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This article argues that a higher degree of book-tax conformity can be achieved through improved documentation requirements and in particular country-by-country reporting. The separate systems for financial and tax accounting use different definition of profits leading to confusion, less transparency and simplicity and in the end distrust in corporate governance. At the same time higher book-tax conformity cannot be achieved without incurring different costs and sacrificing information value of earnings. In addition, financial and tax accounting build on different founding principles and the question is whether an alignment of these two systems is possible at all. This article shows how country-by-country reporting and other similar initiatives make it possible to achieve higher book-tax conformity, whilst at the same time avoid the pitfalls and the costs usually caused by the increased convergence.

1 Introduction

The recent cases of Starbucks, Amazon and Google illustrate how companies with extremely high profits can still pay no or very little tax. The key problem with this kind of statements is what should be understood by profit? Is it the accounting profit or the profit for income taxes? Is it the worldwide profit or the profit from a particular country? And how can we compare one profit with another? The abovementioned questions show the increasing need for transparency and understanding of financial and tax documentation. Moreover, given their nature, these questions need to be analysed and answered in the context of book-tax conformity. The separate systems

1 H. van den Hurk, ‘Starbucks versus the people’, Bulletin for International Taxation, January 2014, p. 27-34
for financial and tax accounting use different definition of profits leading to situations when firms with very high accounting profit can have a very low profit for income taxes. This lack of alignment (or conformity) between financial and tax accounting, also referred to as the book-tax gap, can easily lead to confusion, less transparency and simplicity and in the end distrust in corporate governance.\(^2\) From a logical point of view, convergence of both systems could help overcome these problems and perhaps even achieve true profit. However, as often the case, higher book-tax conformity cannot be achieved without incurring costs. The most important consequence of higher book-tax conformity are earnings which are less informative\(^3\). This leads to a paradox where in order to achieve more transparency and simplicity we have to sacrifice the information value of earnings. In addition, financial and tax accounting build on different founding principles and the question is whether an alignment of these two systems is possible at all. From this point of view, only a partial, rather than full convergence could be achieved and therefore the lack of transparency and simplicity would still exist.

The previous paragraphs consider book-tax conformity only from a particular perspective: the alignment can only be achieved by using the same definition of profit for both financial and tax accounting. On the contrary, book-tax conformity, and the increased transparency in particular, can also be achieved from a more global perspective. The improved documentation requirements, such as improved transfer pricing documentation and country-by-country reporting proposed in the OECD Action Plan on Base Erosion and Profit Shifting (BEPS)\(^4\) as well as other international initiatives aim to achieve the goals of higher book-tax conformity through bridging the reporting gap while avoiding the pitfalls of full alignment of financial and tax accounting.

This article argues that increased book-tax conformity can be achieved through improved documentation, in particular in the field of transfer pricing, and country-by-country reporting. The next section describes the problems of the alignment of financial and tax accounting and


provides arguments for and against increased conformity. The third section analyses the proposed changes to transfer pricing documentation and the introduction of country-by-country reporting. Also other international initiatives are briefly analysed. The fourth section argues how improved documentation and country-by-country reporting achieves the goals of higher conformity, while, at the same time, avoids the problems caused by full conformity. The article ends with a summary and a short evaluation.

2 Book-Tax Conformity

2.1 Sources of book-tax differences

From its origin, tax law and tax accounting build on the financial accounting systems. Most tax systems use the accounting earnings as a starting point and allow for specific adjustments and exceptions in order to arrive at taxable income. The increasing number of these tax-only provisions increases the divergence between financial accounting and tax accounting. The presence of these tax-only provisions corresponds to the different objectives of financial and tax accounting. Financial accounting standards are designed to capture the economics of transactions in order to provide information relevant for the decision-making process of different stakeholders. Tax rules, on contrary, reflect much more a political process. Governments are using tax provisions to raise revenue, stimulate particular behaviour and provide incentives for the economy as a whole. Despite the use of the accruals approach as a starting point, tax systems are in fact a combination of accruals and cash-based approach. Companies are often not allowed to account for expenses before they occur, but also do not have to report income before cash is received. In addition, tax rules focus much more on the location of profit to appropriate tax jurisdiction instead of only the

timing of the recognition of profits. In contrast, a consolidated financial statement would show the total (consolidated) income of the whole group.

