

International Accounting Standards – a „Starting Point“ for a Common European Tax Base?

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I. The EC Tax Policy Background

In October 2001 the European Commission released a Communication to the Council, the Parliament and the Economic and Social Committee on an “Internal Market without tax obstacles”¹, accompanied by an impressive study produced by the Commission’s services on “Company taxation in the internal market”², which together set out the framework for further integration of business taxation in Europe³. The Commission’s communication and the study established the political aim of supplying companies and groups of companies engaged in cross-border commercial activities with a uniform tax base which would apply to all profits of the company or group within the jurisdiction of the European Union (or at least a group of Member States), thus leading to a substantial reduction of compliance costs, to elimination of economic double taxation and to cross-border loss compensation⁴.

Apart from intricate technical details (such as: what is a “group”?⁵), this proposal is built on two major premises each of which requires a closer analysis. The two principal subjects of discussion are (1) the introduction of a common tax base, which could replace or (at least) offer an alternative to the varying rules on the computation of taxable business profits in up to 25 Member States in the European Union, and (2) the definition of a “formula” under which this tax base shall be divided among Member States and taxed according to the corporate tax rate set by the respective Member State. Whilst the latter question has attracted substantial

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¹ COM (2001) 582 final.

² SEC (2001) 1681.

³ First reactions to these proposals are found in: *Company Tax Reform in the European Union: Targeted Measures and Comprehensive Proposals*, Special Issue, *European Taxation* 2002, p.269 et seq. (with contributions by *Osterweil; Schön, Maisto, Gibert, Gassner, Westberg, Raventós-Calvo/Penalosa, Plasschaert, Weiner/Mintz*).

⁴ On the effects of the Commission’s proposals on cross-border loss compensation see *Dieter Schneider*, *Konzernrechnungslegung nach IAS als Besteuerungsgrundlage*, *Betriebs-Berater* 2003, p.299 et seq.

⁵ *Wolfgang Schön*, *The European Commission’s Report on Company Taxation: A magic formula for European Taxation?*, *European Taxation* 2002, p.276 et seq., at 281.

interest mostly from economic writers⁶ who point to similar experience in the US, Canada and Switzerland, the conception of the common “tax base” has found less reflection in academic circles⁷.

As early as 1988 the European Commission prepared a proposal for a directive which was meant to harmonise the computation of company profits in the context of corporate income taxation within Europe⁸. Yet, as resistance from the Member States was immense from the start, this plan turned out to be stillborn, the proposal was never formally launched and the idea of a harmonised tax base was put aside for more than ten years. This standstill – which only reflected the general reluctance to move forward with tax harmonisation in the late 80s and throughout the 90s of the 20th Century – paved the way for private initiatives, most nota-

⁶ See in 2004 contributions by *Michael Devereux*, Debating Proposed Reforms of the Taxation of Corporate Income in the European Union, *International Tax and Public Finance* 2004, p.71 et seq.; *Peter Birch Sorensen*, Company Tax Reform in the European Union, *International Tax and Public Finance* 2004, p.91 et seq.; *Walter Hellerstein/Charles McLure*, *The European Commission’s Report on Company Income Taxation: What the EU can learn from the Experience of the US States*, *International Tax and Public Finance* 2004, p.199 et seq.; *Jack Mintz*, Corporate Tax Harmonisation in Europe: It’s all about Compliance, *International Tax and Public Finance* 2004, p.221 et seq.; *Walter Hellerstein/Charles McLure*, Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission’s Company Taxation Proposals, *IBFD-Bulletin* 2004, p.86 et seq., all with further references.

⁷ *Krister Andersson*, On the way to or away from a European Tax Union (ETU)?, Paper presented at The Swedish Network for European Studies, *Diritto e Pratica Tributaria Internazionale*, 2003, p.365 et seq., at 376; *José Luis Cea Garcia*, En el umbral de la reforma de la regulación contable Espanola ante la adaptación del modelo IASB, *Algunas Reflexiones desde una disidencia parcial pero sustancial con el libro blanco de la reforma*, *Estudios Financieros* Nr.236, Nov. 2002, *Revista de Contabilidad y Tributación*, p.153, 164; *H.M.Treasury*, Corporate Tax Reform, A Consultative Document, 2003, para 1.12 et seq.; *Norbert Herzig/Michaela Bär*, Die Zukunft der steuerlichen Gewinnermittlung im Licht des europäischen Bilanzrechts, *Der Betrieb* 2003, p.1 et seq.; *Christoph Spengel*, International Accounting Standards, Tax Accounting and Effective Levels of Company Tax Burdens in the EU, Paper prepared for the C.F.E. Forum „International Accounting Standards – A way to tax harmonisation in Europe“, 2003; *Christoph Spengel*, International Accounting Standards und Unternehmensbesteuerung in der Europäischen Union, *Internationales Steuerrecht* 2003, p. 29 et seq., p.67 et seq.; *Thomas Wala*, Die Zukunft des Maßgeblichkeitsprinzips gemäß § 5 Abs.1 öEStG vor dem Hintergrund einer internationalen Harmonisierung der Rechnungslegung, 1998).

On the other hand, You find a huge array of literature on the impact of the IAS on domestic tax systems (*Romuald Bertl/Anton Egger/Wolfgang Gassner/Michael Lang/Christian Nowotny*, Die Maßgeblichkeit der handelsrechtlichen Gewinnermittlung für das Steuerrecht, 2003; *Frank Daniel Broer*, Maßgeblichkeitsprinzip und Harmonisierung der Rechnungslegung, 2001; *Eric Delesalle*, Fiscalité et normes comptables internationales, *BF4/03*, p.247 et seq.; *Robert Gröning*, Steuerbilanzielle Gewinnermittlung nach US-GAAP?, 2002; *Peter Gurtner*, Neue Rechnungslegung – Prinzipielle Maßgeblichkeit oder eigenständige Steuerbilanz?, *Archiv für Schweizer Abgabenrecht* 69 (2000), p.63 et seq.; *Norbert Herzig*, IAS/IFRS und steuerliche Gewinnermittlung - Kurzbericht -, 2004; *Graeme McDonald*, The Taxation of Business Income: Aligning Taxable Income with Accounting Income, 2002; *Markus R. Neuhaus*, Rechnungslegungs- und Revisionsgesetz – steuerrechtliche Berührungspunkte, in: *Archiv für Schweizer Abgabenrecht* 69 (2000), p.11 et seq; *Andreas Oestreicher/Christoph Spengel*, Maßgeblichkeit der International Accounting Standards, 1999; *Stefan Rahlf*, IAS-Bilanzierung und Besteuerung, 2000; *Robert Schütz*, Der Maßgeblichkeitsgrundsatz gemäß § 5 Abs.1 EStG – ein Fossil?, 2002; *Holger Kahle*, Internationale Rechnungslegung und ihre Auswirkungen auf Handels- und Steuerbilanz, 2002; *Ulrich Schreiber*, Hat das Maßgeblichkeitsprinzip noch eine Zukunft?, in: *Budde/Moxter/Offerhaus* (Ed.), *Festschrift für Heinrich Beisse*, 1997, p.491 et seq.; *Ulrich Schreiber*, Rechnungslegung im Einzelabschluss nach internationalen Grundsätzen?, in: *Kleineidam* (Ed.), *Unternehmenspolitik und Internationale Besteuerung*, *Festschrift für Lutz Fischer zum 60.Geburststag*, 1999, p.879 et seq.).

⁸ *Kuiper*, EC Commission Proposes a Directive on the Harmonization of Rules for the Determination of Taxable Profits of Enterprises, *European Taxation* 1988, p.319 et seq.

bly the efforts of the “Stockholm Group” which gave birth to a concept named “Home State Taxation”⁹. This concept which comprises an innovative tax framework for multinational groups of companies within Europe, does not – like the earlier draft directive on the taxation of corporate profits - require the European Institutions to agree on a uniform tax base for all Member States; it simply entitles a multinational group to compute its taxable profits according to the tax law of the Member State where the parent company of the group is registered. On the basis of “mutual recognition” other Member States where branch establishments or subsidiaries of the parent company are located will make use of the consolidated tax accounts prepared by the parent company for the whole group and impose corporate income tax on the “slice” of this overall profit which is allocated to them under the “formula” which has to be agreed upon in the political arena.

The innovative elegance of Home State Taxation has to cope with several practical and conceptual drawbacks to this model. Among the major criticisms brought forward we find the argument that the application of up to 25 different rules for the taxation of business profits within a single Member State - depending on the residence of the respective parent company – would not lead to the aspired simplification and reduction of compliance costs but would require tax administrations and enterprises to learn and apply 25 different tax concepts¹⁰. Moreover, the increasing relevance of the location of the parent company for the taxation of branches and subsidiaries would eventually accelerate the competition among Member States for holding companies and distort competition between subsidiaries located in the same Member State by applying different tax rules to them relating to the seat of their respective parent companies. Therefore, the goal to provide a substantial reduction of compliance and administration expenses and to lay the foundations for a “level-playing-field” for companies in Europe will be better achieved if companies and groups of companies could refer to a commonly accepted framework for the computation of taxable profits and losses within Europe. This common framework could serve international or domestic companies as an “option” which would provide an alternative to domestic tax rules (this is the idea of “Common Consolidated Base Taxation”); it could also provide a compulsory set of rules (“Single Com-

⁹ *Malcolm Gammie*, Taxation Issues for the European Company, 7 EC Tax Review 3, p.159 et seq.; *Sven-Olof Lodin/Malcolm Gammie*, The Taxation of the European Company, European Taxation 1999, p.286 et seq.; *Sven-Olof Lodin/Malcolm Gammie*, Home State Taxation, 2001; *Malcolm Gammie*, Corporate Taxation in Europe – Paths to a Solution, British Tax Review 2001, p.233 et seq.; see also *CEPS*, EU Corporate Law Reform, Report of a CEPS Task Force, 2001.

