



Accounting Standards: A Panacea?

Linking the tax base to accounting standards has an intuitive appeal. Taxpayers hope that this might reduce compliance costs and simplify the tax system. Revenue authorities and politicians think that alignment might cut tax avoidance, since it brings the tax base closer to the 'true' profits relied upon by managers and shareholders for the purpose of making distributions and other decisions. At an international level, globalisation of accounting standards may be thought to point the way to an even greater prize: if international accounting standards can be agreed, perhaps this is the basis for harmonising the tax base?

Unfortunately, although accounts drawn up according to generally accepted accounting standards might be an obvious starting point for taxable profits, they do not offer a panacea for the problems of determining the corporate tax base.

Tax impact of International Financial Reporting Standards

In January 2005 International Financial Reporting Standards (IFRS) come into force across the EU for consolidated accounts of listed companies. The recent announcement that only an amended version of International Accounting Standard 39 on financial instruments is likely to be endorsed by the Commission as part of this process shows that this move will not be without complications and controversy but the bulk of International Accounting Standards will be mandatory from 1 January 2005. In many countries this has no immediate tax implications. Some Member States will confine IFRS to consolidated accounts not used for tax purposes. Others, for example Germany, will permit IFRS accounts for individual companies only side by side with accounts based on national law, the latter being required for tax purposes. In the UK and elsewhere the use of IFRS will be more widespread and will have tax consequences. The UK Inland Revenue is at the forefront in considering the tax impact of this change

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and has produced published guidance, 'International Accounting Standards – The UK Tax Implications' (http://www.inlandrevenue.gov.uk/practitioners/int_accounting.htm) as well as legislation (FA 2004, ss 50-54 and consequent regulations). From January 2005 for UK companies which prepare their accounts according to IFRS, those accounts will be accepted as representing generally accepted accounting practice for the purposes of FA 1998, s 42 and will therefore form the basis for UK corporate taxation.

The adoption of IFRS by the EU could result, at a national level at least, in a reduction of the degree of alignment between tax and accounting profits rather than an increase. UK government policy is to move closer to alignment at a national level and the courts have also shown a tendency to follow accounting standards (whilst maintaining their right to adjudicate in some spheres). The move to IFRS is unlikely to change this approach significantly, since UK standards are already moving towards convergence with IFRS. Where the current differences are creating tax problems, notably in connection with financial instruments, this is being tackled by specific legislative intervention in the FA 2004 and regulations. This is not proving easy but, in general terms, it leaves the basic principles unchanged. Whilst the UK moves towards alignment, however, other EU countries are shifting in the opposite direction. For example, according to Professor Schön, Austria, Belgium, Germany and Switzerland, all traditionally thought of as having a principle of dependence of taxable profits on accounting profits, are 'on the brink of cutting off this dependence'. Commercial pressure to extend the use

of IFRS to individual companies may well accelerate this development.

Dependence worked for tax purposes when accounting standards were ultra-prudent and to some extent formulated with tax needs in mind: tax is not at the forefront of the objectives of those designing modern accounting standards. Commercial accounting aims to produce figures that provide information to a range of stakeholders: tax accounts must produce a definitive figure, which satisfies tax requirements by representing current ability to pay tax. Commercial accounts are moving to fair value and a focus on balance sheets rather than profit and loss accounts; most tax systems still concentrate on the concept of realised profit for many purposes.

Another factor pushing some jurisdictions away from alignment of tax with accounting standards is the desire to maintain control over tax matters rather than relinquish it to outside bodies. IFRS are formulated by an independent body not subject to any government control (the International Accounting Standards Board) and will be interpreted by the International Financial Reporting Interpretations Committee. Once adopted by the EU it may also be that interpretation issues will come before the ECJ, since the standards would be absorbed into EU jurisprudence. The relationship between the courts at a national and EU level, on the one hand, and the IASB in its role as setter and interpreter of standards on the other, is an important but under-explored issue. Whatever the place of final adjudication over IFRS turns out to be, there could be a loss of control by governments of taxation issues, which some have suggested would be fundamentally non-democratic.

It is against this background of change and discussion that the EU Commission has been exploring the use of IFRS as a basis for producing a common consolidated corporate tax base.

