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Unitary Taxation: Tax Base and the Role of Accounting

Prem Sikka and Richard Murphy

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Unitary Taxation: Tax Base and the Role of Accounting

Prem Sikka and Richard Murphy

Summary

For more than twenty years there have been discussions on the issue of multinational corporations shifting profits from high- to low-tax jurisdictions, with resulting gains to them from the resulting reduction in their effective tax rate. Underpinning much of this debate has been an implicit assumption that, first of all, profits are a fixed and constant known factor in this tax base-shifting equation; and, secondly, that by adopting consistent international financial reporting standards (IFRSs) the risk of arbitraging on tax is removed from this equation. Arguments for unitary taxation have particularly advanced this assumption.

We seek to show that the relationship between tax and financial reporting is now remote, and that no jurisdiction that we can identify relies upon unadjusted traditional accounting profit as a basis for the taxation of corporate income. This paper argues that this problem would, if anything, increase with dependence upon IFRSs, which serve entirely different purposes. IFRSs contain many subjective elements within their concepts of income and expenses, to provide the certainty that tax reporting requires. We draw instead upon the thinking underpinning the European Union's (EU's) Common Consolidated Corporate Tax Base (CCCTB), to suggest that tax-specific measures of income and expenses for taxation purposes need to be defined. Such a transactional approach provides a potential basis for developing unitary taxation and determining a taxation base that could then be apportioned to each jurisdiction. However, in the practical political context the EU needs to be sensitive to the interests of member states, which have an interest in adopting particular ways of dealing with deductibility of interest, royalty payments and allowances for capital expenditure. In order to secure political momentum for change, we suggest that for the time being such contentious matters be deferred by allowing relief on these items to be granted at a national level after apportionment of other income between participating states in a regional unitary tax system. The paper then makes some suggestions for the development of a conceptual framework for taxation accounting standards that could be used to address these issues.

Keywords: tax avoidance; accounting; transfer pricing; accounting standards; unitary taxation.

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Acronyms

BEPS	Base Erosion and Profit Shifting
CCCTB	Common Consolidated Corporate Tax Base
EBITDA	Earnings Before Interest, Taxation, Depreciation and Amortisation
EU	European Union
FASB	Financial Accounting Standards Board
FIFO	First-in, first-out
FRC	Financial Reporting Council
FSI	Financial Secrecy Index
GAAP	Generally Accepted Accounting Principles
GAAR	General Anti-Avoidance Rule
GDP	Gross Domestic Product
IAS	International accounting standard
IASB	International Accounting Standards Board
IFRS	International financial reporting standard
LIFO	Last-in, first-out
OECD	Organisation for Economic Co-operation and Development
PE	Permanent establishment
PwC	PricewaterhouseCoopers

Introduction

The corporate tax system is in crisis, as intensification of economic globalisation has enabled corporations to shift their profits to low-/no-tax jurisdictions and to avoid paying taxes in countries where most of their sales, assets and employees are located (US Senate Permanent Subcommittee on Investigations 2005, 2008a, 2008b, 2013; UK House of Commons Public Accounts Committee 2013a, 2013b, 2013c). Nation states have responded to the erosion of their tax base in a variety of contradictory ways. For example, the UK corporation tax rate has declined from 52 per cent in 1982 to 21 per cent in 2014, and is scheduled to fall to 20 per cent in 2015. However, this has neither stemmed corporate tax avoidance nor checked the ingenuity of the tax avoidance industry to craft new schemes (Mitchell and Sikka 2011). Not surprisingly, the erosion of tax base and profit shifting is on the international political agenda. Consequently the 2013 communiqué issued by the G8 leaders states that: 'We agree to work together to address base erosion and profit shifting and to ensure that international and our own tax rules do not allow or encourage any multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions'.¹

Corporate taxes are supposedly levied on profits, although as we show below they are almost invariably actually assessed on chargeable income less tax-allowable expenses, with both figures representing data abstracted from accounts. Hence any attempt to address profit shifting needs to pay attention to the role of accounting. Historically profit or loss as shown by the annual financial accounts has been the starting point for the computation of taxable profits. However, for a considerable period taxation and accounting practices have followed divergent trajectories (Green 1995; Whittington 1995), resulting in complexity, uncertainty and leakage of tax revenue (Sikka and Willmott 2010; European Commission 2001). The conventional accounting definition of assets, liabilities, income and expenses do not seem to be able to prevent corporations from creating intangible assets, management fees and royalty programmes that shift profits to low-/no-tax jurisdictions and avoid taxes.² Commentators have noted that spurious intragroup transactions 'can reduce or even eliminate profits in one place at a stroke of an accountant's pen' (ActionAid 2012: 8), and 'transfer pricing is the leading edge of what is wrong with international taxation' (Sheppard 2012). A United Nations Committee noted 'certain transfer pricing practices (i.e. "mispricing") result in base erosion and profit shifting. These practices are particularly prevalent in relation to multinational profits generated by brands, intellectual property or digital services that are highly mobile and can be located anywhere in the world' (United Nations Finance for Development 2014: 2).

Efforts to check erosion of tax base and shifting of profits have resulted in two broad proposals for reform. The first approach, advanced by the Organisation for Economic Co-operation and Development (OECD), is the Base Erosion and Profit Shifting (BEPS) project that advocates ad hoc reforms to the current system for taxing corporate profits (OECD 2013a, 2013b, 2013c). The second approach, unitary taxation, calls for a fundamental reform of the way international corporate tax liabilities are calculated. An example of this approach is the CCCTB, a system for taxing transnational corporations advocated by the EU (European Commission 2001, 2003a, 2011). The key idea in unitary taxation is to eliminate all intragroup transactions and to treat the profits of a group of companies, whether as a whole or for a defined territorial area, as the tax base. These profits can then be apportioned to each jurisdiction according to a formula and be taxed by the relevant state (Picciotto 1992;

¹ Available at <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207771/Lough_Erne_2013_G8_Leaders_Communique.pdf> accessed 15 June 2014.

² In re: WorldCom Inc. et al. (2004) United States Bankruptcy Court Southern District of New York: Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, Washington DC.

Weiner 2005; Clausing and Avi-Yonah 2007; Avi-Yonah et al. 2009). As unitary taxation holds out the prospect of limiting the possibility of profit shifting and the accompanying erosion of the tax base, the relationship between it and the role of accounting has to be considered. This is because in any unitary taxation system tax will still be levied on corporate profits, but which profits are to be taxed and how are they to be calculated remains an issue of contention.

In the face of uncertainty, some have assumed that the spread of international accounting standards (IASs) might produce a single unambiguous set of accounting numbers that can then be used for tax purposes. For example, Picciotto claims that: 'Harmonisation of the tax base could be facilitated since many countries accept accounts for tax purposes based on corporate accounting principles, for which international standards now exist' (Picciotto 2012: 11). The difficulty with such a position is that, even if a uniform reading of accounting rules were possible, it would not change the highly subjective nature of accounting and companies would have considerable flexibility in recognising income, assets, liability, expenses, profits and losses (Smith 1996; Clarke et al. 2003). This is antithetical to principles of taxation, which require certainty. This paper addresses five issues that are central to determining the suitability of accounting practices to be a basis for the proposed taxation reforms (unitary taxation and OECD proposals). On the basis of its analysis, the paper offers some tentative solutions. The issues are:

1. How far do financial accounts (including a profit and loss statement), which could be prepared under a variety of accounting methods and standards, provide an adequate basis for a combined report with consolidated accounts for assessing corporate groups for tax?
2. How suitable are IFRSs as a basis for tax accounts, especially for developing countries?
3. To what extent do the tax base definitions in the CCCTB provide a suitable model for international adoption, and how do they compare with US tax reporting standards as used for state formulary apportionment?
4. What would be the most suitable, practical and effective standards to use when assessing a transnational corporation under a profit split or unitary taxation approach, especially for developing countries?
5. What appropriate recommendations could be made for the development of more integrated international tax accounting standards?