¹⁰ *Wolfgang Schön* supra (Note 5), at p.284 et seq.; *Björn Westberg*, Consolidated Corporate Tax Bases for EU-Wide Activities: Evaluation of Four Proposals Presented by the European Commission, European Taxation 2002, p.322 et seq., at 324.

pulsory Harmonized Tax Base”) in order to avoid the “arbitrage” effects which are intrinsic to each election laid down in the tax code.

The 1988 experience has made it clear that there will be no realistic perspective of drafting a common consolidated tax base or a single compulsory tax base without reference to an agreed set of rules in the field of commercial accounting. At this point, the International Accounting Standards (IAS) or – as they have been recently renamed – the International Financial Reporting Standards (IFRS) come into play. Art.4 of the IAS Regulation¹¹ which was enacted by the European Institutions in 2002 requires all parent companies whose seat is registered in the European Union and whose securities are admitted to one stock exchange in Europe to draw up their consolidated accounts from 1.1.2005 on according to the IAS/IFRS. In 2003 and 2004, the Commission has issued two further regulations which have “endorsed” the majority of existing IAS/IFRS¹² and supplied guidance for the “transition” of current accounts into the IAS/IFRS world¹³, thus transforming these private rules on financial reporting into binding European law. Furthermore, the national legislature is empowered by Art.5 of the IAS Regulation to extend the application of the IAS/IFRS to consolidated accounts of non-listed companies and even to the individual annual accounts of companies¹⁴. This will lead to a widespread application of IAS/IFRS in the corporate sector in Europe.

It is this arrival of the IAS/IFRS which has led the European Commission to set forth the idea that the IAS/IFRS could serve as a “starting point”¹⁵ for a common consolidated tax base. In February 2003 the Commission has launched a consultation on “the application of International Accounting Standards (IAS) in 2005 and the implications for the introduction of a consolidated tax base for companies’ EU-wide activities”¹⁶. The results of this consultation¹⁷

¹¹ Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards, O.J. L 243/1 of 11th Sept 2002.

¹² Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain International Accounting Standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, O.J. L 261/1 of 13th Oct 2003.

¹³ Commission Regulation (EC) No 707/2004 of 6 April 2004 amending Regulation (EC) No 1725/2003 adopting certain International Accounting Standards in Accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council., O.J. L 111/3 of 17th April 2004; for further IAS/IFRS – mostly in the context of the “improvement project” of the IASB – currently waiting for endorsement see the latest update: http://www.europa.eu.int/comm/internal_market/accounting/docs/ias/ias-adoption-process_en.pdf.; in this article, IAS/IFRS are quoted as they have been “endorsed” by the European Commission until May 2004.

¹⁴ An overview of the planned implementation of the IAS Regulation is given by the Commission (http://www.europa.eu.int/comm/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf).

¹⁵ *The Commission’s Communication* supra (Note 1), par. 5.18; *The Commission’s Study*, supra (Note 2), para 13.2, 16.8.

¹⁶ Consultation Document, February 2003.

have led the Commission to move further in this direction. In December 2003 at a High-Level-Conference in Rome organized by the European Commission and the Italian Government during its Presidency of the European Union, both Commissioner *Frits Bolkestein* and Director-General *Robert Verrue* emphasized the necessity to conduct further – comparative and theoretical – research as to the usefulness of IAS/IFRS in the tax field¹⁸. Therefore, it has been a timely decision by the Academic Committee of the EATLP to devote a “slot” at this year’s Paris conference to the relationship between IAS/IFRS and tax accounting.

II. Institutional Issues

Before we can get into the substantive issues some general – institutional – questions have to be dealt with.

1. “Private Legislation” in Tax Law

An issue which comes up both in the context of the EC Treaty and in countries with a strong constitutional tradition addresses the fact that the IAS/IFRS are a product of private standard-setting. The International Accounting Standards Committee, located in London, is a private organisation governed by its Trustees and a Board (the International Accounting Standards Board) which has “complete responsibility for all IASC technical matters including the preparation and issuing of International Accounting Standards”¹⁹. The private character of this type of standard setting has led to a discussion about the legality of a provision enshrined in European or domestic tax law of a Member State which refers details of income measurement to the IAS/IFRS which have been issued by the IASB²⁰. While the mere “information purpose” under capital market law may easily be fulfilled by such reference to the recommendations of a private body, it is argued that the definition of a taxable event has to observe strictly the “rule of law” and may not be influenced by decisions which are taken outside the public do-

¹⁷ Summary Report on the Results of the DG Taxation and Customs Union open Consultation on The application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a consolidated tax base for companies’ EU-wide activities, 2003.

¹⁸ *Joann Weiner*, European Officials Consider Importance of Coordinating EU Company Tax Policies, Tax Notes International 2003, p.1001 et seq.

¹⁹ IASC Foundation Constitution, Approved 24th May 2000, Part B, par. 36(a); for an overview on the basic institutional elements of IAS/IFRS see *Barry Epstein/Abbas Ali Mirza*, IAS 2003, Interpretation and Application of International Accounting Standards, 2003, chapter 1.

²⁰ *Herzig/Bär* supra (Note 7), at 4 et seq.; *Kahle*, supra (Note 7), p.218 et seq.; *Romuald Bertl*, Internationale Rechnungslegung und Maßgeblichkeit, in: *Haller* (Ed.), Internationale Rechnungslegungsstandards für Österreich, 2004, p.121 et seq. (134 et seq.); *Heinrich Weber-Grellet*, Argumentation für die Abschaffung des Maßgeblichkeitsprinzips, in: *Bertl/Egger/Gassner/Lang/Nowotny* supra (Note 7), p.267 et seq., at 279 et seq..

main²¹. Otherwise, not only the private property rights of the taxpayer but also the budgetary sovereignty of the national parliament may be endangered.

In the current context of IAS/IFRS a lot of this criticism can be opposed by pointing to the fact that under Art.3 par.2 of the European IAS Regulation the IAS/IFRS need to be formally “endorsed” by the European Commission before they gain binding force under EC law. By this procedure the “endorsed” accounting standards leave their purely private character behind and become an integral part of the “acquis communautaire” of EC law²². Moreover, no one will recommend that IAS/IFRS will be employed in the context of taxation without further scrutiny at the European or domestic level. The Commission thinks of a “tax regulation” parallel to the IAS regulation in order to “endorse” IAS/IFRS in particular for tax purposes²³. This would prevent the immediate effect of private standard-setting on tax law. The doubts which have been raised as to the substantial influence of the European Commission or the national parliaments on the proceedings in the IASB, have some political relevance but cannot be regarded as a legal obstacle to this sort of legislation.

Of course, we have to ascertain the competence of the European Community to legislate in this area. The relevance of the international harmonisation of the tax base in the corporate sector for the functioning of the Internal Market should destroy any doubt as to the competence of the European Union to legislate in this matter under Art.95 EC²⁴. Of course, as long as tax law requires unanimity under Art.95 par.2 EC one might find a problem in the fact that the accounting rules can be changed by qualified majority under Art.95 par.1 or even by the Commission alone under Art.6 of the IAS Regulation²⁵. But there is no obstacle to the Council of Ministers to decide unanimously that the Commission shall be entitled to “endorse” IAS/IFRS also for tax purposes, thus using the instrument of “delegation” under EC law²⁶.

Under these auspices, a constitutional issue will only arise if national tax law requires the national legislature to formally enact all rules governing taxation. In Spain, an expert commis-

²¹ It has been noted that also in the U.S. the low influence of US GAAP on the computation of the taxable profit is due to the „private character” of their source (*Schreiber* supra (Note 7), at p.507).

²² *Spengel* supra (Note 7), p.6; *Schön*, Gerichtskompetenzen und Auslegung von IAS/IFRS, Betriebs-Berater 2004, p.763 et seq.

²³ *European Commission*, Consultation Document, supra (Note 169, para 3.6.

²⁴ *Wolfgang Schön*, Tax Competition in Europe – the legal perspective, EC Tax Review 2000, p.90 et seq., 101 et seq.; but see *Siegfried Grotherr*, Die Diskussion des Maßgeblichkeitsprinzips in der Bundesrepublik Deutschland, in: *Bertl/Egger/Gassner/Lang/Nowotny* supra (Note 7), p.221 et seq., at 260.

²⁵ *European Commission*, Summary Report, supra (Note 17), par. 3.1.

