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## **COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)**

### ***Taxable income***

**Meeting to be held on Friday 23 September 2005**

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**WORKING DOCUMENT**

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## **I. Introduction and purpose of the paper**

1. It is common in existing tax systems to design rules on the determination of income (business or investment) subject to corporate income tax. These rules primarily cover the timing of the recognition of revenue and deductions. The taxable income (profit or loss) could be in the most general way defined as taxable revenues reduced by deductible expenses and other allowed deductions allocated to a particular tax period. This paper introduces the discussion on the calculation of taxable income for the CCCTB purposes. It refers to, and should be read in conjunction with:
  - The financial accounting practices (the main reference texts are IAS 2, IAS 11, IAS 18, and IAS 20)
  - Corporate income tax practices and principles as currently followed in the Member States (MS) and
  - The ongoing discussion on the relation between the financial and tax accounting as discussed in the Commission Working Paper "The Concept of the Tax Balance Sheet" (CCCTB/WP/016).
2. The purpose of this paper is to identify the main issues which need to be addressed in designing a Common Consolidated Corporate Tax Base (CCCTB) and draws attention to a number of existing practices and principles. The scope of the paper is relatively broad and some of the questions will have to be examined in more detail. Members of the CCCTB WG may wish to consider whether these technical problems should be referred to a subgroup for further analysis.
3. Many issues and problems are mentioned in this working document and questions are asked in the end of each section. As at previous meetings members of the Group are invited to express their preliminary views and remarks on the document during the meeting and in addition are kindly requested to comment in writing after the meeting. Their comments will create a valuable input for any further work carried out in a subgroup.
4. In respect of the terminology used in this document the term taxable income refers to the net taxable amount (after deduction of expenses and other deductible items). The term income indicates the gross amount received or receivable by a company. The terms expense and cost indicate amounts payable or paid and the term tax deductible expense the amount by which company is allowed to decrease income for tax purposes. Income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of company; gains represent increases in economic benefits arising from assets which have been capitalised. Revenue comprises ordinary business income and investment income. Whether any income should be classified as non business income is subject to further discussion (see below). The term 'schedular' system is deliberately not used in this paper.
5. Most MS currently derive the taxable income for corporate income tax purposes from the financial accounting. The level of dependency between tax and financial rules in MS varies as well as the actual techniques for the tax base calculation.

Some MS rely on financial accounting and IAS heavily, others prefer to create many deviations and tax specific procedures. Although uniformity between tax and financial accounting may seem practical and desirable for some MS, it will not be possible to make the CCCTB completely dependent on financial accounts, because the CCCTB will have to work with up to 25 different, not harmonised, national accounting systems.

6. The Commission Services express special thanks to France for their contribution to the work on this working document.

## **II. Determination of taxable income**

7. Two basic practical techniques of how to calculate the taxable income are currently applied in MS's tax systems. The first one derives the tax base from the comparison of balance sheet values (opening and closing) and the second one works with the profit and loss account. The function of the tax balance sheet is analysed in more detail in the Commission Working Document CCCTB\WP\016\doc "The Concept of the Tax Balance Sheet". Both systems further adjust figures obtained from the financial accounting in order to reflect specific corporate income tax rules.
8. Although both methods can lead to the same results provided the scope of taxable revenues and tax deductible expenses is the same, the question arises whether they can be applied and whether it is most efficient way to apply them both at the same time. The CCCTB will have to address the problem of using a non- unified starting point for its calculation. The fundamental question is at what stage the harmonisation of the tax base should start. Theoretically the balance sheet method and the profit and loss method could both be used, in practice some problems may arise particularly when companies operating in MS with different approaches calculate the consolidated tax base. Using the two methods at the same time may be contradictory to the concept of a single CCCTB calculated according to the same set of rules in up to 25 MS.
9. Under the profit and loss approach the determination of the taxable income is based on calculation of all income and all deductible expenses relevant for corporate income tax purposes incurred by the taxpayer in the relevant tax period. Under the balance sheet method the taxable income is calculated by comparing the value of the net assets in the balance sheet at the end of the taxable period plus dividends distributed by the taxpayer during the year with the value of the net assets in the balance sheet of the taxpayer at the end of the previous year. A positive difference (either between income and expenses or between the two net balance sheet figures) constitutes the taxable income and a negative difference a loss.
10. The two models are in practice similar in many respects. The starting point for the balance sheet method is generally the financial accounts balance sheets, which are sometimes transformed into tax balance sheets. The profit and loss method usually starts with the profit and loss account, but may also start directly with the