This paper is organised into five sections. Section 1 outlines the current OECD position and its shortcomings. In this context it is necessary to outline the tensions between accounting for taxation and financial reporting practices, and why mere tweaking of tax rules cannot overcome the way in which accounting issues have contributed to base erosion and profit shifting. Section 2 considers the possibility of using accounting data prepared in accordance with existing financial reporting standards for taxation purposes. This section notes that there is considerable tension between accounting numbers used in financial reports and calculation of corporate tax liabilities. It argues that IFRSs are unlikely to provide a suitable basis for the determination of a tax base. How might this tension be addressed? It is helpful to reflect on the practices of jurisdictions that have a measure of unitary taxation, and those which aspire to adopt unitary taxation. The US has a system of unitary taxation within its federal system, and the EU has been developing a proposal for a CCCTB, a variant of unitary taxation. Therefore Section 3 undertakes a comparison of the EU and US approaches to using financial accounting numbers for unitary taxation, focusing in particular on the CCCTB framework. Section 4 extends the debate to developing countries, as they have expressed dissatisfaction with the current way of taxing multinational corporations and many civil society organisations have expressed a preference for unitary taxation (Jansky and Prats 2013; ActionAid 2014). This section briefly reports on the practices of 153 jurisdictions to see how the interface between accounting and taxation is managed, and the kind of tensions that arise. This encourages reflection on whether the US and EU perspectives on

unitary taxation have some relevance for developing countries. Section 5 concludes the paper, drawing together the evidence presented in previous sections and offering suggestions for overcoming some of the problems encountered in using accounting numbers to develop a tax base for unitary taxation.

1 Accounting and taxation: the OECD approach

In the era of economic globalisation, the current approach towards taxation of the profits of multinational companies is highly problematic. There is some recognition of this in the BEPS project launched by OECD. A major problem is that multinational companies under common control and direction operate through a web of subsidiaries to shift profits yet appear to be compliant with OECD rules. The OECD model for international taxation is based on what is commonly described as the 'separate entity' assumption, that the many subsidiaries of a parent company are independent. In this scenario, arm's length or independent market prices are assumed to be available so that they can be used to allocate profits to each country (OECD 2009, 2010). This approach does not recognise that market participants are linked because they are part of an integrated group. The OECD position has been extensively critiqued (e.g. Avi-Yonah and Benshalom 2010; Durst 2011; US House of Representatives Committee on Ways and Means 2010), but remains largely unresolved in tax laws and practices. This gives companies an opportunity to arbitrage the world's tax systems, and shift profits to favourable jurisdictions.

The problem of profit/loss on intragroup transactions is also encountered by financial reporting practices. The legislators and accounting rulemakers have addressed it through the concept of group consolidated accounts (IASB 2012b). In consolidated accounts subsidiaries under common control are treated as part of a single unified group of companies. Such accounts are underpinned by the understanding that there can be no profit or loss until an entity undertakes a monetary transaction with a third party. Only then is any value added. It is not added by paper transactions between subsidiaries. Consolidated accounts do then represent the results of an entity that does not exist, in the sense that no single legal entity undertakes the transactions that they disclose. Instead consolidated accounts aim to represent the economic substance of the transactions that the group of companies under common control undertakes with third parties, and its outstanding assets and liabilities with those parties. Hence this form of accounting eliminates two significant issues that are highly relevant for tax practices and unitary taxation.

Firstly, upon consolidation the impact of intragroup transactions between companies under common control is eliminated. Both sides of any transaction, whether impacting upon the income statement (profit and loss account) or statement of financial affairs (balance sheet), have to be removed to provide the essential quality of balanced accounts. It is often presumed that this eliminates the effects of profit shifting on the reported profits of the group as a whole. This is, however, very largely the consequence of the second adjustment made, the requirement that the underlying accounts of the separate group entities should be restated on the basis of one common set of accounting standards. It is this second approach that has at least as much impact on the removal of opportunity for profit shifting, because it ensures that the opportunity for arbitraging different accounting standards for temporary or permanent gain is eliminated. We stress that these two processes cannot be considered as independent of each other: the integrity of group accounts is dependent upon both taking place.

The concept of unitary taxation is in some respects akin to consolidated accounting. It considers multinational corporations to be engaged in:

a unified business as a single entity, requiring it to submit a single set of worldwide consolidated accounts in each country where it has a business presence, then apportioning the overall global profit to the various countries according to a weighted formula reflecting its genuine economic presence in each country. Each country involved sees the combined report and can then tax its portion of the global profits at its own rate.

(Picciotto 2012: 1)

Evidently, the issue of definition of the tax base – the standards to be specified for the consolidated accounts of the corporate group for tax purposes – is a central question for any unitary taxation system. In addressing this question the first important aspect is the relationship between accounting for financial and for taxation purposes, and it is to this that we now turn.

2 Accounting and unitary taxation

Central to all arguments for unitary taxation is the assumption that intragroup transactions do not generate profit, and that no economic value is added until a transaction with an independent third party takes place. This is also the basis for consolidated accounting, and since this is required of all companies quoted on the world's major stock exchanges it is something with which the financial and accounting communities have become entirely familiar.

Since consolidated group accounting is now the normal arrangement for most multinational group entities, it might seem that their accounts prepared on this method could form the basis for tax assessment under a unitary taxation system. It would certainly be advantageous if accounting and taxation practices were so closely aligned that accounting numbers could furnish a meaningful tax base. However, as we show in Section 4, this alignment does not exist in any major country. Indeed the differences are such that, to provide a basis for unitary taxation, revenue and expenses need to be (re)defined for tax purposes so that a common tax base can be determined. The challenges associated with this are explored in the remainder of this paper.

2.1 Using financial accounting as a tax base

The starting point for company reporting for both financial and tax purposes is its accounting books and records, and, since separate records are not normally expected to be kept for the two purposes, tax calculations begin with accounting profit/loss. Both accounting and taxation share vocabularies which focus on capital, income and profit, but there is considerable divergence in the meaning that both practices attach to these terms because of the different purposes of the calculations required.

Accounting numbers may exude an aura of exactness and objectivity, but they are in practice a sedimented residue of negotiation and bargaining amongst economic and political interests in a dynamic social environment. Thus companies can choose almost any rate of depreciation for their fixed assets; research and development expenditure can be capitalised or expensed on the basis of arbitrary assumptions (Hope and Gray 1982; FRC 1989); and under certain circumstances even interest payments can be capitalised – not treated as an expense (Smith 1996). Accounting numbers are the outcome of politics, negotiations and bargaining amongst elites, professional judgments and sectoral practices rather than any

rigid interpretation of the law. It is the sufficiency of social consensus that gives accounting numbers the appearance of hardness, even when they are intellectually impure (Hines 1988). Contemporary financial reporting is not designed to provide relevant or reliable bases for taxing corporate profits. In practice contemporary financial reporting is crafted primarily to respond to the assumed needs of shareholders and those buying and selling shares or other financial instruments in capital markets. Thus, the US Financial Accounting Standards Board (FASB) states that the primary objective of financial reporting is:

to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity. (FASB 2010: 1-2)

The focus on prediction of future cash flow depends on a range of revenue recognition and valuation concepts, such as fair value, market value, present values, deprival values and mark-to-model. This emphasis on reporting to capital markets means that profits and losses can be recognised simply because the market prices of assets and liabilities have fluctuated, irrespective of any actual sale. The actual or historical price of assets is not important in this model, and unrealised profits can be recognised in financial statements. This approach is central to the accounting and financial reporting standards set by both the FASB in the US and the IFRSs issued by the International Accounting Standards Board (IASB), and is in marked contrast to the requirements of most tax authorities. Taxation is almost always levied on realised profits. At this most basic level the conflict between accounting for taxation purposes and financial reporting is already obvious. A second major reason for the divergence (as Section 4 shows) is that financial accounting approaches to defining key concepts such as depreciation, profits and capital are frequently considered to be too fuzzy for taxation purposes (Lamb 2002). Hence a more prescriptive approach is often adopted for taxation purposes – such as the common replacement of depreciation charges with a 'capital allowance' for taxation purposes.

Behind both these types of divergence is the perspective or purpose of the measurement methods to be used. Thus in the US case of *Thor Power Tool Company v Commissioner* 439 U.S. 522 (1979),³ the presiding judge said that:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in

³ Available at <<http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=US&vol=439&invol=522>>; and <<http://supreme.justia.com/cases/federal/us/439/522/case.html>> accessed 20 April 2014.

measurement [should] be in the direction of understatement rather than overstatement of net income and net assets’.

Interestingly, accounting rulemakers have oscillated between retaining and abandoning the principle of conservatism (also known as prudence). Traditionally it requires businesses, such as banks, to set aside profits to meet likely bad loans or expected losses at the earliest opportunity. One of the consequences of this was that in good years banks set aside large amounts (known as provisions) of profits, and then in bad years wrote them back to the income statement. This facilitated profit smoothing, with the result that income statements did not show the performance for the year. The accounting rulemakers responded by requiring companies to recognise losses only when they were actually incurred, by promoting the incurred-loss rather than the expected-loss model. Of course banks developed practices for postponing recognition of bad debts. This maintained profits and performance-related executive pay, but banks soon accumulated a large volume of toxic debts. After the 2007-8 banking crash, and following criticism by parliamentary committees (UK Parliamentary Commission on Banking Standards 2013), the IASB restored a large measure of the principle of conservatism to financial reporting (IASB 2014). This episode is again illustrative of the political nature of financial accounting practices, and the resulting numbers cannot provide a tax base that needs to exhibit certainty.