²⁶ *Dimitris Tryantafyllou*, Vom Vertrags- zum Gesetzesvorbehalt, Beitrag zum positiven Rechtmäßigkeitsprinzip in der EG, in: *Jürgen Schwarze* (Ed.), Schriftenreihe Europäisches Recht, Politik und Wirtschaft, Vol.180, 1996.

sion of the Instituto de Contabilidad y Auditoría de Cuentas (ICAC) has released a memorandum, pointing out that the Art.31.1 of the constitution requires the Spanish parliament to decide on the “essential elements” of the tax base²⁷. In this constitutional framework neither the EC nor the national parliament could simply refer to the IAS/IFRS for tax purposes; the accounting standards (at least their basic elements) must be explicitly endorsed by an Act of Parliament.

b) Standard Interpretation and Jurisdiction

The endorsement of the IAS/IFRS by the European Commission under Art.3 par.2 IAS Regulation will not only transform these standards into binding law but also bring forward – as is always the case with legal instruments - the issue of interpretation. In the current situation, the sovereignty of the national parliaments in tax matters is equalled by the jurisdiction of the domestic courts with respect to the interpretation and application of the rules on individual and corporate income tax. A far-reaching reference in tax matters to the IAS/IFRS will inevitably lead to the establishment of the jurisdiction of the ECJ in the field of tax accounting²⁸. In countries where the dependency between tax accounting and commercial accounting is currently strongly developed the question whether tax issues have to be referred to the ECJ is already highly disputed²⁹. In the past, the Court has accepted two references concerning accounting rules by lower German tax courts³⁰; the Federal Tax Court tries to loosen the connection between tax and commercial accounting gradually in order to avoid further references to the Court³¹. In a domestic setting, it makes sense not to submit fiscal sovereignty to international accounting rules without any control by the national legislature and judicature. In the context of European tax harmonisation, however, this common jurisdiction will enhance the uniform application of the IAS/IFRS all over Europe which would be a requirement for the success of the whole concept of a common tax base for multinational enterprises. Common rules for international groups of companies will be useless if the interpretation of these rules differs greatly in the hands of domestic tax inspectors and judges.

²⁷ *Instituto de Contabilidad y Auditoría de Cuentas (ICAC)*, Informe sobre la situación actual de la contabilidad en España y líneas básicas para abordar su reforma, 2002, para 11.2.2; see also: *Gonzalo/Garvey*, Accounting Reform in Spain: ‘in medio, virtus’, World Accounting Report, April 2003, p.12 et seq., May 2003, p.10 et seq.

²⁸ *Schön* supra (Note 22), at p.764 et seq.

²⁹ *Michael Lang*, Maßgeblichkeitsprinzip und Gemeinschaftsrecht, in: *Bertl/Egger/Gassner/Lang/Nowotny* supra (Note 7), p.199 et seq.; *Wolfgang Schön*, Steuerliche Einkünfteermittlung, Maßgeblichkeitsprinzip und Europäisches Bilanzrecht, in: *Klein et al.* (Ed.), Unternehmenssteuern, Festschrift Hans Flick, 1997, p.573 et seq.

³⁰ Case C-275/97 Judgment of 14th July 1999 (DE + ES Bauunternehmung) ECR I – 5331 et seq.; Case C-306/99 Judgment of 7th January 2003 (BIAO) ECR I – 1 et seq.

³¹ Bundesfinanzhof, Judgment of the Great Senate of 7th Aug 2000 Case GrS 2/99 Bundessteuerblatt 2000, Part 2, p.632; Judgment of the First Senate of 8th November 2000 Case I R 6/96 Der Betrieb 2001, p.410.

But there are more players to this game. An auxiliary body to the IASB in London is the Standing Interpretation Committee / International Financial Reporting Interpretation Committee which shall – according to the IASC Foundation Constitution – “interpret the application of International Accounting Standards in the context of the IASC’s framework”³². These interpretations shall be binding for the preparers of annual accounts under the IAS/IFRS in the sense that they have to be observed in order to allow the auditor to testify the compliance of the accounts with the international standards. Does this mean that taxpayers and tax authorities would have to go to London to receive advice on the construction of a standard in a specific context? This can’t be true. Under Art.3 par.2 of the IAS Regulation also SIC/IFRIC need to be endorsed by the European Commission in order to gain binding force within the European Community³³. Moreover, a separate body will have to decide which standards of interpretation will be accepted in the tax field.

III. Commercial Accounting and Tax Accounting – a Contradiction?

One of the obvious arguments against the proposal to develop a common tax base by reference to the financial accounts of a company under IAS/IFRS is rooted in the presumption that tax law and commercial law try to achieve different goals which are hard to reconcile³⁴. Taking a closer look one finds out, that both from a practical and from a theoretical point of view there are no insurmountable differences between tax accounting and commercial accounting.

1. The State of the Art

When we try to analyse the rules on tax accounting in different Member States of the European Union and beyond we find a multitude of links between tax laws on the one hand and the rules on commercial or financial accounting on the other hand³⁵. It is hard to find a single country which has cut off all connections between tax and accounting, and there is no tax law which strictly follows commercial accounting rules when it comes to the computation of taxable profits. Currently the opposite positions are taken by the USA which is said to strongly separate tax and commercial accounts, and Germany which is known for its traditional link-

³² IASC Foundation Constitution supra, part B para 41(a).

³³ Schön supra (Note 22), p.766.

³⁴ Commission, Consultation Document, supra (Note 16), para 2.1; Herzig/Bär supra (Note 7), p.4 et seq.; Schneider supra (Note 4), p.303 et seq.

³⁵ For an overview see Broer supra (Note 7), p.125 et seq.; Oestreicher/Spengel supra (Note 7), p.329 et seq.

age of tax and company law³⁶. Taking a closer look we find in sec. 446 (a) Internal Revenue Code (IRC) the statement that “taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books”. This principle of “book conformity”³⁷ sounds familiar from the German perspective, where sec.5 par.1 Income Tax Act provides that the rules laid down in German GAAP and the individual accounts which the taxpayer prepares for commercial purposes supply the basis for tax accounting. The difference between the tax systems cannot therefore be found in this common “starting point” but in the number and extent of exceptions to this rule which are far more widespread under U.S. law than under the German law. While in the U.S. compliance with US GAAP forms effectively one (minor) element in the identification of taxable income³⁸, in Germany most issues of recognition and valuation are still heavily influenced by commercial rules. In between we find different groups of countries - some have opted for a remote relationship between commercial and tax rules (e.g. the United Kingdom and the Netherlands), others prefer a strong linkage between the annual accounts and the tax assessment (Austria³⁹ and Switzerland⁴⁰), a third group practices a factual correspondence of tax and commercial accounting without an explicit legal rule (Belgium⁴¹, Greece). In France, the principle of “unicité de bilan”⁴² has led to a close alignment of tax and commercial accounting with tax rules playing a decisive role also for the development of commercial accounts. Taken as a whole, there is no simple “black and white” when it comes to the question of linkage between tax and commercial law.

Moreover, in recent years, some countries are loosening their traditional linkage while others move in the opposite direction. In Germany, the number of exceptions to the traditional principle of dependency in the tax statute is rising and voices pleading for the abolition of the

³⁶ Kahle supra (Note 7), p.170 et seq.; Schreiber supra (Note 7), p.492 et seq.

³⁷ Durwood L. Alkire, *Tax Accounting* (looseleaf), 2003, § 2.02[3]; Stephen F. Gertzman, *Federal Tax Accounting* (looseleaf), 2nd Ed., 1993, § 2.02 [1].

³⁸ Public Service Co. v. Commissioner, 78 T.C. 445, 455-456 (1982); Wal-Mart Stores v. Commissioner, 73 T.C.M. (CCH) 1625, 41 (1997); Jennifer C. Root, *The Commissioner’s Clear Reflection of Income Power Under § 446 (b) and The Abuse of Discretion Standard of Law: Where Has the Rule of Law gone and Can We Get it Back?*, 15 Akron Tax Journal (2000), p.69 et seq., at 96.

³⁹ § 5 öEStG; see Michael Tanzer, *Zur Dogmatik des Maßgeblichkeitsgrundsatzes*, in: Bertl/Egger/Gassner/Lang/Nowotny supra (Note 7), p.73 et seq.

⁴⁰ Art.58 par.1 DBG; Brülisauer/Kuhn, *Kommentar zum Schweizerischen Steuerrecht*, I/2a, Art.58 DBG para 9.

⁴¹ Jorissen/van Oostveldt, *Belgium Individual Accounts*, in: Ordelleide/KPMG (Ed.), *Transnational Accounting*, 2001, p.375 et seq., at 381, 392.

⁴² Annexe III CGI, Art.38 quater; Pierre Lassegue, *Gestion de l’entreprise et comptabilité*, 1996, p.289 et seq.

principle of dependency are getting louder⁴³. In Spain, on the other hand, from 1st January 1996 on, Art. 10.3 of the Spanish “Ley 43/1995 del Impuesto sobre Sociedades” (LIS) has introduced an explicit linkage between the commercial accounts and the computation of taxable profits in the case of companies and commercial partnerships. Even in the UK the courts have gradually accepted the significance of commercial accounting rules in tax cases⁴⁴. Sec. 42 Finance Act 1998 prescribes explicitly that tax accounting has to follow the “true and fair view” principle laid down in the rules on commercial accounting⁴⁵, and the British government is currently deliberating further moves in this direction⁴⁶.