recognition of revenues and expenses calculated specifically for tax purposes. The accounting profit/loss is consequently adjusted as necessary to reflect the differences between tax and accounting rules. Similarly while the balance sheet method explicitly starts from financial accounting records, these have to be adjusted to reflect differences between the tax law and financial accounting practices. In practice the calculation often consists of the adjustment of the profit and loss account by adding back items (expenses) recognised in accounting, but not deductible for corporate income tax purposes and the inclusion of items (revenues) not recognised in the accounting, but taxable for tax purposes. The two methods should end up with the same amount of taxable income (if the scope of taxable revenues and tax deductible items is the same).

11. From a practical point of view it has to be noted that not all taxpayers are required to compile comprehensive accounting records including, for instance a tax balance sheet. On the other hand the common understanding and structure of a (tax) balance sheet may be useful when apportioning the consolidated tax base as it may contain information relevant for the calculation of each MS's share of the CCCTB.
12. Various adjustments are required for corporate income tax purposes, because the principal purpose of the financial accounting is different from the purpose of tax laws as already mentioned on various occasions. Whereas the former aims to provide an accurate analysis of the profitability of the company the latter in contrast is concerned with the measuring of the net gain in a fixed period for the purpose of collecting tax. For example financial accounting places great emphasis on classifying revenues by reference to their regularity, whereas in taxation a distinction of this sort is generally not as important. For example, for financial analysts whether an item of income is ordinary or extraordinary is extremely important because it may effect profitability trends, so financial accounting standards are very concerned with defining ordinary and extraordinary income. However, for taxation purposes whether an item of income is ordinary or extraordinary is of little importance, what matters is whether the income is taxable or not.
13. A general definition of income (for expenses see III. Deductions below) for the CCCTB purposes may be useful. In accounting revenue is understood as an increase in economic benefit during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity other than those relating to contributions received from equity participants<sup>1</sup>. Any distinction between various types of income and activities (business/non business) performed by the company should only be done when there is a proper material justification for it. Historical or traditional reasons should not be sufficient. During the discussion on a 'business purpose test' in the SG1 the question of what income of companies should be covered by the CCCTB was raised. The main concern was whether there is a need and sufficient

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<sup>1</sup> IFRS Framework for the preparation and presentation of financial statements, Para 70

justification for differentiation between 'so called' business and non business income which is rather administratively demanding and makes the system very complicated (allocation of appropriate expenses etc.). The most practical and simple approach would be if the CCCTB were to cover any activity performed, and any income earned, by companies. Then the definition of business<sup>2</sup> for the CCCTB purposes would not be necessary.

14. However, the distinction between ordinary business income and investment income for CCCTB purposes will have to be considered. Investment income may be subject to a specific tax treatment or a tax may be collected by a technique different from the assessment of tax as a part of a general tax base (e.g. withholding tax).
15. Interest, royalties and dividends are the most common examples of investment income. Financial accounting describes them as revenue arising from the use by others of entity assets<sup>3</sup>. If a specific tax treatment is applicable to the investment income or its particular elements, the definition of each category will be essential. Definitions of interest, royalties and dividends will be influenced by international practice particularly the OECD Model Convention on the elimination of double taxation and its Commentary. The practices developed and applied at the international level should be used also for the CCCTB purposes and amended only when its specific nature would require it.
16. Some items may be characterised as investment income depending on the business performed by the company. For example investment income would normally include interest income, however if interest is received by a company carrying on a business of money lending it is more appropriate to treat the interest as ordinary business income and not investment income. Similarly it may be practical to treat interest income closely related to the business performed by the company (e. g. the interest on a current bank account) as ordinary business income.
17. For completeness it should be noted that in accounting the definition of income encompasses both revenue and gains on the basis that gains as such are no different in nature from revenue<sup>4</sup>. Work done in SG1 on capital gains taxation also suggests that treating capital gains together with ordinary business income would be the preferred solution for the CCCTB purposes, although the reasoning for this is slightly different.