That said, an uneasy and complex relationship between financial accounting and taxation practices continues. For example, Her Majesty’s Revenue and Customs states that: ‘the question of capital or revenue is a question of law not of accountancy. What matters is the effect of the expenditure in question. Accountancy does not determine that effect but may be informative as to what was the effect’ (HMRC n.d.).

Regarding the key question of the relationship between capital and income, both tax and financial accounting generally recognise that profits can only arise after the capital of the enterprise is maintained or restored, but the practices used for this purpose can diverge and result in a variety of calculations from the same data (Hicks 1965; Sterling and Lemke 1982; Tweedie and Whittington 1984). The extant US accounting standards generally advocate the maintenance of financial (or money) capital, whilst the IFRSs allow businesses to select the maintenance of either financial or physical capital (IASB 2012a).⁴ Historically accounting standards have also used other methods, such as proprietary, entity and other capital maintenance concepts, to provide some relief for the erosion of the capital base by price-level changes (Tweedie and Whittington 1984). One of the consequences of the impact of the politics of accounting is that it is now hard to discern any clear criterion of capital maintenance within current financial reporting, as financial statements are a mixture of historical costs, fair values, market values, net realisable and present values.

In contrast taxation practices usually seek to deliver an element of certainty to the calculation of tax liabilities. This difference in objective is at the core of the difference between tax and financial accounting. Financial accounting has always been to some degree subjective, allowing, for example, what it has called a ‘true and fair override’, which permits rules to be waived if the outcome of their application would appear to lead to an unreasonable result. It also now permits, as the above brief analysis suggests, considerable choice in the approach any company may adopt to meet what it perceives to be the needs of the users of its financial statements. Tax has an altogether different objective, which has been consistency and predictability. This has meant that tax reporting tends to recognise realised income, primarily provides relief for expenditure on the basis of historical costs (sometime adjusted for price level changes), and is closer to the logic of the maintenance of financial (money) capital than any other capital maintenance principle. The reasoning is obvious: in a tax system capacity to pay is paramount, and so these principles matter most. They do,

⁴ See Appendix for an illustration.

however, conflict with much modern financial reporting. The result is that there is considerable divergence between the basis on which expenses, revenue and profits are recognised in corporate financial statements, and those allowed for tax purposes.

2.2 Financial reporting and tax

The divergence between accounting and taxation practices has accelerated as states have delegated standard-setting to private interest groups (e.g. the IASB and its successor the IFRS Foundation, and the Financial Reporting Council (FRC) in the UK). In addition, the general trend towards prioritising the assumed needs of capital markets has made short-term considerations of maximising shareholder value central to accounting standard-setting, and further constrained the possibility of alignment between accounting and taxation prices (Lamb et al. 1998). Since the 1970s financial reporting has oscillated from preoccupation with reporting historical costs, market values and information about corporate stewardship, and something that would enable shareholders to make useful economic decisions. When the mid-1970s banking crash highlighted the failures of published company accounts, a report published by the UK accountancy rulemakers sought to soothe critics with claims that in future they would strive to serve almost all social constituencies, such as shareholders, providers of other capital such as loan financiers, employees, analysts, other business, the government including tax authorities (explicitly stated), and the public (Accounting Standards Steering Committee 1975). The report was never ratified by any professional accountancy body and did not deliver any of its promises. The current position, as expressed by the IASB, is that the general purpose of 'financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit' (IASB 2013: 195).

Contemporary financial reporting standards therefore, by design, do not give any explicit consideration to the interests of the state or broader society, and hence are not directly concerned with enabling the state to collect taxes. This does lead to doubt as to their suitability for this purpose in both developed and developing countries.

2.3 The mirage of convergence of accounting standards

Although there has been a general trend towards defining financial accounting standards aimed at the needs of financial markets, convergence is still in many ways slow and hesitant. Since January 2005 all companies listed on a recognised EU stock exchange have been required to prepare consolidated financial statements in accordance with the requirements of IFRSs. However, national traditions and ways of making sense of cultural practices are not easily displaced by the comparatively recent advent of accounting standards. Instead local application of these standards is subject to various forms of adoption, modification and recommendation; even then there remain a wide range of issues about translation of words and what concepts might mean in a particular cultural setting (Baskerville and Evans 2011)

Despite the formal adoption of IFRSs by the EU there are, for example, material differences between German accounting practices and IFRSs. For example, IFRSs (IFRS 3, IAS 36, IAS 38) require that goodwill appearing in the balance sheet is not to be amortised. Instead it is to be subjected to an annual impairment test. The resulting diminution, depending on circumstances, may be offset against revaluation reserve or can affect the income statement. In contrast the German accounting standard GAS4 requires that goodwill be amortised and the amounts appearing in the balance sheet are to be adjusted to reflect the changes in value (for this and further examples, see PwC 2010).

The problems are not confined to EU countries. In 2007 Japan signed an agreement with the IASB to accelerate convergence between Japanese accounting standards and IFRSs, but progress has been slow. From 1 January 2012 Japan has permitted selected multinational corporations to use IFRSs. Since the end of the Second World War much Japanese financial reporting has been influenced by US practices, and considerable differences with IFRSs remain (PwC 2012).

In the US domestic companies are not permitted to use IFRSs, but foreign companies operating in the US can file statutory accounts prepared in accordance with IFRSs. Since subsidiaries of US corporations operating in Europe or elsewhere have to comply with local requirements, there can be considerable differences when reporting the same transactions in local accounts and in group consolidated financial statements. In addition, important and irreconcilable differences remain between US accounting standards and IFRSs. Perhaps most important are the different preferred inventory valuation methods, with the USA requiring last-in, first-out (LIFO) valuation (FASB 2005) and European countries requiring first-in, first-out (FIFO) valuation (FRC 1988; IASB 2005). The impact is considered in the Appendix.

It is also important to note that even the harmonisation of global/regional accounting rules will not necessarily produce definitions acceptable for tax purposes. For example, financial reporting standards define an asset as a 'resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'; and a liability is defined as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits' (IASB 2012a). Such a definition does not provide a way of distinguishing sham or artificial assets from the rest. The IASB definitions continue to treat each subsidiary/affiliate as an independent entity, and do not consider a corporation to be an integrated entity. For example, in the UK case of *Iliffe News and Media Ltd & Ors v Revenue & Customs* [2012] UKFTT 696 (TC), a company created new assets and newspaper mastheads and leased them to subsidiaries within the group for royalties. The result was to reduce reported profits of some subsidiaries. The subsidiary companies then sought to secure tax relief for payment of royalties paid to the parent company. The court considered the wording of relevant accounting standards and testimony of accounting experts, but felt that in the light of legal interpretations a valid asset had not been created, whether or not accounting recognised its existence.

To sum up, there is a considerable body of evidence that disputes the claims of convergence of accounting standards or convergence between accounting and taxation practices. Some of the problems are captured in the following statement from the Indian tax authority:

It is our conscious decision not to accept IFRS system for tax purposes. And we are not alone here; most countries in the world have followed this approach. Even the US does not have IFRS for tax purposes ... Our system is not ready yet to accept the IFRS system as a recognised system for income-tax purposes ... When you switch over from a historical costing system to a market value system, you can assign valuations which can lead to significant under-reporting of profits. This could lead to under-reporting of corporate income ... frequent reassessment of assets and liabilities based on fluctuating market value would raise problems in taxation, which is based on the cost of purchasing the asset. The tax authorities have serious concerns over the sentiment-driven volatility integral to fair valuation of assets and liabilities, which could lead to under-reporting of income.⁵

⁵ *The Financial Express* (2011) 'IFRS system not conducive for taxation purposes, says Mitra', 7 April 2011, <<http://www.financialexpress.com/news/ifrs-system-not-conducive-for-taxation-purposes-says-mitra/772775/0>> accessed 18 July 2013.

3 Accounting and EU proposals for a CCCTB

The proposal being developed by the EU for a CCCTB seeks to harmonise the tax base on which each member state can levy taxes. It does not seek to harmonise tax rates. The focus on calculation of the tax base inevitably draws attention to accounting practices.