The UK example shows us that the strength and nature of the relationship between commercial and tax accounting is not necessarily prejudiced by the distinction between common law and civil law countries. An example for a civil law country which has – over the years – substantially loosened the linkage between commercial accounting and tax law are the Netherlands⁴⁷. Since 1893, Dutch tax accounting has followed “sound business practice” which originally was understood as a reference to the rules governing the commercial sector⁴⁸. But the modernisation of the Dutch rules on financial accounting from the 1970s on has led to a wide gap between the taxable profits and the results shown in the annual accounts.

The Dutch and the German models may serve as an example for another facet of the linkage between commercial and tax accounting rules. In Germany, commercial accounting is governed by the “prudence principle” which takes a conservative view as to the realisation of profits in order to ensure the maintenance of the company capital⁴⁹. Therefore, in Germany, the principle of dependency has traditionally worked in favour of the taxpayer who could rely on the conservative approach of commercial law in order to reduce his tax burden. In the Netherlands, on the other hand, the rules on financial accounting have gradually lost this tra-

⁴³ *Heinrich Weber-Grellet* supra (Note 20), p.267 et seq.; in a study commissioned by the German Ministry of Finance and written by *Norbert Herzig* the abolition of the Maßgeblichkeitsprinzip will be recommended strongly (*Norbert Herzig*, IAS/IFRS und steuerliche Gewinnermittlung – Kurzbericht - , 2004).

⁴⁴ See Note 108.

⁴⁵ *Judith Freedman*, The Role of Realisation: Accounting, Company Law and Taxation, in: *The Influence of Corporate Law and Accounting Principles in Determining Taxable Income*, IFA Congress Seminar Series, Vol.21b (1996), p.29 et seq., at 46 et seq.

⁴⁶ *H. M. Treasury* supra (Note 7), para 2.13.

⁴⁷ *Peter Essers*, The Relationship between Fiscal and Commercial Accounts in the Netherlands, in: *Fiscal versus Commercial Profit Accounting in the Netherlands, France and Germany*, IFA Seminar Series, Amsterdam 1996, p.15 et seq., at 17.

⁴⁸ *Klaassen*, Netherlands Individual Accounts, in: *Ordelleide/KPMG*, Transnational Accounting, 2001, p.1910, p.1935.

⁴⁹ *Wolfgang Schön*, Entwicklung und Perspektiven des Handelsbilanzrechts: vom ADHGB zum IASC, *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht* 161 (1997) p.133 et seq., at 140 et seq.

ditional character, and the adherence of tax law to the old-fashioned “sound business practice” has not only led to a split between commercial and tax accounting but also saved the advantages of the conservative accounting rules in the tax field. This difference becomes evident when we compare the provisions which lay down the linkage between commercial and tax accounting under German and UK law: Both refer the taxpayer to the generally accepted accounting principles of that country but the German rule looks at the “conservative” GAAP developed in the context of creditor protection and capital maintenance while the British rule stresses the “true and fair view” which describes the overriding principle of an accounting framework supplying managers, shareholders and other participants with adequate information about the situation of the business.

When we look at the advent of the IAS/IFRS in 2005 it is easy to see that these new rules which are focused on investor information and do not take into account the concept of capital maintenance and its consequences for “conservative” accounting, would change substantially the tax base in those countries which have traditionally known a strong linkage between tax and conservative commercial accounting rules. Therefore, countries like Austria⁵⁰, Belgium⁵¹, Germany⁵² and Switzerland⁵³ are on the brink of cutting off this dependency if IAS/IFRS becomes the leading paradigm for commercial accounting. Others, like the Netherlands or the UK⁵⁴ would not feel a major difference as their rules on financial accounts are already quite similar to the principles and rules laid down by the IASB. The U.S., in the end, have in the 1970s cut off the links between commercial and tax accounting rules in the light of the traditional conservatism of commercial accounting and might face new questions under the “modern” capital-market oriented approach of US-GAAP and IAS/IFRS.

2. Fiscal Purpose and Financial Purpose

a) US and EC Judicature

Although a closer look at tax law in different Member States of the European Union and other industrialised countries shows a mixed picture of strong and weak forms of linkage between

⁵⁰ See the contributions by *Eberhartinger, Gassner and Zorn* in: *Bertl/Egger/Gassner/Lang/Nowotny* supra (Note 7).

⁵¹ *Conseil supérieur des Finance, Sections Fiscalité et Parafiscalité*, La Reforme de l’Impot des Sociétés, Le Cadre, les enjeux et les scénarios possible, 2001, p.9 et seq.

⁵² *Herzig/Bär* supra (Note 7), p.4 et seq.

⁵³ *Neuhaus*, Archiv für Schweizer Abgabenrecht 69 (2000) p.42.

⁵⁴ *H.M.Treasury* supra (Note 7), para 2.13.

the taxable income and the annual accounts, theory has quite often declared the goals of tax accounting and commercial accounting to be heterogeneous: The determination of the taxable profit serves the fiscal interest of the state while the preparation of the annual accounts is meant to improve the functioning of the capital market, to ensure effective control of the managers by the shareholders and to protect creditors from opportunistic withdrawal of resources by shareholders and managers. In the context of the arrival of the IAS/IFRS the “information purpose” of these disclosure rules is seen to have no logical connection with the payment of taxes.

This conceptual debate has even been taken up by the courts. In the landmark case “Thor Power Tool Co. v. Commissioner”⁵⁵ the U.S. Supreme Court pointed to “the vastly different objectives that financial and tax accounting have” and rejected the claim of the taxpayer for a full write-off of inventory which had been brought forward relying on accepted practice under US-GAAP:

“The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc.”⁵⁶

In the perspective of EC law a case in point is the BIAO case which has in 2003 been decided by the European Court of Justice⁵⁷. The Hamburg tax court had requested the Court for a preliminary ruling on an issue concerning the interpretation of the 4th Company Law Directive on Annual Accounts which had arisen in a tax dispute under the auspices of the German linkage between tax accounting and commercial accounting⁵⁸. Advocate General *Jacobs* urged the Court not to hear the case; he found it not advisable to give a ruling on an issue of harmonised accounting law which would have consequences in the field of non-harmonised tax law. He said:

“It is clear from what has been said above that the aims and the material and personal scope of the Fourth Directive are radically different from those of the fiscal legislation at issue in the main proceedings. That difference of context brings me to my second point, namely that the present case perfectly illustrates the principle that apparently identical provisions may have

⁵⁵ 439 U.S. 522, 532 (1979)

⁵⁶ *supra* (Note 55), p.532.

⁵⁷ Case C-306/99 Judgment of 7th January 2003 E.C.R. I – 1 et seq.

⁵⁸ FG Hamburg, Case II 23/97, reference of 22nd April 1999, *Entscheidungen der Finanzgerichte* 1999, p.1026 et seq.

different meanings in different contexts. Company law rules regulating company accounts - now harmonised at Community level - seek to protect shareholders and third parties (for example, actual and potential creditors and employees) by the mandatory disclosure of prescribed information. National rules concerning the drawing up of accounts for fiscal purposes seek on the other hand to enhance and protect State revenue. The two contexts are thus manifestly different; indeed in several Member States wholly separate accounts are drawn up for tax purposes and company accounts purposes.”⁵⁹

Nevertheless, the Court took a more relaxed stance and decided to adjudicate on the matter, stating that:

“The Fourth Directive is not designed to lay down the conditions in which the annual accounts of companies may or must serve as a basis for the determination by the tax authorities of the Member States of the basis for assessment and the amount of taxes, such as the trade tax at issue in the main proceedings. However, it is in no way excluded that annual accounts might be used by Member States as a reference base for tax purposes.”⁶⁰

The Court went even further in the “*Société Baxter*”⁶¹ case where the judges forced the French Government to allow the deduction of research expenses incurred by a British parent company of a French subsidiary from domestic income. The Court recommended to the French Government to rely on the annual accounts of the British parent company:

“The Commission and, in substance, the applicants in the main proceedings claim that the information in the accounts of parent companies which have their seat in another Member State, prepared pursuant to the Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (OJ 1978 L 222, p. 11) and the Seventh Council Directive (83/349/EEC) of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts (OJ 1983 L 193, p. 1), constitute a basis from which the tax authorities can proceed in their supervision of research expenditure. The Commission also points out that, as far as the specific needs of fiscal supervision are concerned, the competent authorities have the power to require production of supplementary information, subject to the principle of proportionality.”⁶²

According to these judgements, under current EC law, there can be no doubt that the domestic legislator is free to decide on the impact of commercial accounting on the computation of taxable income. There is no prohibition to refer tax law to commercial law. This leads us back to the general question whether from a political point of view it is advisable to mix tax and commercial accounting in a future common consolidated tax base.

⁵⁹ AG *Jacobs*, Opinion of 15th November 2001, para 60.

⁶⁰ Judgment of 7th January 2003 *supra* (Note 57), para 70.

⁶¹ Case C-254/97 (*Société Baxter*) Judgment of 8th July 1999 E.C.R. I – 4809 et seq.

