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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

General Tax Principles

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WORKING DOCUMENT

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General Tax Principles

I. Purpose of this paper

- 1) When defining a common consolidated tax base for companies it is worth starting with the consideration of some general principles. These may prove useful as a sort of evaluation framework, or at the very least to identify some issues which will need to be resolved when individual structural elements of the tax base will be discussed. In fact, it is difficult to see how Member States with currently different tax bases could agree on one common tax base without the – explicit or implicit – broad agreement on some underlying tax principles.
- 2) At present, there is no such existing statement of EU-wide tax principles. Nor do there even seem to be explicit individual national sets of tax principles. However, there are two sets of principles that could be of relevance for the design of a common consolidated tax base: the general principles for the design of (corporation) tax systems and the accounting principles for the determination of profits, respectively. Both these sets of principles are examined in the present note.
- 3) The Commission Services Study 'Company Taxation in the Internal Market'¹ identified some general principles for the design of a company tax system. These were used as part of the assessment criteria for the possible solutions which were identified in the study. The first part of this paper presents a brief overview of these general principles. The question to be discussed is to what extent these general principles for the design of tax systems are also of use for the design of a tax base.
- 4) The second part of this paper deals with a more specific set of principles developed by the International Accounting Standards Board for the preparation of accounts in its Framework for the Preparation and Presentation of Financial Statements². It makes use of the IASB Framework as a reference point for the discussion of more specific (common) tax accounting principles. This approach has been chosen in preference to selecting individual Member States' examples from their existing tax base as it represents an attempt to provide common principles in an international perspective. The question here is to what extent these accounting principles are also of use – perhaps with adaptations - for determining the different elements of a common tax base.
- 5) The intention of this paper is not to establish a formal agreed set of principles, but to provide for an initial exchange of views and perhaps the identification of some principles which will need to be taken into consideration when working on a number of the structural elements. As the work develops, it is quite possible that the Working Group will wish to discuss 'principles' further and this paper should not be considered to be definitive or final in any way.

¹ Commission Staff Working Paper SEC 1681 2001 'Company Taxation in the Internal Market'

² Framework for the Preparation and Presentation of Financial Statements, approved for publication by the IASC Board in 1989 and adopted by the IASB in 2001

II. General Principles for the design and assessment of tax systems

Introduction

- 6) The fundamental aim of a company taxation base is to provide a measure of profits which may then be subjected to a rate of taxation in order for individual states to raise an amount of revenue. The definition of the profits to be taxed should in addition satisfy as far as possible a number of additional criteria stemming from general economic principles.
- 7) To a certain extent these general principles are designed for appraising a tax system, ie the base and rate and the interaction of company and personal taxation. Furthermore, the concept of increasing overall welfare, ie avoiding the welfare costs of a potentially inefficient allocation of resources, by satisfying the criteria is based on an overall global aim. However, we are concerned only with the base and some of the principles can only be applied or appraised in conjunction with the rate so the tax base need only satisfy part of them, or at least assist in satisfying the principles when the rate is applied. Nor are we directly concerned with personal taxation so again the question of whether or not particular principles are satisfied can only be partly addressed. Finally, an appraisal of whether or not a tax system satisfies the principles has an international aspect beyond the EU. However, regardless of the likely limited applicability of some of these economic principles, for completeness they are included below.
- 8) Traditionally the general principles are viewed from a national perspective – for example how does a tax system deal with an investor in one country who invests in a second country, how 'competitive' is one country's tax base compared to another country's? As we are considering a common consolidated base the consolidation process and the 'sharing' mechanism will have to deal with those aspects which relate to the base within the EU. However, the analysis and comparison between the EU base and non EU tax bases will still be relevant.
- 9) As the rates will be set at the national level, as will the personal taxation arrangements, these aspects of the tax system will continue to be analysed and compared from a national perspective, but these are beyond the remit of this Working Group which is concerned only with the tax base.

The General Principles

Vertical equity

- 10) The burden of taxation should be shared in accordance with taxpayers' respective ability to pay, sometimes referred to as 'the ability to pay' principle. It is difficult to see how this principle (normally applied to personal taxation) could or should be applied to company taxation. However, the 'ability to pay' could be relevant when considering whether or not unrealised profits should be taxable. The concept that higher profits should be taxed at higher rates is not often applied to companies other than certain reliefs for small companies in some countries.