Another possible source of book-tax differences is aggressive reporting for book or tax purposes. In general, managers would have an incentive to report high accounting earnings and, at the same time, a low taxable income. A large body of literature provides evidence about the information contained in the income tax expense and book-tax differences. The idea that book-tax differences provide information about earnings quality corresponds to the view that taxable income is an alternative measure of performance, an additional benchmark, of financial accounting earnings. Hanlon et al. (2005) found evidence that financial accounting earnings provide more information to the market than taxable income. However, both income measures provide incremental information to investors.

The different sources of book-tax differences result in three types of book-tax differences: temporary differences, permanent book-tax differences and income tax expense related differences. Temporary differences are differences in the timing of recognition between book and taxable income. Temporary differences comprise differences resulting from different depreciation allowances or recognition of bad debt and warranty reserves. Permanent book-tax differences are differences in what is recognized as income and which never reverse, such as municipal bond interest (recognized as income for accounting purposes, but not for tax). The last type of book-tax differences are differences which do not affect pre-tax earnings, but affect the income tax expense, and thus only the after-tax income. Since the last type of book-tax differences does not find its origin in the when question, but rather in the who question, it is often generated by the already

mentioned allocation of profits between the different entities of the same group for tax purposes.\textsuperscript{11}

### 2.2 The benefits of book-tax conformity

Proponents of higher book-tax conformity argue that better alignment of financial and tax accounting would reduce compliance costs, improve corporate governance and allow for a combination of a broader taxable base and a lower tax rate reducing the potential for tax aggressiveness.\textsuperscript{12} Operating two separate accounting systems creates obviously additional operating costs for firms. These costs are even higher because of employing two groups of people with the specific expertise associated with each particular system. If there was only one system, and one profit figure, no (tax-only) adjustments would be required. More conformity would not eliminate compliance costs, but clearly some reduction in costs would result.

Also the corporate governance view of taxation has implications for the benefits of a greater degree of alignment between financial and tax reporting. This perspective implies that higher conformity of book and tax reporting would reduce the freedom managers have in characterizing their profits.\textsuperscript{13} More specific, a system with a higher degree of conformity results in an additional monitor for the tax authorities, to assess the same profit reports that financial investors receive. Moreover, managers cannot use the distinction between book and tax reports to report high accounting earnings and at the same time low taxable income. Finally, taxes paid by firms become automatically observable to shareholders, thereby increasing the transparency of accounting and tax reports as well as of the overall economic activity of a company.

Moving towards a higher degree of alignment on the broader base of financial accounting profits could also allow for a revenue-neutral

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reduction of the corporate tax rate. However, despite the notion that accounting profits are closer to the true economic profits, it is rather questionable whether the increased conformity would indeed follow the financial accounting profits. First, the notion that accounting profits are closer to the true economic profits builds on the assumption that the book-tax gap reflects tax avoidance activity. Given that many of the tax-only provisions are designed to achieve policy decisions about what should be taxed and when it should be taxed, this assumption is highly uncertain. Second, since tax rules are a result of a political process, it is doubtful whether the national governments would give this decision making power to organisations like the Financial Accounting Standards Board (FASB) or the International Accounting Standards Board (IASB). In fact, such a move could be even prohibited by national law.

2.3 The costs of book-tax conformity

Whereas there is not much to comment on the possible benefits of a better alignment of financial and tax accounting, higher conformity cannot be achieved without incurring substantial costs. One of the most important reasons why book-tax conformity is so difficult to achieve, or perhaps should not be achieved at all, are the different objectives of accounting standards and tax standards. The objective of financial accounts is to provide a range of relevant and reliable figures to a variety of stakeholders. To achieve this, accounting standards as opposed to tax rules, provide guidance instead of detailed rules and make available a range of options to be applied according to the management judgment. Whereas tax rules require a definitive figure, financial accounts put more emphasis on complementary notes. Therefore, there is no sole or common definition of profits that suits both systems. Obviously, these abovementioned differences correspond with the objectives of tax systems. Tax systems must raise revenue, taking into account equitability and efficiency between taxpayers. These requirements result in rather objective rules, which take into account taxpayer’s capacity to pay tax and administrative efficiency in collecting tax. One of the most notable implications of this approach is the use of

the realization principle: without liquid assets there is an obvious difficulty in paying taxes. Financial accounts would follow in this case a perfect market perspective, where borrowing money against unrealized profits would solve the liquidity problem. In the real world, such a transaction would not only imply transaction costs but also a risk premium. In addition, while financial accounts should reflect fair value accounting, it is much less sensible to tax on the basis of volatile accounts. Finally tax systems are used by governments to deter or incentivise certain behaviour and for public policy purposes, for example allowing for a faster depreciation.