The EU could have accepted the taxable profits or losses shown by IFRS-based accounts as the tax base for the CCCTB even if restricted to the relevant geographic territories covered by the EU, as compliance with IFRSs is mandatory for all EU-listed companies. However, this would have created a number of hurdles. Firstly, although there are a number of EU directives that provide a framework for both corporate law and accounting, there has never been any harmonisation of corporate tax laws because direct taxation is regarded as a matter for member states alone. Secondly, for reasons stated in the previous sections of this paper, conventional accounting definitions are not entirely suitable for tax purposes and IFRSs are not likely to provide a suitable base for any tax computation without significant adjustment. This presented a challenge for developing the CCCTB, and this section will examine the accounting issues experienced in the attempt by the EU to develop a framework for the CCCTB.

3.1 CCCTB Mark 1

The origins of the CCCTB lay in the Ruding Report (European Commission 1992), which considers that what were then called international accounting standards (IASs) can at least provide a good starting point for tax base definition. It says that: 'The Committee believes that commercial accounts produced for financial reporting purposes should form the starting point for the computation of taxable income in all Member States. However, it draws attention to the fact that financial statements are not yet fully harmonised within the Community and even then would serve objectives other than tax' (European Commission 1992: 37-38).

In 2001, with a possible harmonisation of IASs on the horizon, the European Commission added that: 'The increasing integration of financial markets and the creation of pan-European stock exchanges can be expected to accelerate accounting harmonisation even further. Although not directly related to taxation, this development may generally help the future development of a common corporate tax base and to some extent the IAS may serve as a useful point of reference' (European Commission 2001: 18).

In 2002 the EU enacted a Regulation to require companies listed on any European stock exchange to comply with the requirements of IASs with effect from 1 January 2005.⁶ This was followed in 2003 by a programme of rapid endorsement of extant IASs (Schon 2004). Amidst these developments the European Commission noted some of the difficulties in applying accounting rules for taxation purposes (European Commission 1992, 2003a), but a subsequent press release stated that: 'The Commission suggests that if companies will be reporting profits according to a common standard then this common measure of profitability could be used as a starting point for a common EU tax base (i.e. a common definition of taxable profits)' (European Commission 2003b).

A 2006 paper by the European Commission reiterated the need to develop a CCCTB for their EU-wide corporate activities, but there is no mention of any use of accounting standards to provide a uniform tax base (European Commission 2006). The Commission seems to have

⁶ Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards, 19 July 2002 (<http://www.iaasa.ie/legislation/ias_reg_1606_2002.pdf> accessed 29 April 2014).

recognised some of the difficulties associated with using financial reporting standards for tax purposes (see above), and modified this approach to develop the CCCTB.

3.2 CCCTB Mark 2

In 2004 the Commission established a Working Group on the CCCTB to develop the technical aspects; this met until April 2008. It stated that: 'Harmonisation will only involve the computation of the tax base and will not interfere with financial accounts. Therefore, Member States will maintain their national rules on financial accounting and the CCCTB system will introduce autonomous rules for computing the tax base of companies. These rules shall not affect the preparation of annual or consolidated accounts' (European Commission 2011: 5).

This suggests that the EU has followed a two-track development process. The first track continues to develop accounting standards for financial reporting, and the second is to develop a framework for accounting for tax purposes. No immediate convergence between accounting and taxation rules is envisaged, though the calculation of taxable profits will continue to some extent to be influenced by accounting practices.

The Commission's CCCTB proposal⁷ contained 136 Articles (reproduced in full in accessible format in KPMG 2011), and appears to be the beginning of a conceptual framework of accounting for taxation purposes (European Commission 2011). The basic principles were enshrined in Article 9, which stated that:

In computing the tax base, profits and losses shall be recognised only when realised. Transactions and taxable events shall be measured individually. The calculation of the tax base shall be carried out in a consistent manner unless exceptional circumstances justify a change. The tax base shall be determined for each tax year unless otherwise provided. A tax year shall be any twelve-month period, unless otherwise provided. (European Commission 2011: 22)

This Article seeks to provide the certainty that is the goal of most taxation systems, as noted previously. It also rejects many of the valuation bases used for reporting in IFRSs (and other standards, e.g. those set by the FASB). What is also notable is the focus upon the importance of individual transactions that form part of the calculation of taxable profit and loss. In contrast, IFRSs focus on valuation of assets and liabilities in the balance sheet, as their valuation is considered to be a good predictor of future cash flows that rational investors may be able to realise. In this schema the income statement is a by-product or a residue, reflecting in no small part movement in or fluctuation of market prices of assets and liabilities (Bromwich 2007).

Care is, however, taken with the concept of profit in CCCTB Article 10, which states that: 'The tax base shall be calculated as revenues less exempt revenues, deductible expenses and other deductible items'. This Article does not use the term profit in defining the tax base. However, Article 1 defines profits as: 'an excess of revenues over deductible expenses and other deductible items in a tax year' (European Commission 2011: 22).

Whilst accounting profit might be considered the overall change in net worth of an enterprise during a period, which as noted above might include realised and unrealised gains, this Article suggests instead, in combination with Article 9, that there is a residual surplus arising

⁷ We will mainly consider the Commission's proposal as presented in March 2011 and approved with relatively minor amendments by a large majority by the Parliament in April 2012. Since that time it has been under technical examination by the European Council in a Working Group. A revised Compromise Proposal was issued by the Irish Presidency in May 2013 (Doc. 9180/13 FISC 80, mistakenly dated 2012), and another by the Lithuanian Presidency on 1 October 2013 (14769/13 FISC 182), together with Explanatory Notes; we will consider some of these texts later.

from trading and other transactions (e.g. gains) that forms the tax base. This is a long way from the concept of profit as understood for financial reporting purposes. Instead the realisation principle is implicit, and the maintenance of financial capital is clearly implied by Articles 9 and 10. It is a residual surplus that is to be taxed, and not financial accounting profit. Furthermore it is clear that in calculating that residual surplus not all transactions stand equal. Article 12 elaborates that point and explains the principles associated with deductible expenses, whilst Article 14 deals with non-deductible expenses.⁸ The CCCTB represents a transaction-by-transaction basis quite different from that of financial accounting since it allows discrimination in deciding which items are deductible; this is a concept alien to financial reporting.

This is also implicit in Chapter IX of the CCCTB, which explains the principles of consolidation that it uses. Article 59 says that: 'In calculating the consolidated tax base, profits and losses arising from transactions directly carried out between members of a group shall be ignored'.

Despite the superficial resemblance, the draft attaches a very different meaning to the term 'consolidated' here to that usually used for accounting purposes. It does not mean that a single set of consolidated accounts covering all the members of a corporate group will be created for tax purposes, which is what financial accounting means by this term.⁹ Article 57 on consolidation says: 'The tax bases of the members of a group shall be consolidated'.

However, as Article 1 notes: "consolidated tax base" means the result of adding up the tax bases of all group members as calculated in accordance with Article 10'. This means that the accounts of each individual member of the consolidated group are first adjusted for tax in accordance with CCCTB rules, and only then are the resulting numbers added together. This stands in stark contrast to the approach of consolidating the entire financial statements of the various entities involved, and then adjusting the resulting consolidated profit in accordance with the rules of the CCCTB to produce a figure for the tax base for apportionment.

Admittedly Article 59 states: 'In calculating the consolidated tax base, profits and losses arising from transactions directly carried out between members of a group shall be ignored'. Nevertheless enormous difficulties remain which strain the relationship between this consolidation of profits and financial accounting, and there does not seem to have been any reconsideration of the approach adopted during the technical examination of the proposal by the EU Council.

The first of the problems that arises is that there is no requirement that the financial statements of the various member companies whose results are consolidated need be prepared in accordance with the same accounting standards. Despite the adoption of IFRSs for listed companies, local standards vary from country to country across Europe as noted previously. They may, therefore, prepare their financial statements in accordance with local or permitted (as is the case for US-based companies operating in the EU) accounting standards. While for financial accounting consolidation purposes they must then be adjusted to an IFRS-consistent basis, crucially there seems to be no adjustment required in the CCCTB. It is simply stated in Article 57 that the tax bases shall be consolidated and, apart from the requirement that a single currency be used, no further adjustment process is required except for the statement in Article 59 that: 'The method for recording intragroup

⁸ Both have been slightly amended for clarification in the Irish Presidency draft of 2013.

⁹ Note also that the CCCTB covers only those companies resident within a participating EU member state, forming part of a corporate group that (crucially) chooses to become subject to the CCCTB. This means that those entities that are under common control but which are resident outside the EU will be left out of this consolidation. Normal international tax rules, including the arm's length pricing method, will therefore still have to apply at the boundary of this consolidation.

transactions shall enable all intragroup transfers and sales to be identified at the lower of cost and value for tax purposes’.

