than that accounting and yet further anti-avoidance provisions are currently being produced.
[66] This would be unnecessary if IFRS compliance was required.

11.3. 8. Changing nature of IFRS
Finally, it has to be recognised that accounting standards will change, and just because they have been acceptable for tax purposes in the past does not mean that they will always be so. We argued that in principle constitutional equity entitles the taxpayer to time over which to adjust to new tax provisions. Provision should be made for the continued application of such accounting standards as are adopted, notwithstanding subsequent changes in content, until the new ones (or replacement legislation) are constitutionally validated for tax purposes as discussed above.

One of the developments currently being explored by the IASB is a general accounting standard for SMEs.[68] The purpose of this standard would be to limit the costs of compliance with full IFRS whilst still meeting the prime objective of accounts, that of communicating relevant information. In some cases[69] the proposed standard, although simplifying compliance, is more explicit than the existing IFRS with regard to the definition of terms or limits of application. It is too early to say whether there will be content in this standard which is directly applicable to the CCCTB, but it is potentially a source of reference.

XII. CONCLUSIONS

If the CCCTB proposal is to be effective and successful in creating a new tax base, the legislation must create a *common* base and it must be a *comprehensive* base: in fact it should be a ***C***CCCTB. Principles are vital to the achievement of this goal- at all stages- design, implementation and interpretation.

The principles behind the CCCTB must be explicit and express in order to operate as a tool for interpretation and to maintain consistency across all MS. A default to national GAAP or national tax rules in cases where uniform treatment is not explicitly provided for in the CCCTB legislation, as has been suggested by the CCCTB working group, is undesirable and would not achieve these ends.

Since it is impossible for legislation to spell out every detail, in order for it to be comprehensive it must be drafted around principles, allowing the Comitology Committee and the courts to ensure that the provisions for the tax code are made comprehensive and workable within a constitutionally validated principles based framework.

We have shown how primary level objectives, tax principles and accounting principles interact in considering the design of the CCTB. We propose that these should be referred to in the legislation in order to provide future guidance and to specify the parameters of the tax base. This needs to be done in such a way as to provide sufficient detail to be operational, but in broad enough terms to provide guidance in cases where the detail has not been fully spelt out. One way of providing some of this detail is by reference to IFRS as at the date of the Directive, making clear that this is subject to the agreed tax principles set out in the Directive as suggested. The circumstances in which IFRS is to be adapted under CCCTB to meet tax principles should be made explicit in order to prevent conceptual confusion. The principles

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[67] These would always be reductions, and thus increases in taxable profit, because increases would have been claimed through profit and loss account.
[68] Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities, IASB Feb 2007. http://www.iasb.org/NR/rdonlyres/DFF3CB5E-7C89-4D0B-AB85-BC099E84470F/0/SMEProposed26095.pdf
[69] For example with regard to hedging.

should provide a constitutionally validated framework for ensuring that the Comitology procedure, the national courts and the ECJ can work together to provide a comprehensive European tax code.

XIII APPENDIX – Accounting Standards

A more detailed review of the content of particular standards is set out below reflecting the general issues outlined above. The purpose is to identify specific issues that the CCCTB will have to cover in one way or another. The scope and requirements of the standard are briefly described followed by the implications for CCCTB. Footnote references are made to the relevant paragraphs in the Tax Base WP.

13.1 General principles

1. Accounting Policies, Changes in Accounting Estimates (IAS 8).
    a. This requires consistency of accounting policies and prescribes how changes in accounting policies, estimates and errors are accounted for and disclosed. The standard applies to errors and changes in policies only; changing estimates with retrospective effect is not permitted. Changes arising from errors or changes in accounting policies are disclosed retrospectively by restating comparative figures and opening assets, liabilities and equity as appropriate.
    b. For CCCTB purposes:
        i. Consistency from year to year is required for tax purposes but the issue is the treatment of retrospective changes that would have the effect of adjusting prior year profits or losses.
        ii. Identified errors would be dealt with in accordance with the prevailing administrative regime covering error.
        iii. Regulatory provision would be required to include for tax purposes any effects on prior year profits in the year of the change, subject, possibly, to a power to require adjustment of prior year tax liabilities if the effect of charging in the year of change were to result in a reduction of tax liability by more than a specified amount. So long as protection is afforded by such provisions there may be little problem in allowing companies to change their accounting policies, particularly where the objective is to improve the information content of the reports.[70] These provisions would also cover the effects of any changes in accounting standards and the associated transitional provisions.