Horizontal equity

- 11) Taxpayers in the same economic circumstances should receive equivalent treatment. In the context of international company taxation *equity* relates mainly to the fair allocation of the tax base between states where international companies operate. Traditionally inter-country equity can be satisfied by (i) source country entitlement (the source country has the prior right to tax profits earned within its jurisdiction) and (ii) non-discrimination (countries agree not to discriminate against foreign companies). In this way different companies operating in a particular country are treated in a similar manner.
- 12) This inter-country equity is generally governed by bi-lateral or multi-lateral treaties between countries, and in the EU by the application of the EC Treaty and the rulings of the European Court of Justice. An EU CCCTB would aim to provide equity between countries as part of the consolidation process and the subsequent sharing of the tax base between countries. However, for countries outside the EU the traditional tools would have to be employed.

Efficiency (also described as neutrality, particularly in relation to different types of investment)

- 13) Generally taxes should be neutral to ensure that investment decisions take into account the 'best' location from an economic perspective. This avoids 'locational inefficiency' whereby investments are not placed where the productivity of capital is highest. However, taxation policy may be used to correct 'market failures' whereby distortions or inefficiencies in a particular market economy can be 'corrected' by the use of specific tax incentives. Determining whether a tax policy is correcting a market failure, or is inefficient can be difficult.
- 14) Both Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN) are concepts which aim to ensure neutrality. Under CEN investors receive the same tax treatment on home country investments as on investments in another country. This is generally considered to be achieved notably by income only being taxed in the country of residence with no distinction between domestic and foreign source income – ie a residence-based world wide approach to taxation needs to be adopted by all countries. The source of income is effectively ignored. Under CIN all investors receive the same tax treatment, regardless of where they are resident – ie a source-based or territorial approach to taxation by all countries. From a company tax perspective achieving both CEN and CIN is therefore problematic as CEN suggests a residence based approach, whilst CIN suggests a source based approach. Across the EU CEN or CIN for companies is achieved, or not achieved by a number of different national tax policies across the whole tax system.
- 15) However, as regards a CCCTB (as opposed to a common tax system including the base, the rate, and the interaction with personal taxation) within the EU both CEN and CIN are achieved since the calculation of the base is the same for all EU investors in all countries. When investors or investments outside the EU are taken into consideration a comparison will be required between the CCCTB and 3rd country tax bases. However, without extending the work beyond the tax base itself neither the CEN nor CIN principles seem particularly helpful.

Effectiveness

- 16) Effectiveness is essentially the capacity of the tax base to achieve its basic objectives. Taken together with the rate these would be to generate revenues and set the desired economic incentives. Within a single country, or within the EU with a CCCTB such incentives may increase competitiveness but in the international context this depends on interaction with other systems, for example incentives which reduce the effective rate in a source country have no effect if a parent is taxed on the residence basis and the rate in the country of residence is above that of the source country. Such incentives simply shift tax revenue between the source country and the resident country.

Simplicity, Transparency, and Certainty

- 17) The simpler a tax base is the lower the administrative or compliance costs should be, for both administrations and business. These costs are difficult to measure so international comparisons, measuring the incentive provided by a tax base which has 'low' costs against a 'high' cost are difficult. The rules must also be certain and clear which links in to the requirement for transparency. Certainty is desirable to assist business planning, but also to provide a degree of revenue certainty for administrations, for example if the rules governing loss-offset are unclear then neither business nor government can predict tax payments and revenues. The rules must also provide an appropriate level of protection against tax evasion and the unacceptable use of purely artificial tax avoidance schemes. Transitional costs of introducing a new tax base also need careful consideration.

Consistency & coherence

- 18) When two transactions have the same commercial result they should have the same tax result – ie commercial decisions on the structuring of transactions should not be distorted by taxation considerations, for example the finance leasing of plant should arguably produce the same post tax profits as the purchase of plant.

Flexibility

- 19) Markets and business practices change over time so the tax base should be responsive and be capable of change as well. This is particularly relevant for a CCCTB which it might be more difficult to 'change' than the existing national tax bases. However, too much flexibility can endanger certainty from a business perspective.

Enforceability

- 20) The rules of a tax base must be easy to enforce as an unenforceable system is unlikely to be either equitable or neutral. This has particular relevance for the introduction of a CCCTB with regard to the legal arrangements and the potential lack of precedent in the form of decided tax cases.

Some tentative conclusions on general principles

- 21) On the basis of the above analysis it appears that while some of the general principles for the design and assessment of tax systems could undoubtedly be of relevance for the development of a common tax base (e.g. simplicity, flexibility, enforceability), others are likely to be of limited help when considering the various structural elements of a tax base (e.g. efficiency, equity).