⁶² Judgment of 9th July 1999 *supra* (Note 61), para 17.

b) Taxable Income and Financial Profit – a Contradiction?

aa) The fiscal purpose of tax law

The contention that the aims of income computation under tax law and of profit calculation under commercial rules are incompatible starts from the presumption that there is a clear and identifiable set of principles governing the computation of profits and losses for tax purposes. But a closer look reveals that the economic and legal discussion has so far failed to define a “best practice” for income computation. The potential range of income measurements includes crude cash-flow approaches (which are favoured by advocates of a consumption-based approach to income taxation), more refined cash-receipts/disbursements calculations and different models of accrual methods (the results of which bear strong similarities to the balance sheets drawn up under the rules of commercial accounting). The fiscal purpose of income taxation as such is not at all a lodestar for the construction of an income statement. The words of the U.S. Supreme Court in “Thor Power”, that the major responsibility of the IRS is “to protect the public fisc”⁶³ provides no guidance in this respect; nor has the phrase coined by the German Federal Tax Court been helpful that tax law has to identify the “full profit”⁶⁴ (as opposed to which profit?) generated by the taxpayer’s business.

bb) Ability-To-Pay

Things are getting a bit clearer when we assume that income taxation has to measure the ability-to-pay of the taxpayer, i.e. the economic power of a person, and follow the Schanz-Haig-Simons concept which defines income as the increase in value of property rights available for consumption by the taxpayer⁶⁵. This basic assumption will exclude mere cash-flow-concepts which identify taxable income only when resources are actually consumed by the taxpayer. According to the ability-to-pay principle all inflows and outflows of resources generated by the taxpayer in the conduct of his or her business have to be included in the computation of the taxable income. This concept of income which is supported by the majority of economic

⁶³ supra (Note 55), p.542.

⁶⁴ Bundesfinanzhof, Great Senate, Case GrS 2/68, Decision of 3rd February 1969, Bundessteuerblatt, part 2, 1969, p.291.

⁶⁵ *Kevin Holmes*, *The Concept of Income – a Multidisciplinary Analysis*, 2000, p.55 et seq.

and legal writers is in line with the basic principles of financial accounting⁶⁶. According to the IAS/IFRS Framework the relevant “information” which shall be disclosed to the investor requires

“an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans and make distributions to its owners.”⁶⁷

This leads to an “accrual basis” of financial reporting:

“In order to meet their objectives, financial statements are prepared on an accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.”⁶⁸

In the end, “income” under financial accounting rules consists of all increases in economic benefits during the accounting period in the form of inflows or enhancements of assets that result in increases in equity. Financial accounting rules are meant to disclose to the investor the potential cash flow which he or she can expect from the activities of a business. Tax accounting rules look at the consumption expenditure which can be financed from the same source. The theoretical contradiction between the “information purpose” of the financial accounts and the “fiscal purpose” of the income tax assessment boils down to the common basic assumption that income can be defined as the increase of economic power in the hand of a person during a certain period of time.

c) The real issue: Timing

The real issue which is hard to tackle under tax law alone concerns the allocation of profits and losses to different fiscal years. From the perspective of existing tax legislation, there is no unanimity at all with respect to the timing of revenue and expenditure in the hands of the taxpayer. But this – and only this – is what accounting rules are about. “The basic problem in tax accounting” we read in the leading U.S. publication on this subject “is allocating items of in-

⁶⁶ *Holmes* supra (Note 65), p.107 et seq.; *Kahle* supra (Note 7), p.183 et seq.; *Schreiber* supra (Note 7), p.891 et seq.

⁶⁷ IASB Framework, para 15.

⁶⁸ IASB Framework, para 22.

come and deductions to years”⁶⁹. The question whether or not to capitalize expenses, the details of depreciation and impairment, the uncertainty when income is “earned” or the necessity to decide on the time value of money have to be addressed by tax legislation without any help from some “natural” tax concept of income. The U.S. hardly accepts any provisions for future risks in the income tax return while Germany traditionally regards these provisions to give a true and fair view of the current economic situation of a person. The question whether the cost of self-created intangibles are capitalized and written off over the useful life of the asset or expensed immediately finds a broad range of answers in different countries. And the basic distinction between income and capital (gains and losses) which is known in common law countries is not a basis for business taxation in other jurisdictions. As the British Government rightly points out, this distinction has to be abolished if one were to embark on a closer alignment of tax and commercial accounting⁷⁰. Therefore, tax theory and current legislative practice leaves one alone when it comes to the allocation of wealth-increasing and wealth-decreasing items to the respective tax periods⁷¹. For European tax legislation it would be hard to invent a convincing model from scratch.

In this respect, the reference to commercial accounting rules can provide helpful guidance. In the end it is the same economic reality that tax and financial accounting rules seek to picture. Moreover, the economic value of assets and liabilities in the hands of a person is enshrined in the property rights the legal order has conferred upon this person and cannot be viewed distinctly for commercial and tax purposes. Therefore, the strong or weak “linkage” between tax accounting and fiscal accounting which we find in many countries is not simply a pragmatic solution to the problem of finding an appropriate definition for taxable profits but also a consequence of the well-supported view that income itself can hardly be described differently for tax and commercial purposes.

III. Fundamentals of Tax Accounting

The fact that the fiscal purpose in itself and the ability-to-pay principle as a general concept are not in the position to provide a specific framework for the timing of income and deductions in the hands of the taxpayer does not mean that tax law does not know a set of principles

⁶⁹ *Alkire* supra (Note 37), Overview, p.XV.

⁷⁰ *H.M.Treasury* supra (Note 7), para 2.16.

⁷¹ *Kahle* supra (Note 7), p.203 et seq.; *Gröning* supra (Note 7), p.56 et seq.

which have to be observed when the rules of tax accounting are written⁷². Any codification of tax accounting has to comply with the following requirements:

1. Raising Revenue

Income taxation is about raising revenue on a periodical basis. Therefore, the measurement of income has to take into account the recurring nature of the tax claim. Tax accounting should follow this line and “produce revenue ascertainable and payable to the Government at regular intervals”⁷³. Accounting rules which lead to a high volatility of profits and losses over the lifetime of a business or allow for strategic allocation of income and expenditure to different fiscal years by the taxpayer should be avoided.

2. Ensuring Equality

Equal treatment of taxpayers in comparable economic situations belongs to the basic legal requirements of income taxation around the world⁷⁴. This principle of “fairness”⁷⁵ has to be followed by tax accounting rules as well. Differences regarding the source of income, the legal form of the enterprise or the nature of the taxpayer’s assets and liabilities should not lead to different tax burdens if they do not stand for differences in economic power⁷⁶. Moreover, elections and options which are awarded only to one group of taxpayers will eventually violate the principle of equal treatment within the overall community of taxpayers.

3. Craving for Certainty

Tax law requires a person to transfer individual wealth to the public fisc. The question, whether a taxable event has taken place and which amount of tax has to be paid, is of paramount importance both for the taxpayer and the administration. Therefore both parties to this legal relationship are in need of a tax base which helps to ascertain the tax claim beyond rea-

⁷² *Macdonald/Tax Law Review Committee*, The Taxation of Business Income: Aligning Taxable Income with Accounting Income, The Institute for Fiscal Studies, 2002, para 2.23 et seq.; *Drescher*, Zur Zukunft des deutschen Maßgeblichkeitsgrundsatzes, 2002, p.40 et seq.; *Joachim Hennrichs*, Maßgeblichkeitsgrundsatz oder eigenständige Prinzipien für die Steuerbilanz?, in: *Iris Ebling* (Ed.), Besteuerung von Einkommen, Deutsche Steuerjuristische Gesellschaft, Vol.24, 2001, p.301 et seq., p.307 et seq.

⁷³ *Kitchin v. Commissioner*, quoted according to *Alkire* supra (Note 37), Overview, p.XIII.

⁷⁴ *Gerard Meussen*, The principle of equality in European Taxation 1999.-

⁷⁵ *Liam Murphy/Thomas Nagel*, The Myth of Ownership – Taxes and Justice, 2002, p.12 et seq.

⁷⁶ *Macdonald/Tax Law Review Committee* supra (Note 72), para 5.2.

sonable doubt⁷⁷. In the U.S. tax arena, this quest for certainty has led to major differences between tax and commercial accounting as “financial accounting determinations are based on estimates and opinions, while tax accounting determinations are based on closed transactions and identifiable events”⁷⁸. But his antagonism seems to be ill-founded when we take into account that both the investor (under financial law) and the inspector (under tax law) will require reliable information from the business⁷⁹. On the other hand, this focus on “hard facts” does not fully reflect the true ability-to-pay of the taxpayer which is quite often influenced by changes in the value of assets or risks taken by a business which cannot be easily identified. So, certainty cannot be the only principle to be followed in tax matters. Moreover, one should not be guided by the perception that the burden of proof as to the measurement of income always falls on the taxpayer. Taking into account that it is the tax inspector who wants to establish a claim against the taxpayer one can also think about granting the taxpayer the benefit of doubt in certain circumstances.

4. Enforcing Efficiency

It is generally accepted that tax law should strengthen the efficiency of the economy⁸⁰. Tax accounting should not have a negative impact on the competitiveness of certain products and enterprises and should not distort the economic decisions of investors and consumers. The economic necessity to improve the “neutrality” of the tax system converges with the legal concept of equality among taxpayers⁸¹.