2. Events after the Balance Sheet Date (IAS 10).
    a. The standard requires that accounts reflect conditions that existed at the balance sheet date but evidence of which arose after that date but by publication; it prohibits recognition of conditions that arose after the balance sheet date. It ensures a definitive periodic cut off, and is especially relevant to estimates of value.
    b. For CCCTB purposes this represents the best information available.

[70] See para. 54 and comment in annotated WD.

3. Effects of Changes in Foreign Exchange (IAS 21)[71]
    a. The standard covers accounting for transactions and monetary balances in foreign currencies other than those within IAS 39, and the translation of accounting statements into a currency other than that of the economic environment in which it operates (its functional "currency").
    b. The effect on the profit and loss account is to recognise exchange differences
        i. on monetary items in the period in which they arise;
        ii. on non-monetary items when a gain or loss in respect of that item is included in the profit and loss account.
    c. The CCCTB would require measurement of all transactions in euros. Exchange differences will arise either in respect of transactions and balances with MS whose national currency is not the euro, or in respect of foreign operations outside the EU. The methodology of the standard could be applied to the computation of the CCCTB so that the standard would apply to transactions and balances as and when recognised for tax purposes.

13.2 Revenue Recognition and Measurement

1. Revenue (IAS 18).
    a. This standard is central to profit measurement, and as such is arguably under-developed. It sets the criteria for determining when revenue is recognised and identifies the circumstances in which the criteria are met. It applies specifically to the sale of goods, the rendering of services and the use by third parties of entity assets yielding interest and dividends.
    b. In the context of CCCTB, the criteria and circumstances seem unexceptionable, but the proviso that revenue be measured at fair value requires review. Generally fair value will be represented by the cash consideration, but where there is exchange of goods or services a fair value will unavoidably have to be imputed. However the standard also prescribes that where the cash received is deferred the final receipt should be allocated between a sale at fair value and an interest receipt. Nothing would seem to turn on this distinction for tax purposes, so it would be unnecessary to require adherence in this respect but equally unnecessary to prohibit it where companies have followed the standard. Adherence to that part of the standard would therefore be permissible.
    c. The requirement for CCCTB purposes would be that revenues are recognised no later than that required under IAS 18.

2. Construction Contracts (IAS 11).[72]
    a. The scope of the standard is limited to construction contracts. Recognition of profit is not limited under this basis to profit received in the form of progress payments and advances from customers, but that is simply a function of the accrual assumption. The standard limits the recognition of revenues where the outcome cannot be estimated reliably, and requires that any probable loss over the whole period of the contract is recognised as an expense immediately.
    b. For CCCTB it would seem appropriate to follow this generalisation for tax purposes as a solution to a problem which has to be resolved for tax purposes, and for which final completion as the point of recognition for a profitable

[71] Para. 48.
[72] Paras. 36-39 deal with long term contracts generally and adopt the principles of IAS 11.

contract seems economically unrealistic and so inappropriate for tax purposes. Although the profit in any period cannot be said to be accurate, the standard is sufficiently prudent in respect of what is recognised as profit for that profit to be considered distributable, and, therefore, taxable.

   c. The requirement for tax purposes would be that revenues are recognised no later, and costs no earlier, than that required under IAS 11.

