



International Chamber of Commerce

The world business organization

Policy statement

Important Differences between Taxation and Accounting Rules *Commission on Taxation*

Introduction

The objective of this paper is to analyse the relationship and possible interactions among commercial, financial and tax accounting, in order to indicate problems or tensions resulting from the application of different sets of rules in these fields.

Enterprises listed on national stock exchanges must follow financial accounting and reporting rules aimed at providing investors with a true and fair view of the financial situation of the enterprise. These rules increase transparency and international comparability of the results of an enterprise or a group. International Accounting Standards (IAS) or US Generally Accepted Accounting Principles (US GAAP) are widely used by Multinational Enterprises (MNEs).

Financial accounting and reporting rules are quickly shifting away from traditional legal concepts applied in commercial and fiscal laws. They are increasingly based on a fair presentation approach. The results shown for financial purposes (normally the consolidated group results) may differ considerably from the profits shown in the books of single enterprises or in the tax returns. MNEs therefore risk being confronted with unwarranted requests for tax profits adjustments or with the requirement that profits shown for financial purposes in a given country be taxable in that country.

The international business community is of the view that it is important for tax authorities and policy makers to understand the reasons why the results shown in financial statements of an enterprise or a group differ from the taxable results of such enterprise or group.

Different approaches followed to determine taxable profits

Many countries, in particular in Continental Europe, follow the concept of dependence in determining the taxable results. This means that the profits resulting from the commercial accounts are taken as the primary basis for tax assessment. Subject to the relevant taxation rules, certain fiscal adjustments have to be made in order to calculate the taxable profits.

Other countries, in particular those with a common law tradition, follow the concept of independence. Two separate sets of rules are applied, one for the commercial results and another for tax purposes. Such countries do not rely heavily on commercial accounting rules for taxation, which may have as a consequence that the two systems differ considerably.

Both systems have advantages and shortcomings. With separate taxation rules, two sets of rules must be applied, which may increase the compliance burden for enterprises. It may also be easier to deviate for tax purposes from certain principles followed in commercial accounting. However, even when taxation is based on the commercial accounts, certain tax adjustments are unavoidable.

For the time being, it would be unrealistic to ask for a common approach in this respect. Each country is free to decide whether the determination of the taxable results should be based primarily on commercial accounts or derived from the application of a separate set of taxation rules.

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ICC position: Countries have the right to follow different approaches with respect to the relationship between commercial and tax accounting (dependence/independence). Both approaches have advantages and shortcomings. However, in both cases, well-established principles of taxation must not be disregarded.

Differences between commercial accounting and capital market rules

Commercial law prescribes how the financial results of a single enterprise are determined. These rules are often set out in specific accounting laws.

Countries usually have additional specific rules on accounting and reporting for companies listed on national stock exchanges. These can be national standards (such as US GAAP) or widely used international standards (such as International Accounting Standards, IAS, or as they are now called International Financial Reporting Standards, IFRS). Accounting and reporting rules are based on the principle of fair presentation and are mainly designed to increase transparency for investors. The standards must be applied consistently to the whole group. Sometimes, enterprises are given a choice with regard to the application of a given method or rule. The uniform application is examined by external auditors ("full compliance") and is enforceable by stock exchange authorities or other supervisory bodies.

Under pressure of globalisation on capital markets, efforts are being made to reconcile the basic principles of IAS/IFRS and US GAAP in order to facilitate the simultaneous listing of a company on several stock exchanges. IAS/IFRS are gaining ground as the standards used by groups in Europe, since the European Commission has decided to establish IAS/IFRS as the required standard for consolidated accounts of EU companies listed on stock exchanges in the European Union, beginning in 2005 (2007 for entities now using US GAAP or with listed debt instruments).

ICC position: Specific accounting and reporting standards for listed companies increase transparency and comparability, mainly for investors. A convergence of the principles governing existing accounting and reporting standards is desirable in order to increase comparability and to facilitate multiple listings. However, possible tax implications for companies, especially in countries relying on commercial accounts as primary basis for tax assessment, have to be kept in mind, and the convergence should not deteriorate the tax position of enterprises.

Different approaches and different purposes

Commercial, financial and taxation rules serve their own purposes and, as a consequence, differences in the results should be expected and accepted.