**Members of the Group are invited to respond to the following questions:**

- *Which method of calculation of taxable income do they see as the most appropriate for the CCCTB purpose – 'balance sheet' method, 'profit and loss' method or could both be used?*

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<sup>2</sup> In broad terms 'business' has a common meaning of commercial or industrial activity undertaken for profit in name and on account of a company.

<sup>3</sup> IAS 18 Para 29

<sup>4</sup> IAS Framework Para 74

- *Will specific measures for investment income be necessary and desirable in the CCCTB, and will there be a need to distinguish between ordinary and investment income? If yes what should the criteria be for making the distinction?*
- *Is it useful to produce a definition of revenue for tax purposes and to support it with a list of situations when revenue has to be recognised? Are there situations, other than those referred to in this document, when revenue should be explicitly identified as taxable?*
- *Do members agree that distinguishing between business and non-business income is unlikely to be materially important in the CCCTB? If not, how should the distinction be made?*

### **III. Deductions**

18. Costs incurred to earn income which is subject to tax should be recognised for the purpose of determining taxable income and companies should therefore be allowed to deduct them from the income subject to tax. The timing of the recognition in taxation may vary for different types of expenses and may be different from accounting practices. The proper expression and interpretation of how closely the expense has to be related to the business is probably the most complicated part when defining deductible expenses. Some systems require expenses to be incurred wholly and exclusively in connection with business, others allow an element of apportionment.
19. The definition of tax deductible expenses for CCCTB purposes will be necessary. Its elements have to be considered diligently, because the interpretation of this CCCTB rule may become difficult in practice. If the definition is too general different tax administrations may interpret it differently. As the CCCTB will exist in up to 25 tax jurisdictions and will not (initially) be able to rely on developed and consistent jurisprudence, the most feasible model seems to be to have a broad non-restrictive definition of tax deductible expenses as a general rule. For example, expenses incurred in the production of income subject to tax or incurred in the operation of a business carried on for the purpose of producing income subject to tax, plus some specific restrictions on particular items. The double deduction of an expense (either by different companies in the same tax year or by the same company in different tax years) should be explicitly disallowed.
20. Theoretically another possible method of how to identify tax deductible expenses would be to elaborate a "positive list" of tax deductible expenses. However, this seems to be an almost impossible task which would be a potentially endless list of expenses that may be incurred by a business.
21. As mentioned above the general definition of tax deductible expenses is often complemented by a list of tax non deductible expenses (or by a series of historical court decisions on specific expenses which are to be considered as non-deductible) and this technique (the list) might be useful for CCCTB purposes as well. Restrictions on tax deductible expenses in existing tax systems generally