The result of the different founding principles is that full convergence would not be achieved and should not be achieved. In fact, the end result would only be partial convergence, thereby distorting the most important benefits of conformity: lower compliance burdens and improved corporate governance.

A higher degree of conformity between financial and tax accounts would lead also to a substantial information loss at the level of earnings. As already mentioned both financial accounting earnings and taxable income provide incremental information to investors. Therefore, if book and taxable income were conformed to one measure, the markets would suffer an information loss, because both measures provide incremental information and one of the two would be gone with conformity. However, the crucial assumption here is that if book and taxable income were confronted to one measure, the book income would follow the definition of taxable income. Whereas this assumption does not have to be true, for already mentioned reasons, it is reasonable to assume that this would be the case. National government would not be willing to give up their decision making power in cases of taxation and, in fact, they may not be even allowed to do so.

In addition to the information loss by abandoning one of the measures, the value relevance of financial accounting earnings is lower when private-sector bodies, such as FASB or IASB, are not involved in the standard-setting process. Thus, if under a conformed income regime, the national governments set the rules, an additional information loss to the market would be the result. Therefore, despite the obvious desire for more transparency, more simplicity and improved corporate governance, higher book-tax conformity may be not the best way to achieve this objective.

3 The New Documentation Requirements and Country-by-Country Reporting

Recently, different international and European organisations proposed changes to accounting and tax reporting requirements. Examples include Action 13 of the OECD Action Plan on Base Erosion and Profit Shifting (hereafter referred to as the BEPS Action Plan)\(^\text{17}\); EU Directive on Accounting and Transparency (hereafter: Accounting Directive)\(^\text{18}\); and the EU Capital Requirements Directive (CRD IV)\(^\text{19}\). A common element of these proposals is the mandatory country-by-country reporting. The following sections describe the particular initiatives and the specific requirements. The article focuses mainly on the changes to documentation requirements proposed in the BEPS Action Plan. After an overview of the regulations, the fourth section will analyse their significance for book-tax conformity.

3.1 OECD transfer pricing documentation and country-by-country reporting

In the BEPS Action Plan of 19 July 2013, the OECD was directed to "develop rules regarding transfer pricing documentation to enhance transparency for tax administrations, taking into account the compliance


costs for businesses. The rules to be developed will include a requirement that multinational enterprises (MNEs) provide all relevant governments with the required information on their global allocation of income, economic activity and taxes paid among countries according to a common template (*country-by-country reporting*). In today’s globalized world, companies expand their activities across borders, thereby creating distortions in international taxation. This highlights the importance of transfer pricing activities, especially by MNEs. However, the effectiveness of transfer pricing activities is significantly reduced by the asymmetry of information between taxpayers and tax administrations. In turn, this undermines the compliance with the arm’s length principle and creates opportunities for aggressive tax planning.

Therefore the re-examined rules on transfer pricing documentation should enhance transparency for tax administrations and tackle base erosion and profit shifting schemes. Both goals help to bridge the gap between financial and tax positions in the context of book-tax conformity. Whereas enhanced transparency allows approaching conformity from a global perspective, tackling base erosion and profit shifting focuses mainly on the application of different regulations.

With the Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting the OECD provides guidance on the rules and requirements. In the Discussion Draft, the OECD explains that despite the significant increase in compliance cost for taxpayers, tax authorities often find the current transfer pricing documentation to be less than fully informative and not adequate for their tax enforcement and risk assessment needs.

Therefore, the OECD identifies three objectives to be addressed by the new regulations:

1. To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment;

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To ensure that taxpayers comply with the arm’s length principle and report the income derived from such transactions in their tax returns; and

To provide tax administrations with the information necessary to conduct an appropriately thorough audit of transfer pricing practices of entities subject to tax in their jurisdiction.

