MEMORANDUM

20 March 2008

CCCTB – METHOD FOR ACCOUNTING FOR INVENTORY

In the paper "CCCTB: possible elements of a technical outline", number CCCTB/WP057 and dated 26 July 2007, the method for accounting for inventory is found in paragraphs 52-54, as follows:

> "52. Inventories would be valued on the last day of the tax year at the lower of cost and net realizable value.
> 53. The cost of inventories of items that are not ordinarily interchangeable would be assigned by using specific identification of their individual costs. The costs of other inventories would be assigned by using the first in first out or weighted average cost method.
> 54. The cost of inventories would comprise all costs of purchase, costs of conversion and other direct costs incurred in bringing the inventories to their present location and condition. Taxpayers who have traditionally included indirect costs in valuing inventories could be permitted to do so provided that they do so consistently."

In the annotated version of WP 057, dated 20 November 2007, following commentary is included after para. 53:

> "Business Europe would like the option for the LIFO method to be allowed. As a group elects to enter the CCCTB regime, it should include in that election whether FIFO or LIFO will apply for the period of the election."

This memorandum clarifies the BUSINESSEUROPE position.

First of all, BUSINESSEUROPE likes to convey the sentiment echoed at its recent Fiscal Affairs Group meeting that taxpayers currently using a method other than FIFO may not be willing to switch from their current domestic corporate income tax system to CCCTB. This is due to the one-off tax costs and the discontinuation of the deferral of tax recognition of price inflation that companies face when changing from LIFO (or other accounting methods) to FIFO upon opting for the CCCTB.

The relevance of this point is beyond doubt. FIFO is not the norm for inventory tax accounting in all European countries. Other methods such as LIFO and Base Stock accounting are accepted in a number of Member States as long as they are used consistently, in line with actual practice in commercial accounts or company law. Under such conditions, Austria, Belgium, Finland, Germany, Netherlands, Spain and Italy, for example, allow different methods.

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Some of the important characteristics of the LIFO approach can be summarized as follows:

- LIFO is a prudent approach for income recognition in a market in which input costs are stable or rising.
- LIFO matches current stock with current sales which reflects the cost to the business of having to replace that stock once sold.
- LIFO ensures that gains arising as a result of inflation in the price of purchases are deferred in such a way that what is taxed is the current commercial margin.
- LIFO therefore ensures that businesses are not disproportionately penalized in times of rising costs by having to utilize cash flow not only to replace inventory at current, inflated prices but also to pay taxes on a higher base.
- Under a LIFO system and within a full price cycle, there should be no loss of tax revenue, provided that the system is applied consistently.

Taxpayers having used LIFO or other methods of inventory tax accounting than FIFO that respond to the principle of going concern of a company, will be hit with a significant and disproportionate tax charge as the historic inventory is effectively crystallized immediately without incremental commercial profit at the switch over to CCCTB. In addition, the adoption of FIFO as only method will cause businesses in a number of European countries that currently permit LIFO (or other methods) to have to change inventory tax accounting systems. This will cause additional costs in addition to the tax costs.

CONCLUSION

Allowing only FIFO would create unnecessary costs and obstacles for businesses to opt for the CCCTB. FIFO is not used universally across the European Member States. A significant number of countries allow LIFO or other methods. It should thus be considered to allow companies to (consistently) choose one method of stock accounting when opting for the CCCTB. An obligation to use FIFO could effectively deter a significant number of companies from the use of the CCCTB due to the costs to be incurred at the switch over and in each year thereafter.

The CCCTB framework should include inventory methods allowing a deferral of price inflation. This is an important condition for a competitive CCCTB, in particular in times of strongly rising raw material prices. LIFO and Base Stock accounting typically are used in quite a number of Member States to achieve just this objective. It allows companies to operate in conformity with the business economic principle of going concern. Not doing so penalizes them and causes a negative impact on cash flow required for conducting their business.

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