- Commercial accounting rules are used to determine the commercial results of a single entity. They establish, in particular, whether a profit or a loss has resulted for a given period. The rules may form part of a country's commercial or company law. They are intended to protect the rights of shareholders and creditors and, as a consequence, the prudence principle occupies an important place.
- Financial accounting and reporting rules are part of a country's capital market regulations. Their objective is to give investors (and other stakeholders) a reliable and, as accurate as possible, picture of the financial situation of the economic entity (group) at a given moment

(financial position, performance, cash flows). The guiding principle is "fair presentation" or "true and fair view". Other important rules in this respect are "substance over form", "market value measurement", and - as a consequence of true and fair - the factual prohibition of hidden reserves.

- Taxation rules are used to determine taxable profits. Their objective is to define the tax liability of enterprises to the State for a given year. The rules must be susceptible to compliance by taxpayers and control and enforcement by tax authorities. Taxation rules for companies are usually designed to preserve economic neutrality, so that business decisions are not unduly influenced by fiscal measures. The rules may also provide for non-fiscal objectives. A State has, in general, an interest in the longer term "profitability" of its enterprises. Tax laws reflect general principles of taxation, such as non-discrimination or taxation according to economic capacity, but also practicalities, such as availability of funds for payment of the liability (realization), fairness between different categories of taxpayers (neutrality), the annual character of the liability (loss carryovers, standardized depreciations), long-term profitability (prudence, imparity, valuation below market value) and other such factors. For example, tax systems may prescribe special timing rules for the recognition (or deferral) of income, loss carryovers from other years and other rules peculiar to the field of taxation.

As shown in the Annex to this paper, MNEs are required to establish different annual statements (commercial accounts, capital market statements, tax returns) which serve their own purposes, have different objectives and are based on different principles (see table under point 2 of the attached Annex).

ICC position: The approaches followed for the calculation of commercial, financial and taxation statements serve different purposes. Although the respective rules are focussed on the same general object (the results of a business entity in a given period), it is important to understand that, under existing concepts, the rules applied in financial accounting and those applied for tax purposes should not be expected to be strictly comparable.

Possible interactions between accounting and taxation rules

As a result of demands by international capital markets (globalisation), widely used accounting and reporting standards are expected to lead to a certain harmonisation in the area of accounting and reporting. On the other hand, so long as each country imposes its own taxes, implementing its own tax policies, a similar degree of harmonisation of taxation rules is not to be expected. At the same time, the more the rules used for financial accounting differ from those used in the field of taxation, and the more the results of a group become transparent, the more obvious the differences that result from the application of the two sets of rules become. Tax authorities should not use the financial results of an entity (in the same country or in third countries) as a pretext for an adjustment of the taxable profits of an enterprise or to justify transfer pricing corrections.

Under point 3 of the Annex to this paper, a number of financial accounting and taxation rules governing certain business transactions are presented. These examples illustrate that the rules applied for financial accounting and those used for tax purposes may differ considerably and may lead to results that cannot reasonably be compared.

ICC position: Tax authorities and policy makers should accept that the underlying principles of financial accounting are not always compatible with basic principles and practices used in the

field of taxation. From a tax policy perspective, it is important that taxation rules are not undermined by an inappropriate extension of financial reporting requirements (e.g. fair value accounting or disregard of realisation).

Conclusions

Internationally recognized accounting standards (such as IAS/IFRS or US GAAP) can be seen as a coherent set of rules for accounting and reporting that should give investors a "true and fair view" of the financial situation (balance sheet), performance (income statement) and changes in the financial position (cash flow) of an economic entity at a given moment.

In the field of taxation, some widely accepted principles clearly deviate from concepts used for financial accounting and reporting purposes. In addition, tax laws often provide for non-fiscal objectives, e.g. the granting of specific incentives (for R&D, for special reserves, to promote self-financing, to attract certain business activities, etc.). They may be designed to influence the behaviour of enterprises by granting incentives or using disincentives (e.g. environmental taxes or relieves). Furthermore, a country's taxation system is the result of a political decision-making process and therefore, in many cases, neither neutral for businesses nor fully internally consistent.

ICC conclusions: Taxation and financial accounting rules serve different purposes, have different objectives and are based on different principles. Although both sets of rules are used to measure the annual results of an enterprise, differences in the results (profits) or in the methods applied (e.g. valuation) have to be accepted. Financial accounting looks at the enterprise as an economic entity (group), whereas taxation is normally based on a separate entity approach.