A common consolidated corporate tax base

Apparently, EU Economics and Finance Ministers discussed company taxation over lunch at The Hague at their meeting in September 2004. This must have been a rather strange lunch party, especially as their discussions were based on two European Commission 'non-papers': a somewhat *Alice in Wonderland* concept – one wonders whether the Ministers might have had a 'non-discussion'. One of these non-papers (http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/Non-Paper_CCCTB_EN.pdf) discussed a common consolidated corporate tax base (CCCTB) for the EU. At the conclusion of this event the Ministers 'supported the creation of a working group of Member States to consider the idea of allowing all companies to use a common consolidated set of rules for calculating their EU-wide taxable profits'. A parallel project for SMEs, allowing them to use the tax rules of their home state for calculating their EU-wide taxable profits, is also being discussed by the working group. Clearly, change is not imminent but the discussion is on the agenda. The CCCTB non-paper seems to have abandoned the idea of developing this base as a pilot project available only for the European Company, given the findings of the Deloitte's report that this would be likely to be discriminatory and provide state aid: the reference in the quotation above to 'all' companies is significant, although the project might yet be limited to larger or listed companies.

There are enormous problems with the idea of a CCCTB but many prizes to be won if it can be achieved. The decisions of the ECJ on direct tax are creating so many difficulties for Member States that proposals for action which might have seemed unthinkable a few years ago are now being considered. The CCCTB does not, however, offer easy solutions and is still adamantly opposed by a number of Member States, including the UK and Ireland. Even if a common base can be agreed, the problem of allocation between Member States remains. Setting aside these wider issues for the purposes of this discussion, the question remains whether, and to what extent, the application of international accounting standards moves

us forward in the endeavour to achieve a common tax base.

As has been discussed above, there are fundamental differences in the objectives of those designing the rules for commercial accounting and the principles of tax design. The inexorable move towards fair value accounting in IFRS, whilst not without its opponents, looks irreversible. Within tax systems the realisation principle still plays a part and, despite theoretical arguments opposing the notion that realisation is a cornerstone of taxation, it seems unlikely that it will be practical or acceptable to depart from it completely. In 2001, an EU Commission staff working paper (*Company Taxation in the Internal Market* http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip1468/company_tax_study_en.pdf) took the view that the direction in which IFRS were developing meant that tax accounting and financial accounting would be bound to develop independently and this would mean that Member States would be obliged to find autonomous rules for tax accounting purposes. In looking for such rules, the paper argued, there was an opening for coordination and cooperation to start with common base rules, instead of each of the Member States trying to pursue individual solutions. So this paper saw opportunities for a common tax base arising not from the harmonisation of accounting standards but from the divergence of tax from those changing accounting standards. Subsequently, however, the Commission has suggested that the globalised accounting standards might themselves be the starting point for a common tax base across the EU.

The need for autonomous tax principles

The non-paper discussed at the Ministers' lunch offers a finely balanced compromise. It states that IFRS can be used as a tool for designing a tax base, a reference point, but discussions should ultimately be guided by appropriate tax principles which would be discussed at an early stage, taking particular account of similarities to and differences from accounting principles. Of course, it would be foolish to discard carefully agreed international accounting standards altogether and they will certainly be a useful reference point, but if tax principles must first be determined this looks more like the exercise recommended by the 2001 working paper, to find autonomous tax principles,

than one which *follows* accounting standards. The discussions over differences are likely to revolve around fair valuation and realisation. The different attitudes taken by the Member States in regard to dependence or alignment at a national level suggest that agreeing on these principles is not going to be straightforward.

The Commission has taken on board the objection that international accounting standards are not agreed by governments and are also subject to change. It stresses that the CCCTB, once established, would not be systematically linked to any further accounting development and would be primarily driven by tax and not accounting standards. Thus governments would presumably have the opportunity, in theory at least, to agree any changes through some kind of monitoring committee. This is not, then, a recipe for linkage at all, but simply for cross-reference.

Once established, a CCCTB would have an identity and a life of its own. Issues would emerge which would require interpretation and these would have to be referred to the courts at a national and, ultimately, an ECJ level. Since CCCTB would not be linked to IFRS but would have used it only as a guide, interpretations for tax and other purposes could well diverge. The role of the courts in interpreting IFRS has not been considered extensively so far but it is likely to become an issue for accounting purposes. The issue will be further complicated if accounting standards are referred to, but not decisive, for tax purposes.

As the EU Commission has discovered, IFRS might assist in kick-starting the debate on a CCCTB but it is not going to provide the answers to the most difficult questions. Agreeing on IFRS has not been without its difficulties and the process is not complete. Agreeing 'appropriate tax principles' may take a little longer.

This article draws on J Freedman 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges' [2004] *eJournal of Tax Research* 71 (<http://www.atax.unsw.edu.au/ejtr/>) and refers to a paper delivered at the European Association of Tax Law Professors' Conference in Paris in June 2004 by Professor Wolfgang Schön (International Accounting Standards – a Starting Point for a Common European Tax Base?, forthcoming in *European Taxation*).