This means that in financial accounting terms there is no consolidation as such. For financial accounting consolidation means the production of a single set of financial statements covering all members of a group of companies. There is no attempt to do this in the CCCTB. Instead financial statements which may have been prepared in accordance with differing accounting standards are each separately adjusted in accordance with the CCCTB’s rules; these figures are then added up to produce what might at best be called an aggregated profit.

This is a matter of significance. Firstly, because it does not require a consistent set of accounting standards to be applied across the group, the opportunity for tax arbitrage is not eliminated in the CCCTB: indeed, ample opportunity for it to be exploited appears inherent in the process. For example, profit may be shifted between periods within the same CCCTB group by arbitraging inventory valuation or revenue recognition rules within different accounting standards within one unitary taxation area. Such potential abuse could only be challenged under the general anti-avoidance rule (GAAR) proposed in the CCCTB (Article 80). As drafted in 2011 it simply reads as follows: ‘Artificial transactions carried out for the sole purpose of avoiding taxation shall be ignored for the purposes of calculating the tax base’.

As redrafted in 2013 under the Irish Presidency it is substantially more comprehensive in scope and closer in its structure to current prevailing thinking on this issue, although still falling short of being as principles-based as might be desired.¹⁰ Suffice to say for our present purposes here that, due to deficiencies in its accounting approach, the effectiveness of the CCCTB will be heavily dependent on this GAAR provision.

Also importantly, this accounting deficiency may affect the application of the apportionment formula put forward in Article 86 and the following sections. These propose a formula based equally on sales, employees (split 50:50 between payroll cost and employee numbers) and assets. However, without consistent accounting standards being applied across a group it is possible that all of these figures, bar perhaps employee numbers, may be calculated differently for the various entities under different accounting standards. This creates a risk of mis-statement and the opportunity for arbitraging formulas. A proper consolidation might overcome this other potential significant difficulty in the CCCTB.

This calls into question the use of the word ‘consolidated’ in this context. Unitary taxation aims to adopt a different approach from that used under the separate entity principle, to which the OECD is dedicated in its approach to international taxation. Its starting point is a Combined Report covering all the related entities in the relevant corporate group. Under the CCCTB this includes only the entities resident in the EU member states participating in the system, and not all those in the corporate group. This is a significant limitation, since it excludes related entities in non-participating countries which may be used for base erosion and profit shifting, relying on the existing international tax rules based on the separate entity approach to deal with those. A further limitation, to which we have drawn attention in this section, is that the combined report of those related entities under the CCCTB does not require true consolidated accounts prepared under consistent accounting rules and then adjusted for tax purposes. Instead under the CCCTB the related entities would prepare separate accounts on accounting bases which may differ significantly; they would then have their individually-reported income adjusted for tax purposes in accordance with a common set of taxation rules, including the elimination of intragroup sales and expenses; and finally

¹⁰ There is no room here to discuss such shortcomings in greater detail.

the resulting tax-adjusted incomes would be aggregated to create a total for the related entities' taxable income.

3.3 Comparison of the CCCTB's accounting approach with the US state system

As unitary taxation is operated within the domestic context of the US, where the states share common accounting and taxation rules, it is useful to examine the practices briefly. This examination may broaden understanding of the tensions and relationship between accounting and taxation in the US.

A type of unitary taxation operates for US state taxes on corporate income, normally termed formulary apportionment. All states with a tax on corporate income use the company's federal income tax return as the tax base for convenience, although it is not formally required (Siu et al. 2014). At the federal level US tax legislation states that:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

(26 USC § 1502 – Regulations¹¹)

Under the US system the taxpayer is required to provide the state tax authority with the taxpayer's federal taxable income, which states the taxpayer's nationwide income according to federal tax accounting principles. The taxpayer then, using forms provided by the state, must translate the federal income into state-specific tax accounting principles (typically by applying special tax incentives for, say, plant and equipment located in the particular state), and also must identify from the federal taxable income the income from those specific business activities of the taxpayer with respect to which the particular state has nexus under applicable US legal principles. Because of the requirement that states can reach only income from particular business activities of the taxpayer, the process of converting federal income into state apportionable income can be demanding and complex.

The list of adjustments is lengthy and includes eliminating the consequence of intragroup trading and dividends. The key point for our purposes here is that the consolidated tax return is not necessarily aligned with the consolidated financial statements produced by the parent company for the benefit of its shareholders or capital markets. The return is based on the separate entity accounts for tax purposes of the individual entities, which are then re-consolidated for tax purposes to create the combined consolidated federal income tax return. Hence unitary taxation in the US is not based on consolidated accounts as commonly understood by accountants. It is instead based on an aggregation of the type described previously for the CCCTB.

One consequence of this divergence is that no entity may be included in the US federal consolidated income tax return unless it is 80 per cent owned and controlled by the parent entity (CCH 2013: 119). This rule conflicts with US Generally Accepted Accounting Principles (GAAP) on this issue. In US GAAP (as in IFRSs) consolidation into group accounts is required of any entity which is under common control, but US GAAP diverges from IFRSs in

¹¹ See <<http://www.law.cornell.edu/uscode/text/26/1502>> accessed 18 December 2013.

its approach to control. It defines control in two ways, depending on how control of that entity is exercised (Ernst & Young 2011), but in both cases the approach is essentially that an investor controls an investee (and must therefore consolidate its accounts with its own) when the investor is exposed or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.¹² What is unambiguously the case for the purposes of this paper is that such control is considered to exist when the investor has a much lower percentage of ownership than the 80 per cent required for US consolidation for tax purposes. Due to this broader definition, the consolidated financial accounts of a US corporation may well include entities that would and could not be included in its federal tax return, and which must be accounted for separately when it comes to the group's tax affairs.

The CCCTB also uses a test based on control for deciding which subsidiaries qualify for inclusion in the group, but the criteria in the Commission's proposal differ from both IFRSs and the US federal tax rules. The proposed CCCTB Article 54 defines a qualifying subsidiary as an entity in which the parent company holds more than 50 per cent of the voting rights or more than 75 per cent of capital and right to profits. Hence while both the US tax rules and the EU's proposed CCCTB depart from financial accounting rules for consolidation, they each adopt somewhat different criteria for the control test which determines when consolidation is required.

Two conclusions follow. Firstly, the US state unitary tax system is based on separate entity accounts that are aggregated on bases inconsistent with US GAAP, but consistent with its federal tax laws. Secondly, the EU CCCTB replicates this approach and (as discussed in the previous section) provides tax accounting rules which are in many ways different from the logic underpinning IFRSs, although these are the required EU standards for the preparation of the consolidated financial accounts distributed to shareholders and capital markets.

3.4 Issues for international unitary taxation

This section briefly considers the implication of US practices and EU proposals for international taxation, as the adoption of unitary taxation may require regional and/or global agreements.

It is clear that the approach adopted by both the EU and US for adjusting financial accounts to tax reporting standards would pose problems at the international level. Both these systems require this adjustment to be done first for the separate affiliates in each jurisdiction, and then aggregated for the whole corporate group. Both rely on a single set of tax accounting rules – in the US federal tax accounting regulations, and in the EU those being elaborated in the CCCTB; and both start from relatively homogenous financial accounting standards, the US GAAP, and IFRSs (although as we have seen there are still some significant national variations on these in the EU). This raises two questions relating to the transferability of this approach at the international level, and especially for developing countries.

Firstly, worldwide agreement on a single set of tax accounting rules would clearly be very difficult or impossible. Without such rules tax authorities in each country would have to accept an aggregated return for the group based on tax returns prepared for its constituent entities in other countries. Even the verification of these returns would be very difficult, especially as many developing countries do not have tax information exchange agreements. The CCCTB (Article 109) proposes a procedure for submission of the group return by the principal taxpayer (i.e. the parent company within the EU) to the principal tax authority, but this also assumes close relations and cooperation between the tax authorities. More

¹² This form of wording is based on IFRS 10 issued by the IASB, see <<http://www.iasplus.com/en/standards/ifrs/ifrs10>> accessed 29 March 2014.

seriously, starting from accounts prepared under different national tax accounting rules would make it very hard to assure any internal consistency.

Secondly, whilst the US and to some extent the EU have some control of the accounting standards used within their domain, this is not true for many developing countries when the taxation of multinational corporations is considered. Local GAAP is within their control, but the GAAP that may be applied at a multinational level may not be. This creates the possibility that standards deemed inappropriate for use for tax purposes in other jurisdictions, such as IFRSs, might need to be used for unitary taxation purposes in developing countries, with the resulting reported data subjected to adjustments for taxation purposes.