3. Accounting for Government Grants (IAS 20).[73]
   a. The standard requires grants to be recognised as income of a period according to the costs with which they are associated, except that where the grant compensates for past costs, recognition is in the period of receipt. In the case of grants towards assets, the recognition is determined by the useful life of the asset either by reducing the carrying cost of the asset depreciated or by carrying the grant as deferred income and writing it off periodically.
   b. For tax purposes generally grants should undoubtedly be included as revenue as being within the central concept of profit. Nevertheless it might be argued that as a matter of general policy it is inconsistent to grant with one hand and tax back with the other. Further if grants are taxed then the level of the initial grant might be expected to be increased to reflect that, so that those in receipt of grants would remain better off than those not in receipt to the same extent as if grants were not taxed in the first place. The question thus becomes one of where the effective burden of the tax would lie and the answer would seem quite arbitrary.
   c. Under a CCCTB there may be an issue if grants are predominantly a MS function. Would governments wish to make grants if a percentage of them was effectively to raise tax revenues for another MS?
   d. Should it be decided that grants are within the tax base then the requirement would simply be that they are recognised as income no later than that required under IAS 20.

4. Financial Instruments: Recognition and Measurement (IAS 32 & 39).
   a. The term “Financial Instrument” includes both financial assets and liabilities and each of these categories of instrument include derivatives. A derivative is defined in part as an instrument that requires no initial net investment and is settled at a future date.
   b. Central to IAS 39 is the requirement that initial recognition and subsequent measurement of instruments is generally by reference to fair value. However, the entity can in some circumstances designate how changes in value are accounted for –whether through profit and loss or through equity, by categorising the instrument. Once categorised, the category cannot be changed.
   c. The standard requires that where instruments, assets or liabilities, are
      i. held for trading
      ii. designated by the entity as being “at fair value through profit and loss”,

      they should be measured at fair value and any gain or loss on valuation accounted for as profit or loss. The standard defines when assets are held for trading.

      This is clearly a different treatment of inventories from that normally applied. The rationale for the distinction is that although there is no contract to sell, there is certainty (given by the nature of an active market) that the instruments

[73] Para.23 excludes grants relating to depreciable assets from income but notes that the depreciable cost of the asset would be reduced; see also para.59. One MS suggested allowing the option in IAS 20 to ease compliance.

could have been sold at a given price had the entity chosen to do so. Of course not all instruments are traded on active markets; the standard does not allow equity instruments that do not have a quoted market price in an active market to be designated as in (ii), and requires that if held for trading they are valued at cost.

d. Under the standard, derivatives, except those designated as hedging instruments, are assumed to be held for trading. In the discussion following with regard to financial assets and liabilities, hedging instruments will be excluded and discussed separately.

e. All other financial assets are classified as available for sale if
   i. designated by the entity as such
   ii. not defined as held to maturity investments or loans and receivables.

   They are valued at fair value but gains or losses on valuation are not included in profit and loss until the assets are derecognised.

f. Held to maturity investments are those with fixed or determinable payments and fixed maturity that the entity intends to hold until maturity other than those
   i. designated by the entity under c.ii and e.ii
   ii. defined as loans and receivables.

g. Loans and receivables are defined as those with fixed or determinable payments not quoted in an active market other than those
   i. designated as in e.i
   ii. intended for immediate or near term sale
   iii. for which the holder may not cover all of its initial investment.

h. Held to maturity investments, Loans and Receivables and Financial liabilities, other than those held for trade, are generally required to be measured at amortised cost using the effective interest rate method.

i. Hedging instruments are derivatives that, apart from specific hedge accounting provisions, would otherwise be regarded as held for trading under c. The standard requires that, provided there is evidence that the instrument is part of the entity's risk management strategy and that there are expectations as to its effectiveness, they be valued at fair value but that the gains or losses on valuation are recognised either in profit or loss, or directly to equity according to category of hedge and its effectiveness.

j. For tax purposes there two issues arising from this standard:
   i. The reliance on designation by the entity
   ii. Whether changes in valuation should be recognised.