The objectives identified by the OECD correspond to the more general objectives of the re-examined transfer pricing documentation requirements described earlier. A common element of the abovementioned objectives is the efficient provision of information. In the context of book-tax conformity, especially the second objective seems to address the reporting gap between financial and tax accounting.

The OECD answers to these objectives by proposing a two-tiered approach to transfer pricing documentation. This two-tiered approach consists of a master file containing standardised information relevant for all MNE group members, and a local file on the material transactions of the local taxpayer. As will be explained later, it is the combination of these two files, which enables a more global approach to book-tax conformity and in turn bridges the reporting gap. The master file should give a complete picture on the global business, economic activity, financial reporting, tax positions and the allocation of the MNE’s income.

More specific, the part on financial and tax positions includes among others the MNE’s annual consolidated financial statement for the fiscal year concerned and an overview of relevant tax ruling on the allocation of income to a particular jurisdiction. In addition, the section of the master file on financial and tax positions includes country-by-country reporting on the global allocation of profits, taxes paid, and certain indicators of the location of economic activity.

The local file concentrates on compliance with a local country’s tax system. In particular, the local file should assure that the taxpayer complies with the arm’s length principle. In addition, the local file should provide financial information on the annual local entity financial accounts and more importantly allocation schedules showing how the financial data used in applying transfer pricing methods may be ties to the annual financial statements. In this way, both the master file and the local file, provide information relevant to the sources of book-tax differences. Specifically, this combined approach focuses on the third type of book-tax differences: differences resulting from the allocation of income to specific tax jurisdictions, thereby affecting the income tax expense and, in turn, the after-tax income. However, the provided information can be used to assess the magnitude of the permanent
differences and to a lesser extent also the timing differences; respectively the second and first type of book-tax differences.

3.2 The EU Directives on Accounting and Transparency

The new Accounting Directive concentrates on strengthening the existing language in the corporate governance statement regarding the disclosure of financial and non-financial information. The new Accounting Directive applies to EU public interest entities and large EU undertakings in the extractive industries and the logging of primary forests. This includes undertakings involved in the extraction of crude petroleum or natural gas, or involved in the mining and quarrying of various resources. The Accounting Directives requires the parent company to prepare a consolidated report, if any of its subsidiaries is active in the abovementioned industries. However, such a report should only include payments resulting from those activities.

As is the re-examined transfer pricing documentation requirements of the OECD, also the new Accounting Directive includes mandatory country-by-country reporting. The key objective is to promote greater trust to the European investors and to ensure more consistency with other documentation requirements, such as the already described transfer pricing documentation and the EU Capital Requirements Directive. In order to achieve this objective, companies are required to disclose the payments made to governments in each country they operate in, and for each project when the payment has been attributed to a certain project. The types of payments that should be reported include: turnover; profit or loss before taxes; taxes on income, production or profit; royalties; dividends; license fees and other considerations for licenses and concessions. Companies are required to report both the total amount of payments to each government during the year concerned, and the total amount per type of payment to each government.

In addition, management reports should provide for a fair and comprehensive view of policies, results, and risks taken by an entity.

Therefore, management reports should include non-financial statements contacting information on policies, results and risks related to environmental matters, social and employee-related matters, human rights, (anti-)corruption and bribery matters. The new Accounting Directive emphasizes that social matters include also behaviour on tax planning and tax avoidance.

3.3 The EU Capital Requirements Directive (CRD IV)

Also the EU Capital Requirements Directive (CRD IV) aims at increasing tax transparency and trust in the financial sector. Recital 52 to the Directive states: ‘increased transparency regarding the activities of institutions, and in particular regarding profits made, taxes paid and subsidies received, is essential for regaining the trust of citizens of the Union in the financial sector. Mandatory reporting in that area can therefore be seen as an important element of the corporate responsibility of institutions towards stakeholders and society’. In particular, Article 89 of CRD IV requires institutions to disclose profits and turnover, profit taxes, government subsidies, number of employees and the geographical location of activities on a country-by-country basis. Article 89 of CRD IV applies to EU ‘institutions’ as defined in the associated Capital Requirements Regulations. In general, the term ‘institutions’ includes banks, building societies and other credit institutions as well as investment firms as defined in the Markets in Financial Instruments Directive, subject to certain exclusions.