Developing countries have a key stake in international taxation. A frequent complaint is that the current system of corporate taxation deprives them of much-needed revenue, and non-governmental organisations have argued that unitary taxation can address their concerns (ActionAid 2012, 2014). This inevitably raises questions about the role of traditional accounting in tax practices. What use do they make of accounting practices? Do they accept them for tax purposes? If not, how are they modified? Perhaps the difficulties of subjecting multinational companies to a unitary basis found in developed countries would also apply in developing jurisdictions. Therefore the next section briefly explores the relationship between financial accounting and tax reporting standards worldwide.

4 Accounting, tax and developing countries

There is, as has already been noted, a degree of dependence between financial and tax accounting, since financial accounting numbers are usually adjusted to arrive at taxable profits. To assess the impact of this process in both developed and developing countries, using each as a benchmark for the other, an analysis of data on corporate tax systems has been undertaken using PricewaterhouseCoopers' (PwC) *Worldwide Tax Summaries*. This guide (PwC 2014) covers 153 states, allocating 15 pages to each on average. It is clearly intended for use by tax professionals and not the general public, but as a result it does provide a reasonably comprehensive analysis in technical language. Importantly, whilst it is not constructed as a database, it is apparent that the editors required the contribution for each jurisdiction to address a particular range of issues; as a consequence these are fairly uniformly addressed and in broadly consistent style, making it a suitable tool for analysis for this purpose.

Of the 153 jurisdictions considered by PwC, one, the Caribbean Netherlands, had to be excluded from consideration for this survey's purposes as it is at present in a state of political flux. That left 152 jurisdictions in the survey. Together they include more than 98.52 per cent of World Gross Domestic Product (GDP) based upon World Bank data.¹³ Of these 152 jurisdictions, 2 have no taxes on corporate profits (Bermuda and the Cayman Islands); Bahrain only charges these taxes on oil companies so has also been considered not to have a general corporate income tax. Excluding these left a sample base comprising 149 jurisdictions covering 98.46 per cent of World GDP. The survey collected the following information:

- Whether there was a tax on corporate income;
- What the headline rate of tax was according to PwC;
- Whether that tax was primarily charged on profits as per accounts or on chargeable income less allowable expenses (this suggestion, or formulations similar to it, being specifically sought in the text);

¹³ As per GDP estimates published by World Bank, available at <<http://data.worldbank.org/indicator/NY.GDP.MKTP.CD>>.

- Whether accounts were specifically required to be submitted in support of the tax return;
- Whether another tax base (e.g. based on turnover or turnover less fixed rate deductions) was available for assessment;
- Whether a calendar year basis is imposed, potentially overruling an accounts basis;
- Whether a residence basis of taxation on worldwide income is in use;
- If a territorial basis for taxation has been adopted;
- Whether a permanent establishment (PE) concept is in use;
- Whether specific accounting overrides are in place and in particular:
 - Whether FIFO stock accounting is mandated;
 - Whether a capital allowance or similar system of standardised depreciation charges is in use in place of accounting depreciation;
 - Whether an interest cap is in place;
 - Whether thin capitalisation rules apply;
 - Whether transfer pricing rules are in operation;
- Whether controlled foreign company rules are in operation, suggesting that the separate entity rule for taxation purposes has been overridden;
- Whether the jurisdiction has transfer pricing rules;
- If the jurisdiction has double tax agreements;
- Whether a GAAR is in operation.

It is stressed that such a survey is inevitably a perceptions index. It represents the state of play at a point in time. The opinion of at least 149 preparers of data is reflected in the PwC report, and additionally the perception of the researchers undertaking this survey is a factor in interpretation of the data presented by PwC. As such the survey is not definitive: in the time and with the resources available that was not possible. PwC may not have recorded a relevant issue, and equally we may have misinterpreted the report in some areas.

The findings have been assessed for their relevance based on the jurisdiction's:

- Continent
- GDP
- Population
- GDP per head
- Ranking in the Tax Justice Network's *Financial Secrecy Index*¹⁴ (FSI), where a rating of more than sixty was taken as indication of significant tax haven-style activity in a jurisdiction.

World Bank data (see above) was used for the above analysis unless unavailable, such as for some UK Crown Dependencies and Overseas Territories when *CIA Factbook*¹⁵ data has been used.

The survey produced some clear results. As already noted, 149 of the 153 jurisdictions had a corporate income tax. Additionally, of those that had such a tax 112 (75.2 per cent) used a residence-based system charging worldwide income to tax, and 37 (24.8 per cent) a territorial-based system. Of the total sample 109 have a PE concept built into their tax system (73.2 per cent), including 22 of the 37 states using territorial taxation (59.5 per cent).

These initial results indicate some of the issues that arise when considering the relationship between accounting and the tax base. Whilst a country using a residence-based tax system that does not have a PE concept in use (16.8 per cent of the sample, representing 25 jurisdictions) might conceivably use accounting profit as the basis for determining the tax

¹⁴ See <<http://www.financialsecrecyindex.com/>> for further information.

¹⁵ Available at <<https://www.cia.gov/library/publications/the-world-factbook/>>.

liability of those entities that it considers resident in its jurisdiction, this cannot be said to be true of the remaining 124 countries for a number of reasons.

Firstly, a country using a territorial tax system must by definition base its corporate tax charge on data extracted from accounts and not on accounting profit because the company may have overseas income. In that case partial data must be capable of use as the basis for tax assessment. Secondly, the same applies to a country using a residence-based system if a PE concept is in use, since this again means that tax must be charged on data extracted from accounts (to exclude a foreign PE), rather than on accounting profit as a whole. Thirdly, unadjusted accounting profit cannot be the basis for charge if it is explicitly stated not to be, or because other specific adjustments to accounting profit, such as a capital allowance system in place of accounting depreciation charges or an interest rate cap, are in operation.

Examining the sample of twenty-five states with a residence concept but without a PE concept, in eight cases PwC reported them to have a corporation tax based on chargeable income less deductible expenses and not pure accounting profit. That leaves just seventeen jurisdictions that might plausibly solely or mainly use accounting profit as the main basis for charging this tax; but of these fifteen have a capital allowance regime in place of depreciation charges, and of the two remaining jurisdictions one has an interest cap in place. That leaves just one state, Puerto Rico, which is often used as a tax haven (although it is not considered as such by the Tax Justice Network's FSI), which looks as though it may use something close to accounting profit as the basis for taxation – but even there rules to replace accounting depreciation charges with more standardised allowable rates are being introduced.

Hence the immediate conclusion from the survey is that the link between accounting profit and tax exists, but is almost invariably not direct. In other words, however important accounting might be (and it is) there is compelling evidence that tax authorities do not rely solely on accounting data when charging companies to tax. As interesting as that conclusion might be in itself, it seemed appropriate to analyse the available data in a little more depth to see if any trends could be discerned. For this purpose the data was sorted by continent, whether the jurisdiction had high or low income, and if it was considered a financial secrecy jurisdiction, with the latter then also being sorted by high or low income.

It was decided to categorise states by high or low income rather than whether they are developing or not. This was because an objective view could be taken on high and low income from the available data, whereas any developed/developing categorisation tends to be harder to quantify. The measure used to categorise states by their level of income was a simple one: high-income countries were those that had an average income above the median GDP per head in this sample, and low-income ones had an average income below the median GDP per head (the median GDP per head in the sample was US\$8,124 per annum).

Data by continent revealed surprisingly few trends of significance, and as such is not reproduced here. Data when analysed between high- and low-income jurisdictions, and then further analysed on the basis of whether the location was a financial secrecy jurisdiction, does adequately summarise many of the findings as follows (the figures in Table 1 represent the number of jurisdictions falling into each category):

Table 1 Accounting taxation across the world

Country	Lower-income	Higher-income	Total all jurisdictions	Secrecy jurisdictions	Higher-income secrecy jurisdictions
Has CIT?	74	75	149	33	26
Headline rate of CIT % (Ave)	23.98	24.98	-	21.68	19.74
Based on profit?	18	29	47	10	9
Based on income less expenses?	25	19	44	6	5
Accounts required?	15	16	31	9	6
Is another tax base also available?	27	10	37	5	2
Calendar year basis	50	38	88	11	9
Tax charged on worldwide income?	53	59	112	18	15
Is a territorial basis used?	21	16	37	15	11
Does the jurisdiction have a PE concept?	57	52	109	23	17
Is the FIFO basis of stock valuation required?	42	54	96	19	17
Is there a capital allowance system in place of accounting depreciation?	69	68	137	28	22
Does the jurisdiction use an interest rate cap?	28	35	63	12	10
Does the jurisdiction use transfer pricing rules?	57	49	106	15	9
Does the jurisdiction use a thin capitalisation rule?	34	35	69	10	6
Does the jurisdiction have a controlled foreign company regime?	6	23	29	1	1
Does the jurisdiction have double tax agreements?	67	71	138	30	24
Are withholding taxes applied to payments to non-residents?	74	65	139	26	19
Is a GAAR in use?	6	10	16	5	5
GDP per head above median = 1 or below = 0	0	75	75	26	26
FSI score 60 or over?	7	26	33	33	26

The findings are that across the income spectrum there is considerable unwillingness to use of pure accounting data as the basis for corporate taxation assessments.