   Both equity and the ideal of not distorting financial reporting suggest that tax payments should not be at the option of the taxpayer. Therefore the question essentially concerns valuation, and, if changes in values are to be taxed, whether objective circumstances can be prescribed to determine when this should be the case.

k. This is a case where CCCTB legislative provision would both exclude the application of IAS 39 and provide a replacement consistent with the principles above. On the assumption that only portfolio equities are taxed, legislation would require that:
   i. traders in financial instruments are taxed according to market value; the definition of trading could include the IAS classification;
   ii. financial assets, other than derivatives (defined as in IAS 39), quoted in an active market (acceptable markets could be listed in legislation), are taxed according to market value; those not quoted are taxed only on derecognition;

iii. financial liabilities and unquoted counterpart financial assets, other than derivatives (defined as in IAS 39), are allowed for tax purposes under the amortised cost basis as set out in IAS 39, giving symmetry of measurement for the lender and borrower;

iv. derivatives held as a hedging instrument, other than by traders, would be subject to tax only on derecognition except where the hedged item is valued at fair value for tax purposes when it would itself be valued at fair value and tax levied on any gain or loss.

5. Investment Property (IAS 40).
    a. Investment property is property held to earn rentals and for capital appreciation rather than for use or sale in the business. Like other assets it is initially recognised at cost, and like property, plant and equipment it may subsequently be valued at fair value provided all property is so valued. However in this case any change in value is recognised in the profit and loss account. If the cost model is used for the carrying amount of the asset then IAS 16 applies, including the provisions as to depreciation, depreciation being measured only in respect of buildings, not the land.
    b. Where assets are held as investments, rather than for use, it is consistent with the underlying concept of profit to include any change in capital value in the measure of profit. The main issue would be the administrative one of whether there is adequate evidence of market value. Where fair value is used for accounting purposes then presumably there is such evidence, but if this were used as a basis for taxation, then unless the tax provisions required the use of fair value by all entities, there would probably be pressure to report under the cost model, particularly since this would involve depreciating the buildings (whilst leaving the land at cost rather than market value).
    c. A compromise solution for tax purposes is probably a default position of taxation according to the cost model but without any allowance for depreciation. Alternatively, entities which report according to the fair value model could opt to use that for tax purposes. There would be no concerns here with cherry picking losses because of the standard’s requirement that all properties are subject to the same valuation model.

13.3 Expense Recognition and Measurement

1. Inventories (IAS 2).[74]
    a. The effect of the standard is that costs recognised as subsisting in inventories are held as an asset and do not enter the profit and loss account when incurred. Only when they cease to be assets because of sale, or when, because the net realisable value is lower than cost, some of the carrying cost cannot be recovered by future sale, are the inventory costs charged to profit and loss account. Financial instruments are not within the scope of the standard.
    b. The FIFO or weighted average cost basis is permitted as a measure of cost; LIFO is not. The basis for this rejection of LIFO is that it is generally not a reliable representation of actual inventory flows and can distort the profit and loss account. LIFO is used as being more representative of current cost, but

[74] Para.30 broadly recites the definition of inventory used in IAS 2; paras.51/55 deal with valuation.

replacement cost is not used elsewhere in measuring costs, and there seems no principled basis for using it in respect of inventories for tax purposes.

2. Property, Plant and Equipment (IAS 16).[75]
    a. This standard covers the recognition and depreciation of a substantial range of fixed assets. The costs, depreciation and gain or loss on disposal are computed for each asset individually.
    b. Recognition of assets is governed by the framework definition of an asset and includes both initial and subsequent costs. Identification of costs and their measurement is also covered. Fair value is used as a basis of measurement at recognition only where there is an exchange of non-monetary assets; this is unavoidable and would be similarly dealt with by the provisions of any tax system.
    c. Once recognised at cost the assets may thereafter be measured at either cost less depreciation and impairment, or fair value less depreciation and impairment (both based on the carried fair value). The chosen method has to be applied to the entire class of asset. Gains on revaluation go not to profit and loss but to equity, but any final gain or loss on derecognition is transferred to profit and loss; losses are charged to profit and loss unless there is a prior revaluation gain carried in equity.
    d. The depreciation charge for each period is recognised in the profit and loss account unless it forms part of the cost of another asset.[76]
    e. Compensation for impairment is included in profit loss in accordance with the accrual principle when the compensation becomes receivable.
    f. For CCCTB the issue, as discussed, is whether to accept the accounting measure of depreciation; if the IFRS is accepted then only the cost model would be applied. Only if the accounting measure is rejected is there an administrative saving in the proposed pooling system.[77]