III. Accounting Principles of relevance for specific Tax Accounting Principles

Introduction

22) As regards the development of tax accounting principles, the IASB Framework for the preparation of financial statements is a useful example of how such a set of specific guiding principles or concepts can be developed. It also provides some useful parallels for the tax principles themselves. Although the main purpose of the financial accounts may be different to that of the tax accounts or tax base there are obviously significant overlaps. The financial accounts are clearly a major source of the financial information which is required for any tax base. However, the degree of 'dependency' or the 'closeness' of the links between the accounts and the tax base varies across the EU and this will also have to be addressed. Reference is made here to the numbered paragraphs in the IASB Framework where these seem to be of particular relevance and assistance for taxation purposes and follows the format of the Framework sections on underlying assumptions, qualitative characteristics, financial elements, recognition of elements, and measurement of elements.

Underlying assumptions

Accrual Basis (para 22) and the matching concept

23) As the tax base seeks to tax the profits of a specific period the tax base should be based on the accruals basis, ie, transactions and other events are recognised when they occur, and recorded in the periods to which they relate; and where some benefit is deferred (for example when fixed plant and machinery is purchased) only the appropriate proportion of the costs are recognised. The cash basis alternative provides too much scope for manipulation and does not ensure that expenses and income are correctly matched.

Qualitative Characteristics

Understandability (para 25), relevance (paras 26-28), reliability (paras 31-32), faithful representation (paras 33-34), neutrality (para 36)

24) These are necessary characteristics, but should be achieved by complying with the rules for preparing the calculation of the tax base and it is doubtful whether they are 'tax' principles as such.

Materiality (para 29)

25) For accounting purposes information is material if its omission or misstatement could influence the economic decisions of users. For taxation, information or a calculation may be material if it would affect the amount of taxable profits which suggests 'absolute' numeric accuracy is necessary. There may be some scope for setting *de minimis* amounts, for example the boundary between what is a business expense to be deductible in full when incurred and what should be capitalised and subject to tax depreciation may be subject to a *de minimis* amount. However, such examples must be distinguished from the general requirement that transactions must be reported in accordance with the tax legislation. Whereas in accounting it may be possible to

argue that an error in accounting can be ignored as it is immaterial, this principle is unlikely to be applicable for taxation purposes.

Member States are asked to explain (i) what their approach to materiality is, (ii) whether there are any de minimis type provisions in existence (iii) whether they have any rules which differ according to the size of companies and (iv) what, if any alternative approach they could envisage being able to follow in a common tax base.

Substance over form (para 35)

26) For accounting purposes 'substance over form' is increasingly applied. For the tax base this could either be (i) applied in general, which would represent a judgement or principals based approach. Alternatively it could be (ii) restricted in a specified set of circumstances for example in relation to finance leasing where although legally (in form) a company might not own an asset but in practical terms assumed all the risks and rewards of ownership (form) it could be treated in the same way as though the asset had been purchased. If this approach is taken then detailed rules for a range of circumstances would have to be agreed. The third alternative (iii) would be to insist on legal certainty and not apply 'substance over form'

Member States are asked to explain (i) which approach they currently follow, (ii) whether there are any plans to review this and (iii) which, if any alternatives they could envisage being able to follow in a common tax base.

Prudence (para 37)

27) In accounting prudence requires caution when judgement is exercised primarily to ensure that assets or income are not overstated, or liabilities or expenses not understated. For tax purposes although there may be pressure to reduce the areas where judgement is required in order to ensure certainty there will always be some judgement involved. For accounting the emphasis is essentially on not over-valuing the enterprise – to avoid misleading for example outside investors; whereas for tax purposes administrations are primarily concerned to avoid the under-declaration of profits. Examples of areas which will require particular attention when defining the tax base are the treatment of reserves and provisions, and the more general issue of the timing of income recognition, for example on long term contracts.

Financial Elements

Assets, liabilities, equity, performance, income and expenses (paras 53 – 80), (including unrealised gains and losses)

28) For tax purposes each of these needs considerable further definition as different types of assets and expenses will produce a different tax effect. For example it is important to distinguish between an asset (balance sheet), and an expense (profit and loss account). An asset which has been created or purchased will generally give rise to a permitted proportionate deductible expense over some years in the form of depreciation (which will generally be deducted in the profit and loss account), or perhaps no deduction at all. An asset such as a 'trade receivable' or 'debt' generally gives rise to a tax effect when it is created – in the form of the transaction which creates the trade receivable or debt, for example the sale which produces the receivable or debt. So the receivable or debt as an asset in the balance sheet itself is not particularly important - only if it is subsequently 'written off' as irrecoverable does a further tax effect arise.