5. Avoiding Tax Avoidance

The aforementioned basic principles of taxation make it clear that the rules on tax accounting should be shaped in a way as to reduce the possibility of tax avoidance. Any rule which allows the taxpayer to influence his taxable income by explicit or implicit elections or other discretionary accounting techniques must not become part of income tax law⁸². This holds also true if the accounting treatment of a transaction can be changed by a modification of the relevant contract without any change to the economic nature of the transaction. Therefore, the

⁷⁷ *Kahle supra* (Note 7).

⁷⁸ *Alkire supra* (Note 37), Overview, p.XIV.

⁷⁹ *Schreiber supra* (Note 7), p.894.

⁸⁰ *Kahle supra* (Note 7), p.187 et seq.; *Macdonald/Tax Law Review Committee supra* (Note 72), p.2.24.

⁸¹ critical *Gröning supra* (Note 7), p.55 et seq.

⁸² *Spengel supra* (Note 7), p.10.

“substance over form” principle which is part of the IAS Framework⁸³ is in line with this basic requirement of tax law (though there may be some clashes with the principle of “certainty” laid out above in countries where tax law follows a strictly “legalistic” approach⁸⁴).

6. Reflecting Real Income

Tax accounting rules should give a full picture of the income of a person. As income consists of items having a positive or negative impact on the economic position of the taxpayer, income taxation should reflect both elements – revenue and expenditure – in a symmetric way. In particular, one should not share the U.S. Supreme Court’s view, “that an income tax deduction is a matter of legislative grace”⁸⁵. Moreover, any inclusion of fictitious income or deductions would not describe the true ability-to-pay of the taxpayer and should not have a place in the rules on tax accounting.

7. Looking at Losses

A key element of tax accounting rules is the recognition of losses. In order to give an accurate picture of the economic resources generated by a business over its lifetime it is necessary that the annual profit and loss statements which form the basis of the annual tax assessment add up to the economic overall profit or loss incurred in the course of this business. To put it more specifically: Losses have to be recognized either within the rules on tax accounting or by the introduction of a generous carry-back or carry forward⁸⁶. A tax system which does not provide a loss carry-back has to face the question whether foreseeable losses can be included in the income statement before they actually result in an outflow or resources.

8. Protecting Property

The true difference between financial accounting and tax accounting does not lie in a different “concept of income” but in the fact that the disclosure of income under commercial law is only meant to provide information to the management, investors and third parties without

⁸³ IAS Framework, para 35.

⁸⁴ *Macdonald/Tax Law Review Committee* supra (Note 72), para 3.33 et seq.

⁸⁵ *INDOPCO, Inc. v. Commissioner*, U.S. 79, 503 (1992).

⁸⁶ *Herzig*, Steuerliche Gewinnermittlung durch modifizierte Einnahmenüberschussrechnung – Konzeption nach Aufgabe des Maßgeblichkeitsprinzips, *Der Betrieb* 2004, p.1 et seq., p.8 et seq.; *Ulrich Schreiber*, Gewinnermittlung und Besteuerung des Einkommens, *Steuer und Wirtschaft* 2002, p.105 et seq., at 109.

giving rise to an immediate outflow of financial resources to the shareholders or other claimants to the profit of the company. The tax assessment, on the other hand, entitles the state to immediate payments which have to be financed out of the current wealth of the taxpayer⁸⁷. As the traditional income tax does not only look at the periodical cash flow the taxpayer may be forced to sell other assets than cash in order to fulfil his tax duties or to take on a loan for which his business assets may serve as a collateral. His economic freedom will be reduced and his property endangered by the tax burden.

From this point of view, it makes sense not to tax those increases in wealth which are either not yet “certain” in the hands of the taxpayer or have not been transformed into liquid cash (by sale or another transaction leading to the realisation of a profit or gain). The need to protect the taxpayer’s assets against the risk of expropriation may guide tax accounting to a more conservative approach than the capital market requires where investors look for a symmetric picture of the risks and opportunities lying ahead of the business⁸⁸. Therefore, the Supreme Court’s view in “Thor Power”, that “in view of the Treasury’s markedly different goals and responsibilities, understatement of income is not destined to be its guiding light”⁸⁹, does not give enough weight to the argument that the many uncertainties in the lifetime of a business cannot work to the detriment of the taxpayer alone. The “benefit of doubt” which should be granted to the taxpayer and the goal to refrain from tax rules which force the taxpayer to sell assets in order to fulfil the tax claim provides enough reasons for a conservative approach to tax accounting.

9. Counting on Capital Markets

This argument holds especially true when we look at the option for taxpayers to rely on the capital market to finance tax payments even when a profit or a gain is not yet “realised” or uncertain for another reason. Under the presumption of a perfect capital market, the timing of profits and losses under tax law does not play a significant role for the behaviour of economic agents. Any tax claim arising from unrealised profits will find someone providing equity or debt⁹⁰. In a perfect finance world one should even urge the government to tax unrealised prof-

⁸⁷ *Herzig/Bär* supra (Note 7), p.5.

⁸⁸ *Dieter Schneider* supra (Note 4), p.301 et seq.; *Wolfgang Schön*, *Die Steuerbilanz zwischen Handelsrecht und Grundgesetz*, *Steuer und Wirtschaft*, 1995, p.366 et seq., at 372 et seq.; *Joachim Hennrichs* supra (Note 72), p.312; *Herzig* supra (Note 43), p.20 et seq.

⁸⁹ supra (Note 55), at 542.

⁹⁰ *Macdonald/Tax Law Review Committee* supra (Note 72), para 3.66.

its because otherwise the decision whether or not to sell an asset is distorted by the prospect of a tax claim on the realised profit or gain⁹¹. But this does not relate to reality. In the real world it will always be hard to find money to pay taxes on uncertain or unrealised profits while creditors will closely look at unrealised or probable losses⁹². Again, the “underestimation” of income does not run contrary to the guiding principles of tax law but complies with a realistic assessment of the market where taxpayers live in.

10. Result

The idea that IAS/IFRS may serve as a “starting point” for the formation of a common tax base for international groups of companies within Europe does not face insurmountable obstacles which have their roots in a theoretical incompatibility of tax accounting and commercial accounting. Both try to describe the economic situation of a person with respect to the increase or decrease of economic power in the hands of this person – be it a company obliged to disclose its financial position, be it a taxpayer filing his return for assessment and payment of individual or corporate income tax. Nevertheless, the word “starting point” correctly implies that the rules laid down in IAS/IFRS will not be transformed without change into a framework for tax accounting in Europe. Rather, there will be formal and substantive adjustments to be made and requirements to be met before the common tax base will be in force.

IV. Basic Elements of IAS/IFRS and their compatibility with Tax Law

1. Personal Scope

When we try to ascertain whether the reference of domestic or European tax law to the IAS/IFRS as a “starting point” makes sense we first have to look at the personal scope of their application. Art. 4 of the IAS Regulation requires all companies which have their registered seat within Europe and are listed at one European stock exchange to draw up their consolidated accounts in conformity with the IAS/IFRS “endorsed” under Art.3 par.2 of the regulation. At first glance, this seems to correspond perfectly to the goal of the Commission’s initiative on a common consolidated tax base as this is meant to supply internationally active groups of companies to compute their taxable profit on a consolidated cross-border basis. On second thoughts, we have to realize that the legal equality of taxpayers and the goals of eco-

⁹¹ This „Lock-In-Effect“ is described by *Macdonald/Tax Law Review Committee* supra (Note 72), para 3.69.

⁹² *Andersson* supra (Note 7), at p.377.

conomic efficiency urge for neutrality of taxation as to the legal form of an enterprise. Therefore, access to a “common consolidated tax base” should not be restricted to listed groups of companies but opened to other forms of business as well. From this point of view, the policy decisions taken currently by domestic legislators to make use of Art.5 IAS Regulation and to extend the application of IAS/ IFRS to the consolidated financial accounts of non-listed groups of companies and to the individual financial accounts of companies will play a decisive role for the feasibility of the Commission’s project on the common consolidated tax base⁹³. There can be no discrimination between listed and non-listed business or between companies belonging to a group and individual companies in the tax area – moreover if such discrimination would work to the disadvantage of small and medium-sized enterprises⁹⁴. Some countries – like Germany – also have to solve the problem whether the application of the IAS/IFRS can be extended to commercial partnerships and sole entrepreneurs. Only a broad field of application would provide the necessary commercial and company law basis for a computation of taxable profits derived from the IAS/IFRS.

This issue should not be taken easily by pointing out that the Common Consolidated Tax Base is only meant to be an option for cross border business which would not touch the regular application of domestic rules on tax accounting for most other cases. Such an option – if granted only to a small cluster of international incorporated business – would greatly damage the fairness of the tax system as a whole. It should be awarded to all enterprises regardless of their size and legal form. In order to be attractive, also commercial accounting should follow this line on a broad scale.