3. Intangible Assets (IAS 38).[78]
    a. The purpose of the standard is to limit the amount of expense that can be carried as an asset rather than having to be written off as an expense. The default position is that if expenditure does not meet the recognition criteria required for an intangible asset it is written off as incurred; research expenditure is always written off as incurred. The issue for tax purposes is therefore whether expenditure should be capitalised or whether it can attract immediate tax relief.
    b. Intangible assets may be created within the entity or acquired from a third party or acquired in a business combination. Where expenditure is incurred on acquisition in a business combination, but is not attributable to other assets and does not meet the definition of an intangible asset, it is required to be attributed to goodwill; but internally generated goodwill may not be recognised as an asset. Goodwill on consolidation for group accounts is not an issue for the

[75] Paras.56/77 deal with a proposed autonomous depreciation regime for CCCTB.
[76] In this connection the UK recently provided an example of the difficulties arising from adopting some parts of GAAP, inventory valuation, but not recognising them in a separately drafted tax code for depreciation.
[77] Pooling would not be an obstacle to consolidation. Consolidation would involve the aggregation of the depreciation measures based on pools, not the aggregation of the pools. Nevertheless as comments on pooling (para. 56WD) suggest, the sale of part of a business of a single entity would require the identification of individual assets.

[78] Para.68 refers to the depreciation of intangibles specifically.

CCCTB as single entity rather than consolidated accounts form the basis of taxation.

c. As with property, plant and equipment, intangible assets are measured at cost on recognition but may thereafter be valued at fair value. Amortisation (depreciation) is similarly calculated according to the assets carrying value and useful life.
d. For CCCTB the treatment of intangibles would in principle follow that of other fixed assets, either adopting the IFRS standard cost model, or legislating specifically.

4. Impairment of assets (IAS 36).[79]
    a. The objective of the standard is to ensure that the carrying amount of an asset is no more than that which is considered recoverable through use or sale of the asset. Where the recoverable amount is less than the carrying amount, the difference is a measure of the impairment, and is charged to the profit and loss account and deducted from the carrying amount. The standard does not apply to a range of assets including inventories and construction contracts, financial assets within IAS 39, and investment property measured at fair value under IAS 40.
    b. Assets subject to impairment tests include goodwill, and the standard applies both to the goodwill purchased in the take over of a business and the goodwill inherent in the purchase of a controlling interest in another company. The latter would be accounted for in consolidated statements, and the appropriate treatment for tax purposes is considered under the consolidated tax base.
    c. For CCCTB impairment should be recognised, but consistently with the prior decision as to whether adopt the IFRS accounting for the asset or apply CCCTB legislative provisions. Recognition of goodwill on the purchase of a controlling interest would be inappropriate assuming the income and gains on the shares were exempt, and, if not, because the underlying fall in profits or losses of the subsidiary would be reflected in the consolidation of the tax base.

5. Non current assets held for sale and discontinued operations (IFRS 5).
    a. The standard applies to non-current assets the carrying value of which will recovered through sale rather than use. Although it applies to all such assets, it is aimed particularly at assets that are no longer in use because the operations in which they were used have been discontinued.
    b. Compliance with the standard requires that the assets are valued at the lower of their carrying amount and fair value less costs to sell, and that depreciation ceases.
    c. CCCTB acceptance or not of this standard would follow from prior decisions as to depreciation. Were IFRS standards adopted, the effect in tax computations could be to advance recognition of expense (as an impairment loss) and prevent continued depreciation charges when the asset is in fact not in use. It would be made explicit that its application is only to the cost model as adopted for CCCTB.

