Taxation, Accounting and Transparency: The Interaction of Financial and Tax Accounting

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1. Introduction

In the last years, economic areas have constantly moved together. As a consequence, companies, especially the big players in the markets, have headed towards using the international capital markets and to get access to stock exchanges in different jurisdictions. As a prerequisite, the prevailing international accounting standards, be it IFRS and/or U.S. GAAP, have to be followed. On the other side, as tax legislation is still "local" and not harmonized, the companies always have to look for getting the best tax environment they can for carrying on their businesses. The following article tries to summarize shortly the influence of internationalization on taxation and accounting in general and with regard to transparency of tax effects in the international accounts in particular. As a consequence of more transparency, it is important to be aware of possibilities and boundaries of existing influences on the tax rate as well and to clearly define a framework for tax planning, which not only is in line with legal requirements, but as well with ethical standards, as each individual company cannot afford loosing its good reputation.

2. Taxation and Accounting – Two Different Worlds ?

2.1 *Status Quo*

As taxation is still local, multinational corporations have to align business opportunities and needs with finding the suitable tax environment for doing business and structuring their business activities. Needless to say that national and international rules of allocating profits have to be taken as unchangeable preconditions, but nevertheless tax planning is crucial. It is not the local tax rate, but the effective tax burden that in the end really counts, taking always the tax bases as well into account. And there is still flexibility how to structure the business activities, *e.g.* with regard to setting up the whole group structure, financing, choosing the appropriate legal form. Taking the complexity of the local tax systems and the shortcomings of the existing double taxation treaties, the avoidance of double taxation is one of the most important goals in this context – and it is clearly not getting to tax-exempt, nowhere taxed "white" income. There is no doubt: The key objective for tax planning is to support business. Each business decision has to make sense without a look at the tax burden. However, if a business decision is taken, the most efficient structure from a tax point of view has to be chosen.

From the view of a global player, and as tax rates are only rough indicators for the effective tax burden, the political demand with regard to taxation at least medium

or long term should clearly be world-wide harmonization of the tax systems. Then, a fair tax competition via tax rates, not via complex and non-transparent tax bases would be carried out. Therefore, the industry highly welcomes the thoughts of the EU Commission towards a Common Consolidated Corporate Tax Base (CCCTB). Even if this CCCTB is restricted to Member States of the European Community, it would be a big step forward. Unfortunately it looks as if a lot of the EC countries take this approach not too serious, as tax revenues might be threatened. But this shows clearly the necessity of a CCCTB: If companies were taxed on their EU-wide consolidated income, *e.g.* taxes on non-realized profits arising as a consequence of intra group transactions would be avoided. Transfer Pricing adjustments which very often lead to double taxation would be at least within the EU obsolete. The reluctance of some Member States even proves the necessity: taxation should always and only be based on profits realized through a market transaction.

2.2 Outlook

Fortunately enough, the jurisdiction of the European Court of Justice might put pressure towards harmonization: As the Court takes the basic principles of the Internal Market very serious, the Court puts always emphasis on basic Community Law, especially on non discrimination of EC residents, free movement of capital and freedom of establishment. As a consequence, a lot of restricting national tax laws have already been challenged. Especially with regard to cross border transactions, this jurisdiction will lead by itself on the long run towards a forced harmonization. Therefore, it would from this point of view as well be in the interest of the EC Member States to actively support the EU Commission towards a joint tax jurisdiction.

In this context, it is fair to say that some taxation principles have definitely to be taken into account, even if this might be self-evident: Taxation must always be based on the individual ability to pay taxes. In Germany, this principle is even anchored in the Constitutional Law. As a consequence, taxes should only be levied on realized profits. Mark to market valuation would generally not adequately reflect the ability to pay taxes, as the then potentially taxed unrealized gains are volatile. Taxation has to be based on net income, and not on substance. Business expenses must therefore always be wholly deductible. This means an unrestricted loss carry forward as well. Third, taxation has to be based on objective criteria, and the accruals principle has to be taken into account.

Additionally, avoidance of double taxation means avoidance not only of legal, but as well of economic double taxation. Therefore, *e.g.* dividends should be excluded from taxable income, as the underlying profits have already been taxed in the hands of the distributing corporation. The treatment of capital gains should always follow the treatment of dividends. Capital gains on the sale of participations should therefore be exempt as well, as they either represent already taxed retained earnings or hidden reserves which materialize and lead to taxes in the future.

From an accounting point of view, it is fair to say that some countries – by far not all – define their tax basis based on national GAAP (principle that the tax base follows accounting principles; *e.g.* Germany). However, there exists a tendency to

modernize the national GAAP and to integrate thoughts of international accounting, especially IAS/IFRS as well into this modernization. The same is true with regard to the EC Directives on the Accounts and Consolidated Accounts (4th and 7th EC Directive). If a modernization took place it is definitely sure that the modernization will be based on IAS/IFRS as well.