In accordance with the EU Accounting Directive, also the CRD IV requires companies to publicly disclose information on their operations; public subsidies received; number of employees in every country; and name(s), nature and geographic location of activities. However, contrary to the proposed country-by-country reporting and the EU Accounting Directive, the CRD IV requires country-specific data on profits and losses as well as tax payments to be reported only to the European Commission. In addition, entities are required to disclose all the information on a consolidated basis and in accordance with international accounting standards. Although, the CRD IV requires

national legislation of the Member States to implement it and therefore it is up to Member States to define the terms including ‘turnover’, ‘profit or loss before tax’ and ‘corporation tax paid’, the expectation is that the definition of these terms will be consistent with that in the institution’s financial statements. In practice this will imply, that institutions will have to use an accounting approach for consolidation either in accordance with the International Financial reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP). 25 Thereby the CRD IV seems to go even further in closing the (reporting) gap between financial and tax accounting and achieving a higher degree of book-tax conformity.

In addition to increasing the alignment between book and tax accounting, the CRD IV, and to lesser extent the re-examined OECD transfer pricing documentation requirements, show an interesting movement. Both initiatives seem to give more attention to the cash effective tax rate (CETR) instead of the effective tax rate (ETR). In combination with the possibility to report additional information on current tax and deferred tax as well as other taxes paid beyond corporation tax, the CRD IV provides information on long-term tax avoidance. 26 In turn this may further increase the book-tax alignment.

3.4 Summary

The described initiatives, though different in scope, share identical objectives and contain common elements. The general objective is to increase transparency and corporate responsibility. Common documentation requirements include disclosures on the economic activity, number of employees, turnover, income or loss before tax, as well as corporation tax paid. Moreover, all the initiatives require an allocation of these factors on a country-by-country basis. In addition, it seems that this information has to be disclosed in accordance with international accounting standards.

4 A New Approach Towards Book-Tax Conformity

The proposed changes to reporting requirements and the introduction of country-by-country reporting create a possibility to achieve a higher degree of book-tax conformity without incurring the costs of a better alignment. The reason why the re-examined documentation regulations create this possibility is directly linked with the sources and types of book-tax differences as well as a different approach towards this issue. As previously explained, book-tax differences find their origin in the existence of tax-only provisions leading to different definitions of income for book and tax purposes as well as aggressive reporting. Whereas the new documentation regulations do not directly tackle the first source of the differences, they do align the reporting requirements for book and tax purposes. In terms of types of book-tax differences, the proposed changes, and in particular the OECD Transfer Pricing Documentation and country-by-country reporting requirements, address mainly the third type of differences, and to a lesser extent the first and the second type. The third type of differences deals with differences resulting from the allocation of income to specific tax jurisdictions. Under the new approach, the allocation of income to specific tax jurisdictions is not eliminated, which would be certainly undesirable, but becomes more transparent.

One of the most important arguments in favour of country-by-country reporting is that companies would be encouraged to pay their ‘fair-share’ of taxes as well as that country-by-country reporting tackles international profit shifting (especially through transfer pricing). The question whether this is indeed the case goes beyond the scope of this article. However, higher book-tax conformity can decrease managers’ latitude for characterizing their profit and in turn, also aggressive reporting and tax avoidance practices, thereby improving the process of corporate governance.

