# Accounting and Taxation & Assessment of ECJ Case Law
*EATLP International Tax Law Series – Volume 5*

## ***Kari Tikka Memorial Lecture: Accounting and taxation***

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## 1. Introduction

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

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

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

## 2. Terminology and delimitations

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

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

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

## 3. Accounting as a starting point for taxation

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

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

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

This will be put in focus when financial accounting changes. If, for example, historical cost is substituted for fair value as the main basis for the valuation of assets in financial accounting, this will be difficult to handle for taxation for various reasons. The idea of using financial accounting as a starting point for tax accounting is difficult to uphold regardless of the content of financial accounting. I believe that in most tax systems the idea is built on a number of explicit or implicit assumptions regarding the similar content of financial accounting and tax accounting (historical cost, prudence, etc.). Historically, the use of financial accounting as a starting point has therefore worked rather well. But developments in financial accounting create new challenges for tax legislators. This can be seen from the example of IFRS.

### 3.2. The connection between financial accounting and tax accounting

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

1. On this topic see Schön, W., International Accounting Standards – A "Starting Point" for a Common European Tax Base?, European Taxation (2004) pp. 426-440 with further references and Freedman, J., Aligning Taxable Profits and Accounting Profits: Accounting standards, legislators and judges, eJournal of Tax research, Volume 2, Number 1 (2004) pp. 71-99 with further references.
2. The countries mentioned have some connection between financial accounting and tax accounting.
3. See also Schön, European Taxation (2004) p. 433.
4. Schön, European Taxation (2004) pp. 430-432.