- cover three areas. Restrictions on expenses connected with the personal consumption, restrictions on immediate deduction of expenses that need to be capitalised and restrictions motivated by policy considerations. Items included in such a list (except capitalised expenditure) have to be considered and justified carefully, because disallowing a deduction for tax purposes means that the company needs to spend money after tax on them, which makes them more expensive.
22. Expenses that need to be capitalised have been discussed in detail in SG1 as well as capital gains and losses. It should be noted that if capital gains and losses are taxed as ordinary business income and the individual asset valuation for depreciation applied at the same time the tax residual value of assets should be tax deductible when an asset is disposed of. This is without prejudice to the specific rules for some situations as discussed in SG1 and the CCCTB WG (e.g. roll over relief).
  23. Expenses representing personal consumption are not as relevant for companies as for individual taxpayers. However in some cases companies may decide to spend money on the personal needs of their management and/or shareholders. It should be considered whether such expenses, where they represent taxable income for the managers of the company, should be deductible by the company on the basis that they are similar to wages. Although these are unlikely to be material the issue is complex because of the different rules across the EU for personal taxation – the harmonisation of which does not form part of the CCCTB.
  24. Several MS currently apply restrictions on luxuries, entertainment related expenses and representation expenses in general. The issue has already been touched in connection with the discussion on assets and the application of a business purpose test. The denial of deduction of these expenses may be considered also for the CCCTB; however, again, they should be disallowed only to the extent that the amount is not included in the taxable income of the beneficiary of the expenditure. The deductible portion of such expenses could also be limited to a fixed amount as is the practice in some MS.
  25. Tax administrations may try to discourage or penalise a particular activity for public policy reasons by restriction of deductibility of particular items. For example penalties, fines, bribes or similar illegal payments are made explicitly tax non deductible in many MS. In some cases it is the practice agreed on international level (for example the OECD anti-corruption agreement). It should be considered whether the CCCTB should attempt such a regulatory function and if so what expenses should be covered in this respect.
  26. A special consideration should be given to expenses that a company is obliged to spend according to non tax legislation, typically obligatory social security and health care contributions for employees. This question is already being discussed in SG2 in relation to legally required provisions and reserves.
  27. Besides deductions of business expenses the existing tax laws also allow the

deduction of some other items. The annual measurement of the taxable income and the fluctuation in economic performance of companies may result in the situation where deductible expenses exceed the income and the company suffers a loss. It is relatively common to allow companies to deduct such losses in subsequent (or sometimes also previous) years, but usually subject to special conditions and limitations. This is a very important element of a tax base and its function and form in the CCCTB will be discussed as a separate topic at later stage. Some MS also allow companies to decrease their tax liability by other items usually in the form of specific credits, and as these are aimed mainly at stimulating specific activities they should be discussed in conjunction with tax incentives.

**Members of the Group are invited to respond to the following questions:**

- *Do members agree that a general definition of tax deductible expenses, together with a list of specific tax non deductible expenses would be an appropriate technique for the CCCTB?*
- *What elements and characteristics do members consider to be important for tax deductible expenses?*
- *Which expenses should be treated as non deductible in the CCCTB and why?*

**IV. Recognition, timing and measurement**

28. The issue of timing rules for recognition of income and expenses is connected with the problem of the relation between financial accounting and taxation. The level of uniformity/disconnection between tax and financial accounting is different in different MS. Some MS have achieved substantial uniformity, in others, tax and financial accounting are substantially independent. Although some MS may prefer following the financial accounting treatment as closely as possible, this would be very difficult under the CCCTB. As already mentioned above the CCCTB does not include harmonising financial accounting across the EU. So with a common tax treatment there would have to be a breach in the link between tax and the financial accounting as the common tax treatment would be different from at least some of the national financial accounting treatments. Given the existing differences among the national commercial laws of the MS, simply relying on annual accounts for calculating the taxable income would not lead to the same results in different MS.
29. The taxable income is usually measured on an annual basis. A tax period will have to be fixed for the CCCTB purposes. For example, the calendar year could be supplemented by an option for any 12 month period. Some minor complications may occur in connection with this question. However specific situations such as special rules for transitional years, extended tax years (longer than 12 months) etc. should be discussed in connection with other procedural and administrative issues at a later stage.
30. Measuring the taxable income on an annual basis requires rules to allocate income

and expenses to particular tax years. In theory cash flow or accrual methods can be used. Under the cash flow basis system income is recognised when it is actually received and expenses when they are paid. Under the accrual basis, which is predominantly used in the financial accounting<sup>5</sup> (except for cash flow information), the revenues/expenses are recognised when they satisfy the definition and recognition criteria, which is in principle when the right to receive income or the obligation to pay expenses arises. The accrual method seems to be more accurate in respect of the reflection of the economic reality of companies and therefore should be used for the CCCTB purposes. It is also used in most current corporate income tax systems.