That said, it is clear that there are some anti-avoidance measures that lower-income countries (often referred to as developing countries) do not have the capacity to operate. The more limited use of controlled foreign company legislation is an obvious example of this (although the almost total absence of this provision in secrecy jurisdictions, most of which are high-income jurisdictions, is perhaps as notable).

The absence of general anti-avoidance rules is also telling: the power for tax authorities to totally override reported accounting arrangements that these rules permit seems hard for many jurisdictions to contemplate (but not so hard it seems for some secrecy jurisdictions, Jersey being a particularly notable example of a secrecy jurisdiction that has long used such an arrangement to defend its domestic tax base). However, when it comes to more obvious powers to adjust accounting data regimes, such as transfer pricing rules, lower-income

countries actually predominate in the sample, but that is partly explained by the prevalence of secrecy jurisdictions in the high-income category which have disdain for such provisions.

Perhaps surprisingly, more complex provisions such as interest rate caps are also widely found in lower-income countries. Tellingly, though, lower-income countries are also more inclined to provide alternative tax bases to those solely determined by profits, and to have a territorial basis for taxation. This may of course reflect the inability of many such jurisdictions to secure any meaningful data from beyond their own borders, despite the apparent availability of at least some double tax agreements.

Most jurisdictions engage with the problems posed by discretion in accounting, for example by replacing depreciation charges with a capital allowance or equivalent arrangement, and in almost exactly equal numbers irrespective of income; whilst lower-income countries are less inclined to give direction on stock and inventory valuation bases, a majority do.

These points being noted, it remains clear that the differences are much less striking than the similarities in this survey. It is clear that worldwide tax authorities appear united in their reluctance to rely upon accounting data, irrespective of the country's level of income or, from the evidence of the regional surveys, almost irrespective of geographical location.

This suggests a number of conclusions. The first is that the problems that accounting weaknesses create for tax authorities are not limited to higher-income jurisdictions: they are universal. Second, if there is a need to reform the accounting basis for taxation purposes then developing countries need to be involved in that debate, because they are as much impacted by this issue as any other country. Thirdly, whilst lower-income countries have shown a greater willingness to consider alternative accounting bases for assessing some companies, many of those alternative bases are targeted at smaller entities within their own jurisdiction. These include taxation on turnover or on turnover less fixed rate deductions determined by the industry sector in which the entity is engaged (a route now also being explored in the UK). This is not therefore an indication that they have found a solution to the problems of taxing multinational corporations. Lastly, in that case it is safe to assume that any problems in defining a tax base for assessing multinationals on a unitary basis found in developed countries would also apply in developing countries and lower-income jurisdictions.

5 A new approach to tax base definition for unitary taxation

The divergence between financial reporting and tax accounting standards is not just a practical or pragmatic matter. There are conceptual differences between accounting and taxation concepts of income, expenses, profits and losses, as well as in the related capital maintenance concepts to which each adheres. Since the 1970s the financial reporting practices have been primarily concerned about reporting the financial performance of an entity to capital markets (Cooper 2013). At one time accounting standards were consistent with the accruals concept that matched income and expenses as far as possible, and so broadly reflected the realisation principle usually found in tax accounting. It also meant that prudence (or conservatism) was paramount. This gave the profit and loss account priority in financial reporting. In contrast, current financial standards emphasise the importance of the balance sheet and its presentation of market values, reducing the income statement (or profit and loss account) to secondary status. This is contrary to the needs of taxation authorities. However, there is little chance of a change in the nature of accounting standards in the immediate future, as too much is invested in the current structures of reporting for significant

change to be likely. Hence there is a need for alternative thinking on the way in which reliable data can be produced for the assessment of corporation tax liabilities.

As Section 3 shows, some of that thinking has been taking place in the formulation of the EU's CCCTB. This has laid a foundation for a conceptual framework for taxation accounting, for example by adopting the concept of realised profit as its basis, which essentially reverts to a historic cost accounting basis of reporting. This also makes clear that the concept of maintaining financial, or monetary, capital is inherent in this process, which few tax authorities would dispute. Tax liabilities are normally and necessarily determined on the basis of the taxpayer's ability to pay, which necessarily reduces most tax considerations to a cash basis. This is far removed from the jumbled and even confused valuation bases that are found in many current balance sheets, as noted in our discussion above.

This is also true when it comes to the profit concept. In essence financial reporting considers a profit or loss to be the increase or fall in the capital value of an enterprise as shown by its balance sheet worth over a period, having taken out of account movements in equity and distribution of reserves. This makes profit or loss a residual of transactions of all sorts, with little qualitative differentiation. Tax necessarily must take a different approach, and the EU's CCCTB provides appropriate and clear indication of that. Transactions are necessarily considered on the basis of their specific type, and not as an amalgam as is the case in financial reporting. Each source of revenue has to be considered in its own right to assess whether it is subject to tax or not, and expenses may be offset only if allowed by the realisation principle, and only if that expense is explicitly permitted as a deduction for tax purposes. By definition, therefore, taxable income as defined in this way has a limited relationship with profit seen from the perspective of financial investors. Taxable income can be considered as a subset of all the transactions that may contribute to such profit, and the task of tax accounting is then seen as being the identification of the transactions within this subset that have a tax consequence and excluding all others.

In essence this task of identifying the subset comprising those taxable revenues and allowable deductions is the essence of the tax adjustment process which translates profits reported for financial accounting purposes into the taxable income subject to a corporation tax charge. As Section 4 shows, although individual specific rulings with regard to such adjustments will vary significantly from jurisdiction to jurisdiction, there is a remarkable consistency in the areas where such adjustments are made. So, for example, it is usually recognised that capital expenditure and its associated depreciation charges create problems of allowability, consistency and predictability for tax accounting. The replacement of depreciation charges with capital allowances is a common response to this difficulty, but there will remain other areas where rulings are necessary to overcome similar problems. Examples include provisions against both inventory valuation and recoverable debt (receivables), as well as provisioning for potential future liabilities and the treatment of assets with time-limited worth, such as derivative and hedging contracts. All these are likely to require particular accounting rules for tax purposes. The CCCTB provides examples of some possible treatments.

Another area where the same potential problem arises is with regard to interest payments. Although interest expenses are for financial accounting purposes appropriately considered costs incurred during the course of a period, they may also be considered a substitute for profit distribution to the owners of equity capital, which are almost invariably not allowed as deductions to reduce tax liabilities. These conflicting accounting treatments can therefore create tax distortions. Again tax rulings are required, which may entail considerable scope for discretion. Exploiting differences in such treatment between national tax authorities is fertile ground for tax avoidance, and dealing with this is an important aspect of the OECD's Action Plan on BEPS.

Perhaps less commonly appreciated, but nonetheless still within the same category of transactions at the interface between the recognition of the capital asset and the revenue expense, are payments for the use of patents, copyrights and other intellectual property. Payments of this type give rise to taxation difficulties because they fall on the boundary between asset recognition and the deduction of allowable expenditure for taxation purposes.

In principle, unitary taxation should apply to the whole of a multinational corporate group, defined in terms of a suitable control test and on its consolidated accounts. Financial accounting standards already include both control criteria and principles for consolidation, and multinationals already produce accounts based on those standards. The issue, as we have pointed out in this paper, is what would be the most practical approach to adopt to adjust group financial reports to tax accounting standards. The two main systems, the US state taxation and the EU's CCCTB, both apply only to a subset of the corporate group, the entities operating within the region concerned. Neither begins from the consolidated financial accounts of that subset of entities; instead the financial accounts of each entity are first adjusted to the tax accounting standard, and the result is then simply added together or aggregated into one total to form the basis of the sum to be apportioned to individual jurisdictions. This approach is far from satisfactory.

Probably the main reason for adopting this approach is the desire to remain compatible with existing international tax rules. Thus US states which previously applied formulary apportionment on the basis of a worldwide combined report were obliged to offer a water's edge election following an international campaign and constitutional challenges (Picciotto 1992; Siu et al. 2014). The CCCTB seems to have been crafted to operate on this narrower basis.