As, however, the targets of international accounting and taxation do not match, the principle that taxation follows accounting is always dependent on the underlying local GAAP and questionable in case of any changes with regard to these principles. Take as an example Germany: The national accounts have been so far suitable for taxation as the underlying principles have complied with taxation principles. Especially the targets of capital maintenance, protecting the rights of creditors and being the instrument to determine the possible dividend distributions have lead to a basis that complies with the ability to pay taxes as well. On the contrary, IAS/IFRS are rather a tool for information and take therefore unrealized gains as well into account. If the German accounting principles get modernized towards IAS/IFRS, then as a consequence the principle that tax follows accounting has at least partially to be given up. At least, each individual law has to be reviewed and evaluated according to its suitability for taxation.

A CCCTB must be based on similar views. First, IAS/IFRS can from a mere formal point of view never be taken as basis for calculating taxable profits. A democratic authorization of the IASB does not exist. Besides, *e.g.* Germany applies the principle of legislative sovereignty. Therefore, a transformation into national law would always be necessary. Taking IAS/IFRS as tax base would mean endless and ongoing processes of adapting the national law to changes in IAS/IFRS. Secondly, and more important, IAS/IFRS are from a material point of view in general not suitable either: The IAS/IFRS principles can lead to a taxation of unrealized gains, which is in contrast to the ability to pay taxes principle. They contain a lot of management judgments which contradict uniform tax treatment of all taxpayers as the tax basis would then depend on individual judgment. And partially, a taxation of mere profit projections would be the result. However, IAS/IFRS can be taken as starting point for taxation: Each standard should then be evaluated whether or not it is compliant with basic taxation principles. This judgment seems now to be consensus on EC level.

When describing the tax base, the EU Commission tends either to define a separate independent tax balance sheet law, or a separate set of tax rules that define the tax base not based on the accounts, but rather on profits and losses, with description of income, tax-exempt income, deductible and not-deductible business expenses.

At the moment, the EU Commission seeks a solution rather based on defining taxable profits and losses. This approach makes uniformity on EC level more likely; however, this approach is more difficult in application for the companies, as in the end they must calculate – if there are timing differences compared to accounting – deferred taxes as well. By filing a tax balance sheet control and substantiation of potential differences and the deferred tax assets/liabilities thereon is much easier.

3. Transparency of the International Accounts and Influence of Transparency on Tax Planning

3.1 Actual versus Effective Tax Rate

As the tax burden constitutes a cost factor to all business activities, the effective tax rate plays an important role for management, and not just the current tax payments have to be looked at. The local accounting principles, but much more IAS/IFRS and U.S. GAAP lead to showing the "right" tax burden, taking temporary differences between accounting and taxation as well into account, followed by numerous information on taxes. This transparency of the accounts further leads to analysts challenging the tax burden and management needs for explanations of the tax line. Thus, information that was only a decade ago due to the tax secrecy in a lot of countries confidential constantly becomes more and more public.

Take the concept of deferred tax assets and tax liabilities. Postponed or up-front tax payments due to differences in calculating taxable profits and losses which reverse over the time loose importance. These timing differences lead only to temporary tax savings/tax burden and as a consequence, a deferred tax liability/tax asset has to be accounted for. The accounts show in these cases the overall tax burden that would arise based on the accounts of the prevailing year (*i.e.* current taxes and deferred taxes).

An example for timing differences which lead to setting up a tax asset are write downs that are not at once acknowledged for tax purposes, but reverse over time. As current taxes are higher than the tax burden that matches with the accounts, a deferred tax asset can be set up. A deferred tax liability may result from reserves which are tax deductible according to national law, but constitute equity according to IFRS/U.S. GAAP.

According to international accounting principles, a tax asset on losses carried forward has as well to be set up: loss carry forwards lead to potential tax savings in the future, as the underlying net business expenses are therefore not lost, but can be used against future, not yet realized profits. However, the company has to examine the realization possibility of this tax asset, and in case that realization seems not/not fully realistic, make a total/partial valuation allowance.

Let me give two examples for permanent differences and their impact on the effective tax rate: Tax exempt dividends or capital gains lead to a tax rate below the actual tax rate in the prevailing country. The effective tax rate takes this into account. In case of additional profit distributions or capital gains that were not planned the effective tax rate is even lower than the expected effective tax rate. Interest expenses, which in some countries are not tax-deductible if in direct connection with tax-exempt income lead to a higher effective tax rate than the normal local tax rate. If refinancing is shifted to another location (*e.g.* debt push down), and the interest burden is in this country deductible, then the overall tax burden decreases.