6. Provisions, Contingent Liabilities and Contingent Assets (IAS 37).[80]
    a. A provision is an obligation of the entity which is expected to result in an outflow of resources, the amount and timing of which is uncertain. At the heart

[79] Para. 76 applies impairment to non-depreciating assets only as depreciation.
[80] Para. 32 adopts the principles of IAS 37 but limits them to legal obligations.

of this standard is question of how certain the entity has to be as to its obligation in order to recognise it.

b. The standard allows both legal and constructive obligations to be provided for. A constructive obligation is one founded past practices of the entity and the expectations it has thereby created; it would have no legal basis.
c. Contingent assets and liabilities are also within the scope of the standard, but these are even less certain than provisions and are not allowed to be recognised for reporting purposes. They would be similarly disallowed for tax purposes.
d. The issue for tax purposes is the level of certainty required before a provision can attract tax relief. Probably the threshold for tax purposes would be set at the level of a legal obligation so that provisions made in accordance with the standard pursuant to a legal obligation would be allowable. A possible limitation, aimed at increasing the level of certainty for tax recognition, might be to allow only those provisions which relate to a future expense within a specified future time limit. All provisions should be reviewed each year in order to prevent the build up of tax free reserves.

13.4 Specific transactions

1. Leases (IAS 17).[81]
    a. The standard distinguishes between a finance lease as one which "transfers substantially all the risks and rewards incidental to ownership of an asset", and other leases which are classed as operating leases, and prescribes the accounting treatment for both lessee and lessor. It is concerned primarily with the information given by the balance sheet, but, given the articulation of balance sheet and profit and loss account, the effects inevitably impinge on the profit computation. The standard reflects an example of accounting according to perceived economic substance rather than legal form with the object of providing relevant information.
    b. A lessee is required to recognise a finance lease as constituting the acquisition of both an asset and a liability at fair value. As a consequence the asset is depreciated in accordance with IAS 16 or 18, and any impairment recognised under IAS 36, with the lease payments allocated each period between an interest charge and repayment of the liability. In the lessor's accounts the asset is shown as a receivable equivalent to the direct costs of investing in the lease, and the lease receipts are apportioned between repayment of the debt and the receipt of interest.
    c. Under an operating lease payments and receipts are recognised as an expense or revenue on a straight-line basis over the lease term in the lessee's and lessor's accounts respectively, subject to each of them adopting their own other systematic basis. In the accounts of the lessor the asset would be depreciated in accordance with IAS 16 or 18, and any impairment recognised under IAS 36.
    d. The fact that the lessor and lessee could each adopt different systematic measures for apportioning lease payments over the period that the tax base might be best protected by requiring that both parties to any operating lease allocate the total lease payments over the life of the lease on a straight-line basis.

[81] Para.60 would allow depreciation for "the economic owner", but notes there might need to be further provisions for finance leases.

e. For CCCTB purposes the question is whether finance leases should be treated any differently. Three considerations would seem to be:
    i. Whether the calculations for finance leases are an unacceptable administrative burden for companies whose national GAAP does not require the IAS treatment of finance leases.
    ii. Whether there would be any unintended tax consequences arising from treating part of the lease payments as interest as opposed to rental payments
    iii. Whether leaving the depreciation in the accounts of the lessor rather than the lessee would have any tax implications, in particular for loss reliefs. One of the purposes of finance leasing has been to transfer depreciation allowances (which may have been accelerated) to entities with taxable capacity. If tax depreciation is tied to accounting depreciation, the avoidance benefits are significantly limited.
f. On the face of it there would seem few disadvantages to treating all leases as operating leases and requiring the payments and receipts to be allocated over the life of the lease on a straight line basis over the lease term. Alternatively the provisions of the standard could be applied. From experience the position that is not tenable is not to regulate at all, for then there would be
    i. no limitations on when substantial front end loaded payments were recognised for tax purposes, and
    ii. potentially significantly different bases of allocation as between member states.