In addition to regional adoption, a limited unitary approach could also be applied to multinationals on an activity basis. This possibility has been analysed particularly by Michael Durst, who points out that its similarity to the profit split method under current transfer pricing rules could make it acceptable without changing existing tax treaties (Durst 2013a). However, he also indicates some of its disadvantages, especially the problem of defining the particular business activity to be treated separately and creating segmented accounts for it, as well as separating investment income from business income. Also, although he suggests that an advantage of this approach could be avoiding the need for full-scale 'book to tax income conversion' (i.e. adjustment of financial accounts to tax standards), in our view he understates the drawbacks and limitations of making these adjustments on an ad hoc basis, involving a detailed examination of the accounts, which he accepts it entails.

Hence in our view a better approach would be to start from the worldwide consolidated financial accounts of the corporate group, and adjust them to the appropriate tax accounting standards. This provides a trail from financial accounts representing actual economic activity undertaken to tax accounts. In the absence of internationally-agreed tax accounting standards this does, however, raise questions on how such adjustments should be made; an issue considered briefly by Michael Durst, who also advocates this approach (Durst 2013b). One solution he suggests is a move by tax administration towards 'book-tax conformity' – convergence of tax with financial reporting standards. For the reasons discussed in greater detail earlier in the paper, this does not seem either desirable or feasible. Secondly, Durst argues that even if national tax administrations require conversion of consolidated financial accounts to their own tax standards, the resulting disparities would be no more than what already occurs under the current separate entity/arm's length approach.

Based on the analysis in this paper, we can make a number of suggestions regarding such possible convergence or harmonisation of accounting and tax rules. First of all, we believe that the EU has laid the foundations of a viable conceptual framework for taxation in the proposed CCCTB. Its transaction-based approach to the recognition of revenue and

deductible costs is sound, as is its adherence to the principle of only recognising realised profits, with the associated capital maintenance concept of maintaining financial capital. These are all necessary in a corporate taxation system where capacity to pay is vital if the resulting charge to tax is to be considered fair by those asked to pay it.

Secondly, by eschewing many of the problems embedded in financial reporting the EU is promoting certainty and predictability, considered to be major principles of taxation (Smith 1776).

However, perhaps the most important development that the CCCTB has to offer is found in the 2013 version put forward as a compromise document by the Irish Presidency (European Commission 2013). Within that document a revised Article 12 was presented that offered individual jurisdictions the opportunity to present differing approaches to the deductibility of payments made to charities. This opens an intriguing possibility that we think worthy of further exploration. As we have noted above, due to social settlements, local conflicts and histories, there are a range of contentious issues where the interface between tax-deductibility and capital recognition concepts give rise to significantly differing judgments on tax-allowable expenses. On each of these judgments, it is possible that interstate disputes might arise when seeking to agree a unitary taxation base. For example, deductibility of interest payments and tax relief for royalty payments frequently give rise to disputes, and governments may use tax policies to encourage investment. Tax relief for research and development and investment in plant and machinery may be connected with macroeconomic policies and pursuit of competitive advantage, whilst some others may be routine and non-controversial (e.g. deduction of rent, travel costs). Thus, international or EU-wide agreement on deductibility of some expenses may be easier for some categories of expenditure, whilst others may be more protracted.

As a result, for pragmatic reasons we would suggest that deductible expenses included in the unitary taxation base should be subdivided. By far the majority in terms of both type and value could be agreed by default between the states agreeing to use a unitary taxation base, precisely because they are not contentious. The remaining range of expenses (e.g. interest payments) could be agreed to be subject to deduction, but in accordance with rules determined locally by each participating jurisdiction (which could be EU member states) within the unitary taxation base. Such an approach would encourage an acceptance of unitary taxation. We suggest that the 2013 draft of the CCCTB might now provide (albeit tentatively and only so far with regard to charitable expenditure) a basis for this approach.

On this basis, and with necessary refinement of this proposal being the subject of political negotiation, we think it possible that a taxation base for unitary taxation that is broadly, but not precisely, equivalent to the accounting concept of EBITDA (Earnings Before Interest, Taxation, Depreciation and Amortisation) could be developed. This resulting tax base before offset of locally-determined allowances could then be apportioned in accordance with a formula that is likely to exclude assets, because relief for expenditure on capital will be given locally and capital costs do not therefore need to be considered for formula purposes. This approach will have the advantage of removing from contention an area of considerable accounting difficulty, which asset valuation always represents.

In that case there remains one further recommendation that we would make. In preparing this figure for what we might for shorthand purposes call Taxation EBITDA (although it will also exclude items like royalties and research and development expenditure), one of the problems that we have already noted with regard to aggregated entity accounting as we define it should be overcome. We believe it is essential that the figure for revenue to be used for the purposes of this exercise should be prepared on a consolidated basis in the sense that is used for financial reporting – that is, a consistent set of accounting standards must be applied for the purpose of calculating this one figure, with adjustment being required between

each individual jurisdiction to accord with this universally-applied standard. By definition this will of course mean that the same standard will apply to intragroup purchases, since that will be necessary for the purposes of their elimination from consideration for aggregation purposes. This pragmatic approach would mean that all other expenses would not need to be consolidated, simplifying the process, but by definition problems of accounting for, and arbitraging of, transfer pricing adjustments within the unitary base should be removed from consideration using this approach. Dependence upon a GAAR to eliminate abuse would therefore be reduced, although we would strongly recommend the retention of such a rule to cover other areas of potential exploitation.

This approach can provide a basis for the regional adoption of unitary taxation. Firstly, many of the potential obstacles to agreement of that unitary taxation base are eliminated from consideration. Secondly, a simple method of aggregation that overcomes most of the problems inherent in the CCCTB is proposed with a backstop to prevent abuse being retained. Thirdly, those parts of the tax base that are frequently subject to tax competition (e.g. rates of capital allowances) would remain under local jurisdictional control. This way political subsidiarity is preserved in areas where it is likely to be important.

Of course the proposals here are not a panacea, but do offer the possibility of structured negotiations around important issues. Pragmatic solutions based upon fundamental concepts important to corporation taxation can be developed from existing thinking; these could be significant in tackling taxation abuse in wide geographic areas without the creation of major political obstacles to agreement. We believe that the development of tax reporting standards would be a significant step, and would encourage further research into that possibility.

How then do these suggestions relate to the need of developing countries for an effective mechanism to protect their taxation revenue from multinational corporations, which frequently constitutes a significant part of their tax base? We suggest there are three ways in which this might be the case. Firstly, the EU's CCCTB suggests that regional solutions to unitary taxation are possible and potentially viable mechanisms for tackling issues of base erosion and profit shifting. This would appear to have application in developing countries because neighbouring countries are inevitably major trading partners, and so likely to be the subject of potential transfer pricing activity. Secondly, we think that the development of common tax reporting standards between these nations would reduce the risk of tax competition on these issues, and so focus attention on economic fundamentals when issues relating to business location might be under consideration. Lastly, and importantly, by combining pragmatism on the creation of common tax bases where agreement is likely to be relatively easily secured with the recognition of the significance of tax sovereignty to nation states, we suggest that the basis of profit apportionment we suggest in the final part of our paper might form the basis for a practical way forward in negotiations on this issue.

Appendix

Inventory valuation and company profits

The following example illustrates the issues arising from the use of FIFO and LIFO methods for valuing inventories. A company converts small widgets to big widgets. During the year it made the following purchases:

Lot 1: 2,000 widgets at £3 each	=	£ 6,000
Lot 2: 1,200 widgets at £4 each	=	£ 4,800
Lot 3: <u>1,000</u> widgets at £5 each	=	<u>£ 5,000</u>
Total <u>4,200</u>		<u>£15,800</u>

It sold 3,000 widgets at £8 each (total sales, £24,000). At the end of the year, the company had an inventory of 1,200 widgets. What is its profit? The answer will depend on the cost that is assigned to the inventory.

Under FIFO, goods are assumed to be sold in roughly the order in which they are purchased. Thus inventory in-hand is to be valued at the most recent prices. These are 1,000 items at £5 (£5,000) and another 200 at £4 (£800), giving a valuation of closing stock of £5,800. Thus the profit (sales – cost of sales (purchases – closing stock)) would be (£24,000 - (15,800 – 5,800)) = £14,000.

Under LIFO, the latest items are assumed to be sold first. Thus inventory in-hand is valued at the earliest prices. This is 1,200 items at £3 each, giving a valuation of closing stock of £3,600. Thus the profit (sales – cost of sales (purchases – closing stock)) would be (£24,000 – (15,800 – 3,600)) = £11,800.

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