Of course one has always to be aware of so-called quasi-permanent differences, *i.e.* differences that never reverse due to the prevailing individual situation of the company: As an example, the minimum taxation in Germany might lead to a situa-

tion, especially with regard to volatile businesses, that loss carry forwards can be used up in theory, but not in practice, as profits have always to be integrated to 40% in taxable income regardless of a still existing loss carry forward.

3.2 Disclosures and Notes to the Accounts

In the international accounts, an explanation of the main drivers of the effective tax rate (compared to the expected tax rate) is done in a so-called "reconciliation". As far as this information has to be disclosed (*e.g.* Form 20-F), this transparency leads to a deeper analysis and understanding of the tax situation, as well as of business decisions: *e.g.* in case of high tax-exempt income the analysts might assume that extraordinary (not operating) income was earned (*e.g.* additional profit distribution or additional capital gains).

In case tax assets on loss carry forwards are written down, this might be a consequence of too aggressive multi year plans in the past. However, it might also be the consequence of tax rate changes (*e.g.* the tax reform 2008 in Germany will lead to a write down on tax assets on losses and other temporary differences of around 25%), as the tax rate differential is 10% (40% to 30%). If the company that suffers the write down as a consequence of the tax rate decrease shows operating profits, this effect should then be interpreted in a positive way, as this means a lower tax burden in case of profitability in the future. Thus the hit has rather to be taken as a one time effect.

A write back on deferred tax assets on losses might have different reasons as well: It might be a consequence of overachieving on plans and targets and therefore higher taxable operating income. It might be the consequence of structures to use up losses, *e.g.* buying in of income or selling of loss carry forwards to external parties.

And of course, effects of tax audits might be open to the analysts in case of materiality as well. In this context, the question might arise, whether or not tax planning was too aggressive. The setting up of tax contingency reserves might also have quite different reasons: It can be an indicator for too aggressive tax planning, but as well of uncertain tax interpretation or change in jurisdiction.

3.3 Possibilities and Boundaries for Tax Rate "Management"

Of course, earnings as well as tax rate "management" is strictly forbidden. But with *e.g.* postponing or accelerating business decisions in cases where the tax treatment does not follow the accounting treatment, the effective tax rate could of course be influenced. *E.g.*, the decision to additionally sell tax-exempt stock might be taken shortly prior or after year-end, leading to effects on the effective tax rate in the old or new business year. Tax planning strategies, *e.g.* the sale of loss carry forwards – if possible –, might lead to a revaluation of tax assets and therefore to a lower effective tax rate. But companies always have to bear in mind that too aggressive tax planning might lead to high contingency reserves or tax expenses for prior years, yet alone perhaps interest on delayed tax payments.

In the insurance markets as well as in the hedge fund area, a market for insuring tax risks is currently developing. However, taking out insurance of tax risks – if possible at all – is very complex. First of all, the contracts and documentation behind

require a lot of thoughts, are technically complex and must reflect all possible risks – in order to avoid problems with the insurer afterwards. Second, the advantage of insuring tax risks is still questionable from the insurer's side. Offering insurance does only make sense if the insurer is more convinced than the insured that potential negative tax consequences do not arise. Otherwise, the premium could be as high as the discounted worst case scenario, which would be unacceptable for the insured. Finally the insurer will always look for a self-retention of the insured, or at least for the full right to settle the case with the tax authorities, as otherwise the insurer's position might be rather weak. This to some extent contradicts the interests of the insured, who very often seeks to get rid of the whole risk, or will at least try to further on lead the negotiations with the fiscal authorities.

From an accounting point of view, insurance of tax risks might influence the effective tax rate as well: Insurance premiums as well as claims settlements lead to expenses/income in the pre-tax result. However, it depends on the prevailing jurisdiction and prevailing single case whether or not the insurance premium is tax deductible. The same is true for any claims settlements: If these payments are taxable, it is necessary to get an insurance cover on the "grossed-up" amount, as tax payments on settlements would otherwise lead to losses even in case of insurance. Any tax payments as a consequence of settlement very likely go in general through the tax line. This would result in a distortion between pre-tax income and tax line. So, even if from an economic point of view insurance of tax risks could make sense, the effects on the effective tax rate have to be evaluated as well, even if these effects are potentially not decisive for the decision to take out insurance on tax risks.

4. Framework for Tax Planning

4.1 Technical Issues

Tax planning must always follow business needs. It can be aggressive, but must always be well-founded. In this context basic principles in the following areas should be taken into account: Technical soundness of the tax analysis, steady business link, adequate risk attitude and flexibility.