2. Employee Benefits (IAS 19).[82]
    a. The standard covers three different aspects of employee benefits:
        i. Short-term benefits such as wages, salaries and bonuses, both monetary and non-monetary.
        ii. Post employments benefits, typically pensions.
        iii. Termination benefits.
    b. In all three cases the thrust of the standard is to require that proper provision is made for costs for which payment may not have been made. The need for such a standard in the context of reporting to investors is to ensure that costs are not understated in a current period only to appear unexpectedly in a later period.
    c. In the tax context the pressure will be quite the opposite. In general terms it would seem that the general standard with regard to provisions should suffice subject to limitations imposed for tax purposes. There would thus be no requirement to follow this standard, though, subject to what follows, it would be permissible.
    d. Liabilities under defined benefit schemes are potentially not only very large but also uncertain. Provisions for such liabilities, if unfounded, could effectively provide a substantial tax-free source of funds within the company. It may, therefore, be considered appropriate to depart from the accrual assumption and recognise pension expense only when payments are made, whether as contribution to a fund external to the entity or as pension payment to past employee.

3. Share based payments (IFRS 2.)

[82] Para. 33 refers to pensions. The comment of one MS notes the issue of building up tax free reserves.

a. The scope of standard extends to payments for goods and services that are made by reference to shares. It explicitly covers share based transactions which are
    i. Cash-settled
    ii. Equity-settled.
    iii. Either of the above but with cash alternatives.
b. Cash-settled transactions and the goods or services acquired are accounted for according to the fair value of the liability. Recognition is as the services are provided or over any period until the right vests. Measurement will depend on the nature of the transaction, but may be by reference to option pricing models of valuation, and remeasurement takes place at each reporting date.
c. Equity-settled transactions, and the goods or services acquired, are accounted for according to the fair value of the goods or services, or if that cannot be reliably measured (which it is assumed it cannot be), by reference to the fair value of the equity instruments granted. Recognition is as the services are provided or over any period until the right vests. Measurement is by reference to option pricing models and is at the grant date.
d. These transactions are no different from any other exchange and where this is a payment under contract for a service like any other, it seems little different from either direct remuneration, profit share or pension benefits.[83] In the case of equity-settled transactions where the consideration is a share option the accounting treatment is to treat a dilution of shareholder wealth through the exercise of share options as if in substance it were a cost incurred by the company.
e. For CCCTB cash settled transactions could be recognised in accordance with the provision principles but estimates made according to the cash payment (or proportion of it if recognition is over the period during which the services are required to be performed and other service or vesting conditions are met) for which the entity would be liable if made at the reporting date.
f. An equity-settled transaction, like a cash-settled transaction, is a payment for goods or services and should therefore be recognised for tax purposes. Where the consideration consists of purchase and transfer by the company of shares, tax recognition and measurement can follow that for cash-settled transactions. However, where consideration is in the form of share options, four main issues arise:
    i. Whether this is in fact a transaction between the company and supplier[84] or the shareholders and the supplier. In legal form it is a transaction between the company and supplier, but is there in economic effect a cost borne by the shareholders if the arrangement dilutes the entitlements of existing shareholders.
    ii. Whether fair value is an appropriate measure of cost and, if so, whether there is sufficient certainty and objectivity in measuring fair value.
    iii. Whether there is any objective way of measuring the cost to the company as an entity.
    iv. When any cost should be recognised.
g. Any cost allowed for tax purposes should be the cost to the company or shareholders. Fair value does not seem appropriate because there may be a difference between the value to the employee and the cost to the company or

[83] However the arrangement might in fact represent the creation of internal goodwill. Under IAS 38 no expense could be carried as an asset.
[84] Typically, but not exclusively, an employee.

shareholders who are effectively parties to the contract. Fair value implies an agreed value of the option by parties to an option contract rather than the particular service contract which the option rewards. Given the use of fair value for accounting purposes, there need to be specific tax provisions.

h. The cost to shareholders will be the dilution of their interest in the company through the issue of additional shares on the exercise of an option by the employee. In principle the dilution with which the tax system is concerned is the interest in profits generated by the company, not any market volatility surrounding the shareholdings. As such the cost is equivalent to a profit share, and so the shareholders should be in an equivalent position after corporation tax whether employees are remunerated by a share option scheme or by a share of profits.