Because of the speed and the direction of developments in financial accounting and reporting (transparency, market valuation, single performance statement, convergence of standards), existing differences will become even more important in the future. Policy makers in the fields of taxation and accounting must be aware of these differences. Tax authorities must respect them and refrain from using companies' financial results for tax adjustments.

Annex

1. Multinational Enterprises have to establish several annual statements

A business entity acting as a group in several countries is confronted with a number of requirements with respect to the preparation of its annual accounts. In order to better understand those requirements, the situation for such a group and possible interactions are briefly described:

- **Commercial accounts:**
A commercial balance sheet and an income statement (profit and loss account) must be prepared in all countries in which the group has legal entities, in order to determine the commercial profits and to establish what amount may be distributed as dividends. The rules to be applied can be called "local GAAP".
- **Capital markets statements:**
Usually, each entity listed on a stock exchange must submit its results based on local GAAP

or an internationally used accounting standard such as IAS/IFRS or US GAAP. The listed holding company must submit the consolidated worldwide results, based on the application of the same standards by all entities entering into the consolidation, with "full compliance" for the whole group.

- **Tax returns:**

Each legal entity has to submit a tax return in its residence country in order to determine its taxable profits and, in some countries, its capital (local tax liability). In a number of countries, a group can submit, under certain conditions, a consolidated tax return reflecting the liability of the holding company and each legal entity in that jurisdiction (in some countries even foreign entities can be included).

2. Different approaches and different purposes

Commercial, financial and taxation rules serve their own purposes and, as a consequence, differences in the results are to be expected. Certain of these purposes, objectives and principles are noted in the following table:

Legal Sources	Purpose of the rules	Objectives	Valuation/measurement principles
Commercial law (company law)	- Determination of commercial results of a legal entity	- Protection of creditors - protection of shareholders - measure distributable profits	- Prudence - historical cost - separate entity approach
Capital market law (financial accounting and reporting standards)	- Determination of financial performance of an economic entity (domestic and foreign entities)	- Information/protection of investors/stakeholders - transparency - comparability	- Fair presentation - substance over form - economic view - recognition of value changes
Taxation law	- Determination of taxable profits - single entity approach or consolidated profits of (domestic) group	- Establish tax liability - protection of state revenue - neutrality - equal treatment - avoidance of double taxation - non-fiscal objectives (incentives, disincentives)	- Realisation - prudence - annual liability (loss carryovers, depreciations, deferrals) - recognition of foreign tax - profits smoothing

3. Examples: Treatment of selected business transactions

In the following sections, a number of financial accounting and taxation rules governing certain business transactions are presented. These examples show that the rules applied for financial accounting and those applied for tax purposes may differ considerably (depending on a country's policy) and may lead to quite different, but clearly intended, results.

a) Rules for group consolidation

Financial accounting rules:

As a principle, the results of the world-wide group (economic entity) must be consolidated, based on the same accounting principles. Internal relations and transactions in a group are disregarded. Special rules exist in order to determine whether an entity must be consolidated (based on control concept) and to what extent it has to be consolidated (full control = full consolidation; significant influence = equity consolidation). The treatment of special purpose vehicles is another important issue.

Taxation rules:

As a rule, taxation is based on a separate entity approach. Group taxation is allowed as an exception in some countries. But in such cases, the conditions usually differ considerably from those used for financial accounting purposes, e.g. only 100% (or some other high level) shareholdings, only domestic group members, specific requirements for intra-group transfers, for the creation or dissolution of group consolidation. Countries that allow for group consolidation do so normally for domestic members only, in order to make sure that the profits are calculated based on the same taxation rules, and that losses of foreign entities are not taken into account.

Conclusion:

It is evident that because of the differences in the two approaches, the financial results of a group will usually differ considerably from the consolidated taxable profits.

b) Treatment of intellectual property and goodwill

Financial accounting rules:

As a rule, intellectual property acquired from third parties, i.e. non-monetary and non-physical assets such as trademarks, patents, licences, know-how, which keep their value over a longer period, must be capitalized, when certain criteria are met (e.g. future economic benefits to be received from the assets are probable). Internally generated intangible assets may be recognized as well. Intangibles assets must be amortized over a period of time, e.g. up to 20 years under IAS. The accounting treatment of goodwill (resulting from acquisitions and being the residual difference between market value of identifiable net assets and acquisition cost) is similar. Under existing IAS rules, goodwill must be capitalized and amortized. There is a rebuttable presumption that the amortization period should not exceed 20 years. This concept is currently under discussion and new rules, very similar to the new rules of US GAAP, will probably apply from 2004. Under the new US GAAP rules, goodwill can no longer be amortized by regular instalments, but an annual impairment test must be applied (impairment-only approach). The former US GAAP concept of "pooling of interests" (where goodwill could be ignored) is no longer applicable. This change is also proposed under IAS. Under some national accounting rules it is still possible to directly deduct goodwill from equity.