31. The rules for the recognition of revenues and expenses often follow from financial accounting. Many MS do not currently provide explicit tax rules, because the matter is already taken care of appropriately by the financial accounting rules. Since the CCCTB will not be able to rely on a harmonised system of financial accounting it will be necessary to establish fundamental tax accounting principles and adopt rules for particular types of transactions.
32. In financial accounting revenue is only recognised when it is probable that future economic benefits will flow to the enterprise and these benefits can be measured reliably. IAS 18 identifies the circumstances in which these criteria are met. Although the general principle applicable for recognition of revenue and expenses in taxation is similar emphasis should be put on different elements of the definition. Tax rules should indicate when the taxpayer is required to recognise revenue and allowed to recognise an expense in order to satisfy the purpose of tax base legislation, which is to measure the income in order to collect a portion of it as a tax. Generally it should be at the moment when an initial right to receive (in the case of revenues) and an obligation to pay (in case of expenses) is established.
33. Consequently it should be clear how to proceed if a claim or obligation changes after having been recognised or a taxpayer finds out that it has been recognised incorrectly. In some situations (generally falling within the latter group of cases mentioned above in relation to errors) the assessment for the tax year in which income or expenses were recognised should be reopened and adjusted, in others the adjustment can be allowed in the tax year when the change emerged.
34. It should be further analysed what tax solution is appropriate for transactions with a contingent component in the price and whether the contingent amounts should be attached to rights or obligations that arise when the condition precedent to further payment is met (e.g. the right to technological know-how sold for a fixed price plus an amount for each item produced with the know-how).
35. One of the areas where tax accounting rules differ is the treatment of revenue to which a future liability may attach or revenue that is related to goods or services to be provided in future taxable periods. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is

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<sup>5</sup> IAS 1 Paras 25-26

deferred and recognised as revenue over the period during which the service is performed<sup>6</sup>. Financial accounting attempts to measure income of a continuing business over an extended period and uses a variety of means to ensure that the calculation of income does not present a distorted view on long term profitability when a taxpayer's right to retain income is contingent on the provision of goods or services in the future or is otherwise associated with potential future liabilities. Tax rules should not be as concerned with qualifying or deferring recognition of income for the purpose of noting the taxpayer's future obligation as it measures annual profit to determine taxable income that should be subject to tax. They tend to recognise income when the taxpayers have control over it. The deferral of the recognition of revenue should be allowed only in specific situations and under prescribed conditions in taxation.

36. Special attention has to be paid to situations when a taxpayer continues to receive the payment for products or services that are being delivered over a period of several years. In financial accounting what is assessed is whether the seller retains significant risks (e. g. a customer is entitled to return the product and receive a full refund) connected with the sold items or not<sup>7</sup>. The revenue is then usually spread over the periods during which the retention right is uncertain or the possibility of related expenses remains. Revenues and expenses that relate to the same transaction are recognised simultaneously (matching of revenues and expenses) but revenues cannot be recognised if the likely expenses related to them cannot be measured reliably in financial accounting<sup>8</sup>. A different approach to such situations is common in taxation. It may be acceptable to allow deferring recognition of revenue which is subject to repayment, i.e. when there is a risk that the company will have to return the revenue. Deferring the recognition of revenues is not generally acceptable in taxation merely because its receipt may give rise to future expenses. Actual solutions for this situation vary in different jurisdictions and are also nuanced for particular situations, for example provisions for future claims against the company may be established. In general it could be acceptable also for the CCCTB purposes to spread the amount prepaid over the period during which goods or services are delivered as customers lose their rights to refunds. It may be disputable whether revenues related to services and goods over which customers have no claim of right should be recognised immediately.
37. Companies also enter into contracts extending over several years. Allocation rules for activities and related revenues and expenses to particular years are necessary both in the financial accounting and taxation. In practice this problem is mainly associated with construction contracts. An overall price and method of payment is usually set in the contract. It can be either a fixed price (also fixed rate per unit), which in some cases may be subject to cost escalation clauses (a fixed price contract) or a reimbursement for allowable or otherwise defined costs plus a percentage of these costs or a fixed fee (cost plus contract)<sup>9</sup>. IAS suggests a