i. A simple example[85] shows that in fact existing shareholders are unaffected after tax by whether remuneration is by a direct profit share or a share option (a simple share transfer in the example). However there is a difference in the tax revenues because the profit share is tax deductible whereas the equity share is not. It is not the existing shareholders, but the employee being remunerated who suffers this increased tax burden[86], and arguably this is because he has chosen to be remunerated in this legal form.

j. The alternative view is that in making the grant the company is, to the extent that there is a transfer of right to profits to the employee, using the shareholders' wealth to pay for that right to profit. In so far as that is regarded in substance as remuneration, tax relief could be given on that transfer of wealth.[87] This would then equate the tax treatment of share options funded by shareholders and those funded directly by the company through share purchase.[88]

k. The cost could be recognised at grant but the shareholders are liable to meet the cost, only if, and not until, the option is exercised. At that time the cost

[85] Consider a company C with 100 shares earning a required market rate of return before tax of 10% on assets of 90; the corporate tax rate is 20%. C is valued at 90 by discounting the after tax return of (9-1.8) by .08. C believes it could earn an even higher rate of return and employs a director D on the basis that if he increases the profits to 10 or more he will be paid 10% of the profits in perpetuity. In the event C's profits are increased within a year to 20 before tax. D is paid 2. After tax profits are (18-3.6) and C is now worth 180. Alternatively shareholders in C could have agreed with D to transfer 10 shares to him at no cost if profits increase to 10 or more. In this case after tax profits would have been (20-4) valuing C at 200, of which 180 would be attributable to the original shareholders and 20 to D. Had the case been the same except that there was no profit condition placed on either the profit share or share transfer, and in fact there was no increase in profit, then profit after profit share and tax (9-0.9-1.62) would result in a value for C of 81. Alternatively, under the share transfer arrangement, the value of C would have remained at 90 (tax 1.8) with 9 being attributable to the director and 81 to the original shareholders.

[86] However there might be personal tax advantages.

[87] In the example, 9 would have been the value transferred to D attracting 1.8 in tax relief. Capitalising the flows at 10% for the purpose of comparison, the original flows were valued at 90. Under the profit share scheme this was divided as to 16.2 in tax, 9 to D and 64.8 to the original shareholders. Under the transfer of shares the 90 is divided as to 18 in tax 72 in equity, of which 7.2 is to D and 64.8 to the original shareholders. The tax relief of 1.8 would equalise the value of the tax flows (16.2) and D and the original shareholders would have equity valued at 73.8, but there would be no means of ensuring that D benefited to the extent of 9 as under the profit share.

[88] If in the example C had purchased 10 shares in the market the productive assets would have fallen by 9 to 81. The capitalised values of the tax flows are 16.2 less the tax relief of 1.2 on the share purchase, a total of 15. This is 1.2 less than under the other arrangements because the profit stream is less. If this was restored by asking for further equity capital of 9, the capital value of C would return to 90, and the values of the tax and equity flows to 16.2 and 73.8.

would be calculated as: the share price at grant, plus any retained profits between then and exercise, less the exercise price.
This reflects the fact that the liability was entered into at grant and equates the timing difference between exercise and grant by adding to the grant value of the shares so much of the actual return earned by them as has not been distributed.[89] It is consistent with an *ex post* measure of profit in that it is recognised only when it is certain that it will be incurred and it is measured by reference to known values.

4. Borrowing Costs (IAS 23).
    a. The standard is concerned with the timing of recognition of borrowing costs, those costs being measured under IAS 39. Where the costs are directly attributable to the production or construction of an asset, they are required to be capitalised. They are then effectively recognised when the cost of the asset is recognised as an expense.
    b. Recognition of interest costs as incurred is clearly preferable to the taxpayer, but the accounting treatment discriminates between finance used for one purpose and another. Whether or not the standard is followed for CCCTB purposes should depend upon whether the accounting measure of depreciation is accepted; if it is, then compliance costs would suggest that IAS 23 should also be followed.

[89] This is an *ex post* equivalent to the minimum value of the option referred to in IFRS 2 Basis for Conclusions, BC 80.

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