Since the re-examined documentation requirements and country-by-country reporting do not aim at achieving a single definition of profit for both the book and tax purposes, the new approach avoids the pitfall of combining two systems with different founding principles. Financial accounts can still provide information relevant for the different stakeholders, whereas tax systems can still be used to address tax policy objectives and ensure equitable and efficient enforcement of tax law. In addition, higher book-tax conformity through improved reporting requirements and country-by-country reporting do not decrease the information value of earnings. Once again, since the book and tax
income will not be conformed to one measure, both will still provide investors with incremental information. On the contrary, additional disclosure of tax information may provide investors with even more information and appear beneficial from the point of view of capital markets. Murphy (2009) shows how knowing the geographical location of multinationals’ operations potentially enables the investors to better assess the companies’ geopolitical risk and the sustainability of its tax liability.\(^ {27}\) Also private bodies like FASB and the IASB will still be involved in the standard-setting process. The re-examined documentation requirements and country-by-country reporting achieve the main objective of a higher degree of book-tax conformity: increased transparency and simplicity. Yet, country-by-country reporting is still suspected to cause several direct disclosure costs as well as implicit costs.\(^ {28}\) Direct disclosure costs result from adjusting the existing systems and processes to the requirements of country-by-country reporting. In addition, direct costs will be incurred on a regular basis depending on the scope of disclosure requirements, materiality thresholds and the need for the auditing of the report. However, some authors argue that numerous existing financial reporting systems are already technically able to provide country-specific data, and that the necessary information can be found in financial and internal accounts as well as in tax returns.\(^ {29}\) Moreover, the relevant tax authorities can be seen as an additional monitor of the quality of not only tax returns, but also of the relevant information in general. Besides the direct costs, also implicit costs may result from country-by-country reporting, stemming in particular from disclosing the information to the public. Diverse authors argue that country-by-country reporting may lead to considerable competitive disadvantages, especially if the new regulations were not mandatory for all companies. Public disclosure of information may further appear ineffective in interpretation because of

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27 R. Murphy, ‘Country-by-country reporting – holding multinational corporations to account wherever they are’, (Task Force on Financial Integrity and Economic Development, 2009)
29 R. Murphy, ‘Country-by-country reporting – holding multinational corporations to account wherever they are’, (Task Force on Financial Integrity and Economic Development, 2009)
lack of profound knowledge by some parties and cause wrong accusations. Evers et al. consider as a disadvantage that country-by-country reporting and the related provisions on tax disclosure cannot be based on extended financial accounting standards.\textsuperscript{30} In their opinion neither consolidated nor individual statements can serve as a suitable basis for country-by-country reporting. Therefore, the information should be disclosed in a separate tax-specific template; consistent with the point of view of the OECD. Yet, a tax-specific template is just what contributes to the convergence of book and tax accounting standards. Using financial accounting standards as a ‘platform’ for country-by-country reporting could in fact limit the potential for explaining the book-tax differences. By requiring companies to report also the non-financial information, mainly related to the nature and magnitude of the economic activity, a more global approach towards better alignment will be possible. Instead of focusing on aligning the particular regulations of financial and tax accounting, the global position of the company will be shown. The allocation of the total economic activity would not lead to book and tax figures being the same, but ensures that they represent the economic activity in a particular country or jurisdiction.

5 Conclusion

The recent high profile cases of companies reporting high accounting income and still paying no or few taxes, highlight the importance of book-tax conformity. A higher degree of book-tax conformity will increase transparency and simplicity, lower compliance costs and improve corporate governance. However, the different sources and types of book-tax differences make it difficult to achieve a higher degree of conformity without incurring different costs, such as lower earnings informativeness. In addition, the different founding principles of financial accounting standards and tax rules, question whether full conformity is possible at all. This article does not argue whether country-by-country reporting will limit international profit shifting. The article does argue that a higher degree of book-tax conformity can be achieved through improved

\textsuperscript{30} M.T. Evers, I. Meier & C. Spengel, ‘Transparency in financial reporting: is country-by-country reporting suitable to combat international profit shifting’, Bulletin for International Taxation 68 (6/7), 2014
documentation requirements and country-by-country reporting. Different initiatives like Action 13 of the OECD Action Plan on Base Erosion and Profit Shifting; the EU Directives on Accounting and Transparency; and the EU Capital Requirements Directive (CRD IV), make it possible to achieve higher book-tax conformity, whilst at the same time avoid the pitfalls and the costs usually caused by the increased convergence.

The re-examined documentation requirements and country-by-country reporting do not affect the different principles of financial and tax accounts. Also, they do not decrease the earnings informativeness, caused by conforming financial accounting methods to tax accounting methods. Instead, by providing information on the allocation of income between different jurisdictions the new reporting disclosures directly tackle the third type of book-tax differences. Moreover, through giving insight in the overall economic activity of the business, the new documentation requirements and country-by-country reporting allow for a more global approach towards conformity. The goal is not, and should not be to achieve a single set of rules. Instead, the different sources of book-tax differences should be explained, through increased transparency and improved corporate governance.