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<sup>6</sup> IAS 18 Para 13

<sup>7</sup> IAS 18 Paras 16, 17

<sup>8</sup> IAS 18 Para 19

<sup>9</sup> IAS 11 Para 3

percentage of completion method for allocation of revenues and cost to particular years. Based on that the recognition of revenue and expenses is done by reference to the stage of completion of a contract, i.e. the revenue and expenses is recognised in the periods, in which the work is performed<sup>10</sup>. This method could be acceptable for the CCCTB purposes but current practice across the EU varies. The principal issue that would require more analysis, discussion and guidance is how to measure the percentage of the contract completed during the taxable year. The percentage of completion method is generally applied in financial accounting only when the outcome of a construction contract can be estimated reliably. When the outcome of a construction contract cannot be estimated reliably no profit is recognised until the contract is substantially performed. This approach does not seem to correspond very well to the principal purpose of taxation and may give rise to an unwarranted deferral of tax.

38. Some consideration needs to be given to payments in instalments. Pro rata allocation over the payment period or recognition of the entire sale price at the time when the contract commences could be possible solutions, although the precise terms of the contract *vis a vis* when the obligation to pay becomes unconditional is important. When assuming that the return of costs and profit on the whole transaction is spread equally over this period the pro rata basis seems to be more appropriate. The final solution has to be carefully coordinated with such related issues as the treatment for tax depreciation of assets by the economic owner and any subsequent capital gains in order to minimise disproportionate advantages arising from any deferral of income under a pro rata revenue recognition approach. The immediate recognition at the commencement of the contract simulates the situation of a sale for full price combined with a loan from the seller to the purchaser at the time of sale.
39. Taxable income should be measured in one currency. The actual method used for translating amounts denominated in other currencies in financial accounting (e.g. valuation according to the exchange rates announced by the central bank), could be replicated in the CCCTB without any major problems. It does not seem crucial that all companies use the same method. It is more important that a company uses one method consistently during the whole taxable year. Currency translation can be done on a transaction by transaction basis, i.e. all revenue and expenses should have an equivalent in for example Euros or where the transaction by transaction basis is too cumbersome an average rate for the period could be used (e.g. tax accounting for a permanent establishment/subsidiary outside the Euro zone).
40. A related issue is the tax treatment of foreign currency exchange gains and losses. The currency translation rules mentioned above apply when determining the amount for initial recognition. Companies often hold foreign currencies or hold loans and debt claims and receivables denominated in the foreign currency for periods during which exchange rates move. Accordingly, if the exchange rate at the date when the receivable or liability arises is different from the one at the

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<sup>10</sup> IAS 11 Paras 22-31

moment of payment or more precisely at the exchange day, a foreign currency exchange gain or loss arises.

41. Foreign currency holdings may be subject to an annual valuation and recognition of gains and losses may be done on accrual basis. A similar approach is sometimes adopted in respect to financial instruments and it is important that the treatment of foreign currency exchange gains and losses is consistent with the treatment applicable to financial instruments. In cases of assets/receivables and liabilities denominated in foreign currencies these may be recalculated when the income is actually received or the expense paid so that the actual foreign exchange rate is reflected. This solution would often require reopening previous tax years which may represent an administrative burden particularly if the tax base extends to more tax jurisdictions. It is also possible to make the correction in the tax year when the income is actually received or the expense paid and attribute it either to the specific account to which the amount relates or to recognise the difference simply as a foreign currency gain or loss without an attempt to change the underlying account by attributing the amount to the underlying transaction (which is probably the simplest possibility from administrative point of view). Foreign currency exchange gains and losses (or some of them) can also be taken into account on a realisation basis. Providing the foreign currency holding represents an asset/liability such an approach would be consistent with the suggested directions on unrealised capital gains and losses<sup>11</sup>. If foreign currency gains and losses are recognised only when realised, members of the group may wish to discuss whether the deduction of foreign currency exchange losses should be allowed only against foreign currency exchange gains or all capital gains or against the taxable income without any limitation.
42. It will be also necessary to agree on a common treatment of government grants and public subventions, subsidies or premiums. Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are attached to it. Some grants relate to assets and a company qualifying for them is obliged to purchase, construct or otherwise acquire a long-term asset with the assistance received. Other grants relate to income. In some systems the benefit represented by the grants is not taxed. It may be classified as non taxable or exempt. Specific rules on the treatment of connected expenses (e.g. when the acquired asset is capitalised, disposed of or expensed) need to be adopted in such cases. The purpose of such rules is to avoid giving a double benefit in the form of a tax deduction for expenses connected with the asset acquired with the grant, as well as an exemption of the grant itself. In accounting government grants should be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They should generally not be credited directly to the shareholders' interest<sup>12</sup>. Theoretically two broad accounting approaches exist to the treatment of government grants. The first (the capital approach) credits the