First, international tax planning requires a fundamental analysis of the tax environment and international tax legislation that exist in the various countries. But just as important is the analysis of the prevailing very individual tax situation a Group is in.

In a world where tax legislation seems to get even more complex and complicated, it is important to assure having the right people working in the tax department. But even if this is the case, and even if the quality of a tax department is on a high standard, outside advise gets more and more important – due to the aforementioned complexity and the time pressure the in-house tax department very often faces. And especially with regard to international transactions different tax jurisdictions – not just the well-known home country tax legislation – have to be looked at. If one takes interest payments on delayed tax payments or even penalties as well into account, the involvement of an outside advisor should really pay off.

Notwithstanding the aforesaid, from an accounting point of view documentation and so-called unqualified should level opinions – whether written in-house or externally – are crucial. This is the basis for calculating current and deferred taxes and for setting up necessary tax reserves.

Second, each tax decision must comply with the business needs. Therefore, a permanent review of the overall tax and business framework and direct access of the tax department to the decision taking bodies is required because tax laws change as well as business goals and decisions. Information should be in time and tax-oriented as well as business-oriented. The tax department needs an information flow back and forth – one could call this "management by walking around". The tax department cannot expect everybody to call whenever there might be a tax problem. It is however the tax department's task to develop a basic understanding and awareness for tax questions in the company in order to get the information needed and all potential problems addressed. This in the end means to get the tax information in such a simple way across that also the non-tax experts understand them.

Third, it comes to risk taking with regard to decisions on tax questions. In this context I really like to point out that each tax director runs a high risk that he or she is afterwards blamed for having been not cautious enough. But the tax environment and the attitude of fiscal authorities towards a transaction/interpretation may have changed with the time and transactions which were two years ago generally accepted with virtually no risk involved, might at once get under scrutiny and different judgment. But even external should level opinions are not the universal remedy. The world of taxes is too complex and difficult. As a tax director, he or she must himself or herself feel comfortable with the chosen decision. An external opinion might help in finding this decision, but he or she has to take the final decision in the end and the risk connected herewith. The tendency towards "re-delegating" this task to external advisors gives perhaps some comfort, but is not sufficient. Also, "re-delegating" the decision on tax questions to the CFO or Finance Committees as a "strategy" to get comfort might be understandable, but is in the end rather "unfair", as non-tax specialists are forced to decide. If a tax director wants to take only decisions with absolutely no risk, he/she is on the wrong place. If processes and diligence are on a high standard, and decisions on tax questions well founded, no reproach should be made. However, potential even remote risks have to be made transparent as well.

Fourth, flexibility. Flexibility is a valid ammunition against locking the company or the whole Group into a tax situation where restructuring is not or only at high cost possible. We always have to comply with changing tax environments. The optimal solution from today's view may quickly turn into a disaster if tax legislation changes and there is no way out. "Over-optimization" very often leads to inflexible and complicated structures and downsides in case the tax legislation changes.

4.2 Reputation

Enjoying a good reputation should be a core element of each company's attitude towards taxes and tax planning. Everybody – whether in a national or international company – has to assume responsibility for the preservation of the company's good reputation, thus contributing to the economic success.

Reputation risks relating to taxes can easily occur – be it in the field of business decisions or with regard to services or products offered. Therefore, it is so extremely important to do nothing just for the sake of saving taxes, but always have sound economic business reasons. Financial institutions run potentially a higher risk than other business segments, especially with regard to products offered. These institutions could hurt their reputation if employees or business partners with the help of the company either violate existing tax laws by acting or omission or if they carry out transactions which are generally considered as tax critical, and thus causing a negative effect on the good reputation. Such risks could *e.g.* derive from the production, the purchase, the advice or the marketing of products and services. There are some basic principles, however, which should shelter the good reputation of the Group or the individual company with regard to taxes as far as services or products are concerned:

First, it should always be omitted to execute transactions or to provide services which might qualify as a tax offence or a tax administrative offence as well as any abetting if a violation cannot be excluded after careful analysis. The company has to ensure adequate professional and organizational structures for such scrutiny.

Second, a company should never give tax advise to their clients. The decision how a service or product is treated on the clients' side, must always be taken by the client or his tax advisor.

Third, if possible, rulings from the tax authorities should be asked for.

Fourth, all products and services must have economic background and not be done just for the sake of tax savings. The underlying reasons should always be transparent and easily to communicate. Getting pre-tax profits is the main prerequisite for a structure that is not done only in order to reduce the tax burden.

If all these prerequisites are fulfilled, the company's good reputation should not be endangered with regard to tax questions. We all have to be aware, however, that in the next few years integrity issues will definitely gain even more importance than today.