- 29) In contrast to a capitalised or income producing asset an expense will generally be deductible in full, or not be deductible at all. Because of the difference in tax treatment (eg depreciation spread over several years as opposed to an immediate deduction) the tax base distinction will probably have to be 'tighter' than the accounting rules, certainly than the outline definitions in the Framework. Not only will it be necessary to distinguish between an asset and an expense but also the quality of the asset or expense will have to be defined, for example there may be some form of business purpose test which is not necessarily required for accounting purpose.
- 30) The accounting definition of income is broad – it includes both revenue (arising from course of ordinary activities of the business) and gains (may arise from non-business activities) and includes unrealised gains. For taxation purposes it may be necessary to distinguish between revenue and gains, and realised and unrealised. In some jurisdictions 'gains' are subject to a separate tax but even where they are subject to the normal company tax there may be circumstances, such as the sale of shares where they need to be distinguished from 'ordinary' revenue. Taxable profits are likely to be based on the measurement of business performance via the flow of transactions; rather than in line with the accounting trend of measuring the increase (or decrease) in value between the balance sheet at the beginning and end of the period.

Recognition

(including unrealised gains and losses)(para 82 onwards)

- 31) In accounting terms an item should be recognised if it is probable that any future benefit will flow to the enterprise and either a cost or value can be reliably measured. This gives rise to the recognition of unrealised gains (market value principle), and supports the accounting treatment of provisions for example against probable bad debts. For taxation purposes such a general principle is unlikely to be the defining one – taxation is likely to require more specific definitions of the assets and provisions than probability. However, the accounting principle that where items cannot be reliably measured (for example probable proceeds from an ongoing lawsuit) they should not be recognised is likely to apply for taxation purposes. The timing of recognition is particularly important for taxation and can create complexities with, for example, long term contracts, the provision of certain services and deferred payment terms.

Measurement

(including 'fair' or 'market value')(para 99 onwards)

- 32) In accounting a number of methods for measuring monetary amounts are available such as historical cost, current cost, net realisable value or present value. For taxation it is likely that historical cost will be the norm, with any deviation being subject to specific definition. For each item where historic cost is not applied then a specific tax treatment will have to be defined. For example if current cost or market value is applied to assets then this results in either unrealised profits or losses and whether such profits or losses (via provision or reserve accounting) should be taxed will have to be resolved.

Legality

- 33) The legal basis for the imposition of tax is particularly important, but currently varies across the EU. The CCCTB will therefore have to satisfy the legal requirements for imposing taxation in all the participating Member States. The CCCTB will also have to satisfy the EU Treaty and in particular the four 'fundamental Treaty freedoms', the State Aid provisions and the principle of non-discrimination. The jurisprudence of the European Court of Justice and the Code of Conduct on business taxation must also be respected.

Some tentative conclusions on specific tax accounting principles

- 34) On the basis of the above discussion it appears that some of the accounting principles may, with some adaptations, provide assistance in the development of specific tax accounting principles. However, without going into details no firm conclusions can be drawn at this stage.

IV. Overall Conclusions

- 35) For convenience two types of principles have been identified in this document: 'General Principles' and 'Specific Tax Accounting Principles'. The first section relies heavily on the 2001 Company Tax Study and the second makes use of the IASB Framework which sets out the concepts that underlie the preparation and presentation of financial statements. The purpose is to identify the main principles which may need to be taken into account when defining a CCCTB.
- 36) Although the general principles provide some general ideas about the CCCTB they seem to be of limited practical help and relevance to the task of defining a CCCTB. They may thus not play a major role in the forthcoming discussions. The specific tax accounting principles should be of more direct assistance. Some are likely to be relatively uncontroversial – for example the need to adopt the accruals and matching approach, and the requirement to ensure that income and expenditure are recorded in the 'correct' period; others such as 'substance over form' and materiality are more likely to produce a range of opinions and interpretations. Eventually through the process of agreeing on the individual structural elements agreed principles will emerge. However, the intention of this paper is to highlight some principles which need to be taken into account when the structural elements of the tax base are discussed. Whether these principles should be further developed into a formal statement of principles (cf the IASB Framework and the International Accounting Standards and International Financial Reporting Statements) is open to debate.

V. Questions for discussion

- A. Do members wish to add, or comment on the General Principles and do they wish to further develop this work before addressing the more detailed structural elements? To what extent are they useful for designing and evaluating a (common) tax base?
- B. Do members wish to add, or comment on the Tax Accounting Principles? In particular do they wish to add (or delete?) some specific tax principles? To what extent are they useful for designing and evaluating a (common) tax base?
- C. Do members believe it would be useful to further develop the work on Tax Accounting Principles by preparing a formal statement of principles; or should this possibility be considered after work has progressed on the more detailed structural elements?
- D. Do members have examples of their own national statements of Tax Accounting Principles which could form the basis for any such 'statement of EU CCCTB principles'?