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<sup>11</sup> Commission Working Document "Capital Gains and Losses" CCCTB\WP\010\doc, Paras 15-19

<sup>12</sup> IAS 20 Para 12

- grant directly to shareholder's interest and the second (the income approach) considers a grant as an income over one or more periods. If the income approach can be also accepted for taxation, the connected assets can be capitalised (the grant would increase the depreciable basis) or expensed in ordinary way.
43. The acquisition and disposal of inventories should be subject to a specific treatment in relation to acquisition and disposal of potentially depreciable assets in both taxation and the financial accounting. A primary issue in the financial accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised<sup>13</sup>. Taxation seeks to ensure that the deduction for the cost of inventory is not allowed until the inventory is sold.
  44. The term "inventories" is not often specifically defined for corporate income purposes and takes its usual meaning. IAS 2 defines inventories as *assets held for sale in ordinary course of business; in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services*<sup>14</sup>. Such a definition should be acceptable also for the CCCTB purposes. For an asset to qualify as inventory the circumstances under which it is acquired and held are important. The same asset may be inventory in the hands of one company but not in hands of another.
  45. Several methods exist to calculate the cost of inventory to be recognised and allowed as a deductible item in a particular tax year. The result should be equal to opening inventory plus cost of inventories acquired during the particular tax year minus closing inventory. A number of technical issues related to treatment of inventories (for example, valuation of inventories, valuation and recognition of inventories manufactured or constructed by company itself, the allocation method for interchangeable items and the treatment of loss on inventories) will require more analysis and discussion. Although the distinctions in treatments in existing national MS systems do not seem to be profound, it would be useful to examine preferable options, for example whether LIFO, FIFO or averaging should be the agreed valuation basis.
  46. Accruing liabilities that will not have to be satisfied until future tax years is addressed by the creation of reserves, provisions and accruals in financial accounting. Specific conditions have to be met for recognitions of accrued liability in taxation and this particular issue is under discussion in SG2.
  47. For the sake of completeness it should be mentioned that some corrections to the amount of taxable income will be needed for bad debts representing receivables that have already been included in the taxable income of a company, although the company has not received the underlying amount and is not likely to receive it in the future. This particular issue is also being dealt with in SG2.

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<sup>13</sup> IAS 2 Para 1

<sup>14</sup> IAS 2 Para 6

**Members of the Group are invited to respond to the following questions:**

- *Do members agree with the general comments above on the importance of the concepts of recognition, timing and measurement, and do they wish to make any specific comments at this stage?*
- *Do members wish to comment on the particular areas mentioned – e.g. income deferral, long term contracts, exchange gains and losses, government grants and inventories; and do they wish to mention any additional areas at this stage?*

**V. Concluding questions for discussion**

48. Many technical issues and questions arise in connection with the calculation of taxable income. The identification of appropriate solutions for the CCCTB requires further analysis and focused expert examination. A detailed discussion on these issues in a sub-group appears to be the best working method.

**Members of the Group are invited to respond to the following questions:**

- *Do members of the group agree that further technical analysis and discussion should be carried out in a new subgroup? If so, are any members able to indicate now whether they would like to participate and/or chair the sub-group?*
- *Do members wish to comment further on how the sub-group should address the issue?*
- *Do members of the Group want to add or amend anything to this paper for example do they think that it covers all the important issues relevant for the calculation of the taxable income to be covered in the CCCTB?*