2. Management’s Discretion and Materiality

A second key element of the IAS/IFRS which is not easy to reconcile with the aims of tax accounting is the range of discretion awarded to the managers of a company in preparing the individual and consolidated accounts. As the IAS/IFRS are meant to provide rules for the information by the management to the investors and third parties about the future benefits which are expected to be generated by the business, it is up to the management to describe the economic situation of the company according to their best estimate. According to IAS 1.20 the management “should select and apply an enterprise’s accounting policies so that the fi-

⁹³ *European Commission*, Consultative Document, supra (Note 16), para 2.5.

⁹⁴ *European Commission*, Summary Report, supra (Note 17), para 3.3.; *Spengel*, supra (Note 7), p. 7 et seq.; *Carson*, *The Tax Journal*, 11th Nov 2002, p.7, at 8; *O’Carroll*, *The Tax Journal*, 7th Oct 2002, p.11.

financial statements comply with all the requirements of each applicable IAS and Interpretation of the SIC. Where there is no specific requirement, management should develop policies to ensure that the financial statements provide information (...).” This discretion recurs in the basic definition of assets “from which future economic benefits are expected to flow to the enterprise” and liabilities “the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits” (IASB Framework para 49 (a) (b)) and other rules (e.g. the provisions on the recognition of gains and losses).

This discretion seems to run foul of the principle that a tax claim shall not be subject to manipulation by the taxpayer in order to avoid schemes of tax avoidance. On the other hand, IAS/IFRS have become more detailed over the years and will in the future transform into a set of very specific rules leaving not much leeway as to the choice between different methods of accounting. The overarching aim of the International Accounting Standards to achieve comparability of information⁹⁵ will inevitably lead to an increasing pressure to “standardize” all rules of recognition and valuation. As far as assets and liabilities have to be recognized and evaluated with respect to subjective estimates, there is not much difference to present tax law where we have to decide on the capitalization of expenses with regard to the future benefits generated by these expenses or other items of tax accounting like provisions for future losses. Of course, it is up to the tax administration to draw a line between a realistic variety of probable outcomes and the deliberate manipulation of the tax base by the taxpayer.

In this context, the rule laid down in the IAS Framework that only such information shall be shown in the accounts which is of “material” relevance to the investor⁹⁶ has been criticized from the tax perspective⁹⁷. As the “materiality” of an information changes with the context, the same item of income or expenditure can be regarded to be of material importance for a small or medium-sized enterprise while it will be without relevance in the context of a multinational company. But this should not be a valid obstacle when it comes to the application of IAS/IFRS in the computation of taxable profits. It suffices to say that the taxpayer will not be in the position to decline the disclosure of certain transactions or other facts concerning his business to the tax inspector by declaring them to be not of “material” relevance⁹⁸.

⁹⁵ IAS Framework, para 39 et seq.; “comparability” is also one of the requirements which have to be met to qualify for “endorsement” under Art.3 par.2 IAS Regulation.

⁹⁶ IAS Framework para 29, 30.

⁹⁷ *European Commission*, Consultative Document, supra (Note 16), para 2.6; *Herzig/Bär* supra (Note 7), p.4 et seq.

⁹⁸ *Macdonald/Tax Law Review Committee* supra (Note 72), para 3.40 et seq.

3. Assets

It has been said above that the “timing” of revenue and expenditure is the basic issue which has to be addressed by accounting rules – be it in the commercial context or in the tax arena. From this point of view there are two mostly identical questions which have to be addressed under the respective accounting rules: Tax law asks whether to deduct or capitalize expenditure; commercial law asks when to recognize an “asset” in the balance sheet⁹⁹. Under both headings we have to ascertain whether expenditure leads to identifiable future benefits for the company or the taxpayer or whether it is consumed immediately in the course of the business. In the terminology of the IAS/IFRS “an asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.”¹⁰⁰ This sounds pretty similar to the results of the test for “capital expenditure” in U.S. tax accounting where it is asked whether the expense will result in future benefits as well (although tax accounting does not require a “distinct and separate asset” in the strict sense)¹⁰¹. In the same vein, UK tax law looks at the financial accounts where roughly the same definition applies as under IAS/IFRS¹⁰². Even in Austria and Germany where traditional linkage to commercial accounting would lead to a narrow view of what constitutes an “asset” (Wirtschaftsgut), the courts have established the rule that expenditure resulting in long-term benefits for the taxpayer will be regarded to be an asset¹⁰³. Not very far is French tax judicature, whereas an “immobilisation incorporelle” will be recognized if a resource generates periodic income of duration for the taxpayer¹⁰⁴.

Of course there are some minor distinctions to some of these tax definitions which have to be born in mind – under IAS/IFRS and most other financial accounting rules the future benefits resulting from the expenditure must be generated by a “resource” which is somehow under the control of the company. But on the other hand – it would be perfectly in line with the ability-to-pay principle if the recognition of a capital asset under tax law (as opposed to ordinary business expense) would require that a “resource” representing economic power is actually in the hands of the taxpayer and not only a vague expectation without individual control. *Herzig*

⁹⁹ *Macdonald/Tax Law Review Committee* supra (Note 72), para 5.21 et seq.

¹⁰⁰ IAS Framework, para 49(a).

¹⁰¹ *INDOPCO, Inc., v. Commissioner*, supra (Note 84).

¹⁰² *Arnold/Hope/Southworth/Kirkham*, *Financial Accounting*, 2nd Ed., 1994, p.144 et seq.

¹⁰³ *Heinrich Weber-Grellet*, in: *Ludwig Schmidt*, *Einkommensteuergesetz – Kommentar*, 23rd Ed. 2004, § 5 EStG para 93 et seq.

¹⁰⁴ *Austry*, p.12.

points to the fact that the valuation of assets is more “output-oriented” in the IAS/IFRS world than in the tax arena¹⁰⁵. But it is doubtful whether this actually leads to a substantial loss of certainty in the measurement of taxable profits.

The most highly disputed issue in the context refers to the capitalization of expenditure incurred in the creation of an intangible asset. Under IAS/IFRS both the acquisition and the self-creation of an intangible (patent, copyright etc.) lead to the recognition of an “asset”¹⁰⁶. Domestic tax laws vary greatly in this context. Specifically in the case of research and development expenditure some countries do not capitalize it with respect to the uncertainty of these intangibles (Germany) while others choose to offer a full deduction of these expenses as a matter of tax policy (UK). There is no easy solution to find: If we opt for a full deductibility of expenditure incurred in the self-creation of an intangible we distort the economic decision of the taxpayer to invest in intangibles vs. tangibles and to invest in self-created vs. acquired intangibles. If we opt for capitalization we will face the complex question which expenditure can be attributed to a specific intangible (see the distinction between research cost (no capitalization) and development cost (capitalization under certain conditions) in IAS 38). In order to avoid far reaching discretion of the taxpayer¹⁰⁷ and to enhance the R & D environment there are good reasons to exclude at least research and development expenditure from capitalization. Moreover, this will take from the taxpayer the burden to find capital in order to pay tax on the income enshrined in this intangible.

4. Liabilities

Accounting rules – including the IAS/IFRS – tend to recognize liabilities at an early stage; according to IAS 37.14 a provision should be recognised when (a) an enterprise has a present obligation as a result of a past event, (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. The outflow is probable if the event is “more likely than not” to occur. Tax accounting – on the other hand - differs vastly when it comes to the recognition of liabilities including provisions for risks and future losses. Tax systems which are closer to a cash flow method – like the U.S. tax accounting rules – tend to recognize liabilities only at a very late stage. Either the payments or other performances have actually

¹⁰⁵ supra (Note 43), p.12.

¹⁰⁶ IAS 38.18 et seq.

¹⁰⁷ Kahle, supra (Note 7), p.187.

been made or an “all-events-test” has to be passed which requires that all events determining the liability have occurred by the end of that year¹⁰⁸. Contingent liabilities are not recognized at all under U.S. tax law. This restrictive approach is justified by the necessity to produce “certainty” in tax matters but it obviously grants to the tax administration the “benefit of doubt” and takes money away from the taxpayer although it might be hard for him to raise funds in order to pay the tax debt. Across the Atlantic, the UK courts have – referring explicitly to commercial accounting rules – accepted the inclusion of provisions in the tax accounts¹⁰⁹. Another twist is offered by Germany where traditionally provisions have been accepted over a long time but specific legislation has (in recent years) more and more restricted the recognition of a provision under tax accounting rules¹¹⁰. Also in France where we find a close relationship of tax and commercial accounting, tax rules have invented additional “tests” in order to recognise provisions, most notably the requirement that they relate to current events (*événements en cours*)¹¹¹.

Taking into account that losses have to be recognised in order to correctly define the lifetime income of a person or a business, the tax legislator has a choice between the recognition of a liability or provision – which will lead to a loss at an early stage which can be carried forward if it exceeds the positive income of that year – or the introduction of a loss carry-back in case a loss is recognized at a later stage. From the point of view of the business community, the recognition of provisions for probable losses and other risks which is laid down in the IAS/IFRS fits well in the context of inter-periodic loss compensation. As most states hesitate to introduce far-reaching loss carry-backs in order to avoid budgetary damages to preceding fiscal years it might seem advisable to follow the IAS/IFRS in this respect and recognize a (contingent) liability at an early stage.