Taxation rules:

In the tax field, the rules for the treatment of intellectual property and goodwill vary widely. In many countries intangibles can - or must - be depreciated according to the rules provided for in domestic law (accounting law or special rules in fiscal law). In some countries, however, there is no tax relief for intellectual property, which means that amortization or depreciation of intangibles is not allowed. Often, different types of intangible property are afforded quite different tax treatment. Because of the prudence principle, expenses for internally generated intangible assets can usually not be capitalized and are therefore not tax deductible. Goodwill resulting from an acquisition of another company is in many countries not deductible for tax purposes. In the US, despite the impairment-only approach used in financial accounting, goodwill resulting from an acquisition is written off on a straight line basis.

Conclusion:

Intangibles and goodwill are important assets for most MNEs, and the accounting rules may have a substantial impact on the overall results of a group or an individual member of a group. Whereas amortization of goodwill from acquisitions has an impact on the consolidated financial results, it usually has no effect on the taxable profits. This is another reason why the total of taxable profits of all the entities of a group may differ considerably from the consolidated financial results of the group as a whole.

c) Treatment of tangible and financial assets***Financial accounting rules:***

Valuation, or measurement of the elements to be considered in the financial results, is highly developed in financial accounting, with a multitude of approaches and differentiations. As a rule, historical costs are taken as a basis. There is, however, a tendency to come closer to a fair market value measurement for certain assets and in particular for financial assets (fair value approach, e.g. under the new IAS/IFRS 39 for financial instruments). One of the characteristics of such an approach is that the principle of realisation is not respected.

Taxation rules:

In the field of taxation, the valuation rules and methods for depreciation of tangible assets vary considerably from country to country. Usually, such assets must be valued at historical costs (acquisition or manufacturing costs). Revaluations are possible, or compulsory, for certain assets (e.g. financial investments) and in certain circumstances only. Capital gains are only taxed when they are realised (realisation principle). Depreciation is allowed based on standardised methods. Writedowns must sometimes not be reversed if they are no longer justified. The creation of "hidden" reserves is often permitted. Potential and foreseeable losses must be taken into account, but profits are only taxable if realized. Special reserves are in most countries allowed for specific purposes (e.g. R&D).

Conclusion:

Financial accounting is moving closer to the principle of fair value measurement in order to give as clear and objective as possible a picture of the enterprise. In the tax field, however, the taxation of unrealised profits is normally not permitted or required and "hidden reserves" are in many cases tolerated.

d) Treatment of share based payments (stock options)

Financial accounting:

Whether and how the "cost" of employee stock options should be accounted for as compensation expense under accounting principles, has for some years been a matter of controversy. An Exposure Draft of a new IFRS has been published requiring that stock options must be expensed when services are rendered during the vesting period and that they shall be measured at fair value at grant date. In the US, the Financial Accounting Standards Board eventually issued Statement 123, which provides for their accounting as an expense, but its application was made optional. Instead of expensing, companies can choose to make a disclosure only. Under FAS 123, the cost of options is also measured at fair value at grant date but a mixture of grant/vesting date is used for allocation of the resulting cost to the service period. Both standards (IFRS and US GAAP) determine the cost of the options by using an options pricing model, such as the Black-Scholes model.

Taxation rules:

Deductibility of option costs by issuers is also a controversial issue for tax purposes. Many countries do not allow for such a deduction, except for effective costs related to the implementation, or running of stock options plans. In the US, a distinction is made based on the nature of the options ("statutory" or "non-statutory"). The tax treatment to the issuer varies depending on the type of option, the ascertainability of its value, and the taxation of the recipient. The timing of the expense deduction ranges widely: upon grant, upon exercise, upon disposition of the options or the underlying shares by the recipient, or never. The amount of the deduction may be based on value (before or at exercise), or on the amount of ordinary income taxed to the recipient.

Conclusions:

Stock options are a typical (and prominent) example which demonstrates that governing rules for taxation and accounting principles are grounded in widely diverging policy considerations. Therefore, the results of their application are, in most circumstances, notably different.