5. Valuation

The most ardently discussed issue of modern accounting refers to “fair-value-accounting”¹¹². There are two possible ways of evaluating assets and liabilities in the hands of a company: Either you look at the historical cost of acquisition or creation and calculate depreciation or

¹⁰⁸ *Alkire supra* (Note 37), § 4.03 [2]; *Gertzman supra* (Note 37), § 4.03 [1].

¹⁰⁹ *Jenners Princes Street (Edinburgh) Ltd. v. IRC* [1999] STC (SCD) 196; *Herbert Smith v. Honour* [1999] BTC 44; *Chandler/Edgway* [1999] British Tax Review, p.309 et seq., p.312.

¹¹⁰ § 5 par.2a – 4b EStG.

¹¹¹ *Maurice Cozian*, *Précis de Fiscalité*, p.140 et seq.; *Mercier/Plagnet*, p.239.

¹¹² *Henk Langendijk/Dirk Swagerman/Wilhelm Verhoog*, *Is Fair Value Fair?*, 2003.

amortization on the basis of the useful life of the asset. Extraordinary devaluations can be recognized by an impairment test. Or you try to ascertain the current market value of an asset (or a whole cash-generating-unit) by the end of every year, which – taken as a whole – should reflect the full value of the business at any time. IAS/IFRS as they stand now tend to accept both methods of valuation: the historical cost method is used in the context of “Property, Plant and Equipment” (IAS 16) while fair value accounting is used for some investment properties (IAS 40) and financial instruments (IAS 39). Currently, the European Commission and the IASB are at odds about the final version of IAS 39 which will decide about the extent to which fair value accounting can be used in the derivative market¹¹³.

From a theoretical point of view, full fair value accounting seems to be the ideal measurement for the increase and decrease in the economic power of a person in the light of the Schanz-Haig-Simons concept of income, giving the full and “real time” picture of the resources controlled and liabilities incurred by the taxpayer¹¹⁴. Nevertheless, full fair value accounting runs foul of several requirements which have to be met by tax accounting rules as laid down above¹¹⁵. Firstly, fair value accounting gives huge room to uncertainty and discretion (either of the taxpayer or the tax inspector), thus endangering the raising of revenue and the equality of taxpayers¹¹⁶. It will generate enormous compliance costs and legal disputes as the value of the whole business has to be reassessed every year. If – on the other hand – fair value accounting is restricted to some assets which are subject to an open market price there will be disagreeable distortions and tax arbitrage between different investments, because some investments will be subjects to fair-value-accounting while others will be subject to the historical cost method. Moreover, under IAS/IFRS the method of valuation of financial instruments depends on the expectations and strategies of the management (whether a financial instrument will be “held for trading”, “available for sale” or “held to maturity”¹¹⁷); from this “starting point”, tax avoidance schemes will be on the rise.

Moreover, fair value accounting will show gains in the accounts which have not yet been realised, so that there is no corresponding liquidity in the hands of the taxpayer. Of course – in a perfect capital market every increase in the value of the business assets can be used as a col-

¹¹³ Editorial, *World Accounting Report*, March 2004, issue 7.2., p.1.

¹¹⁴ *H.M.Treasury* supra (Note 7), para 2.36.

¹¹⁵ *Andersson* supra (Note 7), at p.377; *Carson* supra (Note 93), at 8; *Schreiber* supra (Note 85), at 114; *Wilson*, *British Tax Review* 2001, p.86 et seq.

¹¹⁶ *Kahle* supra (Note 7), p.186; *Schreiber* supra (Note 86), p.114.

¹¹⁷ IAS 40.10.

lateral for a loan taken to finance the tax debt. One might even say that the current rule to recognise a capital gain or a profit only in the course of a transaction might work as an obstacle to the efficient timing of these transactions¹¹⁸. But as these increases in value are in most cases very hard to identify for possible creditors this is no viable solution for the taxpayer¹¹⁹. On the other hand, the historical cost method does not only support the objectivity of the tax assessment, it also reduces the danger that profits and losses are highly volatile (which again would put the periodic inflow of revenue to the public fisc at risk and lead to the necessity to introduce a well-working system of loss carry-backs and loss carry-forwards). Therefore, the IAS/IFRS will only provide for a practical “starting point” for a common consolidated tax base, if fair value accounting does not become the paramount standard for the valuation of assets and liabilities.

6. Realisation of Profits

Another general point which should be addressed in this context refers to the realisation of profits or gains. In the context of capital gains, the application of the historical cost method leads to the result that a gain is shown only when the capital asset is sold and the consideration is in the hands of the taxpayer. The same holds true for profits from ordinary business, i. e. from the sale of goods by a trader or producer. Under IAS/IFRS, the profit is realised when the “enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods” and “the amount of revenue can be measured reliably”¹²⁰. Also, dividends “should be recognised when the shareholder’s right to receive payment is established”¹²¹. *Herzig* rightly stresses the point that also in the financial derivatives sector where the realisation principle is currently on retreat in financial accounting, it should be kept for tax purposes¹²². A highly discussed issue concerns long term contract in the service sector, specifically construction contracts. Under U.S. law both financial accounting and tax accounting rules prefer (with some differences in the detail) the “percentage of completion method” which requires the company/taxpayer to show part of the overall profit in relation to the stage of completion of the whole contract¹²³. The UK practice goes in the same direction¹²⁴. In Germany (and with some restrictions in Austria), under the “prudence principle” which lies at the root of German

¹¹⁸ *Macdonald/Tax Law Review Committee* supra (Note 72), para 3.69

¹¹⁹ *Kahle* supra (Note 7), p.200 et seq.

¹²⁰ IAS 18.14.

¹²¹ IAS 18.29.

¹²² *Herzig* supra (Note 43), p.14 et seq.

¹²³ § 460 IRC.

¹²⁴ *John Tiley*, Revenue Law, 4th Ed., 2000, p.444 et seq.

commercial and tax accounting, the profit arising from such a contract is realised when the contract is finished (“completed contract method”)¹²⁵. France is somewhere in between where the percentage-of-completion method (“méthode de l’avancement des travaux”) is gaining ground although it is not yet binding in any case¹²⁶.

IAS/IFRS are following the Anglo-American line, providing for the application of the percentage-of-completion method in the preparation of the financial accounts¹²⁷. For information purposes, this seems to be sensible (it would not, however, comply with the rules on capital maintenance which require strict conservatism). For tax purposes, the situation is unclear. On the one hand, the percentage-of-completion method leads to a periodical stream of revenue, avoiding high volatility of profits and losses and resulting tax claims. On the other hand, the percentage-of-completion method requires the company to pay taxes on a profit which is not yet certain (and which might not be accepted as a collateral in the capital market in order to finance the tax bill). In the end, the different solutions found in different Member States show that there is no compelling argument for one or the other accounting method – so the European legislator could reasonably follow the IAS/IFRS in this respect as well.

V. Conclusion

It is fair to say that the decision of an individual Member State to refer basic elements of its domestic tax base to the international and European standard-setting process under the Rules of the IASC and the IAS Regulation would lead to a major loss of fiscal sovereignty, which will not easily be accepted by a national legislature. But it is also true that in order to establish a common tax base for all (or a large part of the) Member States of the European Union the IAS/IFRS are the only practical “starting point” available in the legal framework of the EC Treaty. This paper tries to show that there are no major institutional obstacles to a tax regulation which recognises the IAS/IFRS as endorsed under Art.3 par.2 of the IAS Regulation as binding European law in the company law and capital market sector and tries to evaluate which of these standards will serve best the interest of the tax administration and the business community in the tax sector. In this context we neither find any fundamental difference between the “income concepts” of tax and accounting law nor do we believe that basic elements of the IAS/IFRS are out of touch with the necessities of an enforceable tax code. The accrual

¹²⁵ *Brigitte Knobbe-Keuk*, Bilanz- und Unternehmenssteuerrecht, 9.Aufl., 1993, § 6 I 4.

¹²⁶ *Xavier Paper*, Le Traitement comptable des contrats à long terme, Option Finance, No.621/2000, p.27 et seq.

¹²⁷ IAS 11.22 et seq.

concept laid down in the IAS Framework and most features of recognition and valuation (assets, liabilities, profit realisation, historical cost method, depreciation and impairment) are in line with the goals of corporate and individual income taxation. Even the inclusion of risk provisions serves a reasonable purpose in the context of loss recognition. Only the “fair value concept” which is gaining ground in IAS/IFRS stands out as a measurement of income which is too uncertain and volatile to grant the much needed certainty to taxpayers and tax inspectors and will not be applied in the tax field. Moreover, it endangers the liquidity of a business and will force the taxpayer to sell assets in order to fulfil the tax debt.

Of course, companies and tax inspectors from every country will look closely at the existing body of IAS/IFRS in order to find out whether the respective rules will work to their advantage or not when compared with current tax accounting in their countries. But they all should take into account the fact that tax accounting is merely about “timing issues” while the advantages of a common tax base regarding compliance costs, reliability, cross-border loss-compensation and economic double taxation will be definite. Therefore, “country specific concerns about the implementation of IAS should not be allowed to be taken as an excuse for postponing the necessary work to improve the European tax structure and to make the European economy more competitive”¹²⁸.

¹²⁸ *Andersson supra* (Note 7), p.377