


IFRS: Tax implications for the EU financial services industry – are you ready?*

IFRS – Global Reporting Revolution

November 2006



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Introduction

It is now almost two years since the date (1 January 2005) from which EU-listed companies were first required to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS).¹ Indeed, the second phase of the consolidation of accounting practice across listed companies within the EU (the convergence of the domestic GAAP in the various EU territories with the principles of IFRS) is now under way in some territories.

Although the migration of accounting practice to IFRS is by no means complete, it has at the very least moved a long way down the track and is on the way towards completion. The same cannot, however, be said of the adoption of IFRS-based accounts for taxation purposes across the EU member states. At the present time, there is a wide divergence of views among the tax authorities within the various member states as to the appropriateness of allowing adoption of IFRS accounts as a basis for computing profits for corporate income tax purposes. This has led to different approaches being applied in different member states, ranging from those which have taken positive action to amend their taxation laws to

accommodate the principles of IFRS (such as the UK and Republic of Ireland) to others which, at this stage, do not allow IFRS-based accounts to be used as a basis for computing taxable income (such as France and Germany).

Some of the biggest issues associated with the adoption of IFRS for accounting purposes arose in relation to the financial sector, such as the controversial issues associated with the accounting standard dealing with financial instruments – IAS 39. For similar reasons, many of the taxation issues associated with the adoption of IFRS are particularly acute for financial sector institutions. For this reason, we felt that the financial sector was the most appropriate community of

taxpayers in which to explore some of the tax issues arising from the adoption of IFRS. In exploring the practical impact of these issues we have drawn, in particular, on the experience of dealing with these in the UK banking sector, since they have been acute and the subject of much debate between taxpayers and the UK tax authorities.

In the first part of this discussion paper, we explore some of the reasons why there is such a cross section of different views in relation to the appropriateness of using IFRS-based accounts as a basis for computing income for taxation purposes. In doing this, we will look at some of the fundamental concepts underlying IFRS and consider the question: 'Are these



compatible with the fundamental concepts of a fair tax system?’ We will also explore some of the financial sector issues where the tension between IFRS and taxation principles is most acute.

In light of this conceptual backdrop, in the second part of this paper we go on to look at the alternative ways in which a tax authority may choose to approach the interaction of IFRS and tax from a policy perspective, and the practical consequences of the different approaches. We will also seek to answer the question: ‘Which of these approaches is the best?’

In the final part of this discussion paper, we provide a snapshot of the approaches being adopted by the tax authorities across the various EU member states at present. We then go on to consider how these approaches will influence the way in which adoption of IFRS for financial statement purposes will manifest itself in these territories for taxation purposes going forward. In particular, we seek to answer the question: ‘Is the IFRS transition a matter for accountants alone?’

We expect this to be an area of ongoing debate in the tax world for some time to come and we hope that this document will put you in a position to join that debate.

This publication deals with the tax policy issues associated with IFRS. In future publications we plan to explore some of the tax issues associated with other accounting developments under IFRS, including provisioning for uncertain tax positions and disclosure of tax in the accounts.

David Newton

¹ Pursuant to IAS Regulation 1606/2002, listed companies within the EU are required to prepare their consolidated financial statements in accordance with IFRS for accounting periods commencing on or after 1 January 2005.

IFRS can be described as essentially ‘investor focused’. The rationale underlying this investor focus is basically that if the financial information produced satisfies the needs of investors, it should also, by definition, meet most of the needs of other users of the financial statements. Are the fundamental principles underlying IFRS appropriate from a tax perspective?

Part 1: Are IFRS accounts an appropriate basis for computing taxable income?

This is the fundamental question that many tax authorities and tax professionals have been grappling with since the EU-wide adoption of IFRS for accounting purposes became a reality following the passing of IAS Regulation 1606/2002 in 2002.

A single set of books for accounts and tax?

There are clearly attractions to having a close alignment between the measure of profits for commercial accounting and taxation purposes, not least the avoidance by taxpayer companies of the additional time and expense associated with the production of separate financial accounts and tax calculations. On a more macro level, the adoption of a common basis for computing taxable profits for all companies within the EU may also be attractive in terms of providing a first step on the road to the development of a common consolidated corporate tax base (CCCTB) for companies within the EU. However, this remains a controversial topic in itself.

Surrendering the reins of power

On the other hand, some tax authorities may feel uneasy about what might be

seen as surrendering the reins of their country’s tax system to an unelected body over which they have no control – namely the International Accounting Standards Board (IASB). This is likely to be most acute in those countries where the tax system is closely aligned with domestic GAAP (these are often referred to as ‘dependent’ countries) as compared with those countries where the tax system has developed separately from the accounting system (these are often referred to as ‘independent’ countries). As discussed in Part 3 of this paper, many of the countries within the EU can be described as ‘dependent’ countries for this purpose and are therefore likely to feel the effects of the IFRS transition at a tax level. Consequently, it can be expected that the tax authorities in these territories will be taking a close interest in this matter.

The fundamental concepts: Are they appropriate in the tax arena?

It is clear that, notwithstanding the benefits of pursuing closer alignment of accounting and tax systems, this cannot be achieved at the cost of ensuring a fair tax system, both for taxpayers and tax authorities. In making this assessment, it is necessary to examine whether the

fundamental concepts underlying IFRS are consistent with those of a fair tax system. In order to explore this question, it would seem appropriate to start with the fundamental objectives of IFRS, as these clearly inform the underlying concepts of the rules.

The IASB is responsible for developing IFRS. It would therefore seem appropriate to look to its objectives to give some guidance in this area.² These can be found in the Preface to IFRS and include the objective:

to develop... a single set of high-quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users to make economic decisions.³

It is worth pausing for a moment to look at this objective in a little more detail, as its content lies at the heart of the debate as to whether IFRS is appropriate for taxation purposes.

² The IASB’s ‘Framework for the Preparation and Presentation of Financial Statements’ (the ‘Framework’) also sets out the underlying concepts of IFRS. The Framework is currently subject to review and draft proposals were issued in July 2006 on the ‘Objective of Financial Reporting’ and ‘Qualitative Characteristics of Decision-Useful Financial Reporting Information.’

³ See Paragraph 6 of Preface to International Financial Reporting Standards.



Although the objective refers to ‘other users’ of financial statements, which would include tax authorities, it is clear that the central focus of IFRS is on providing financial information to providers of risk capital (i.e. investors) to enable them to make informed decisions regarding the companies in which that risk capital should be placed. The intention is therefore to ensure true comparability of the financial position of different companies, irrespective of where those companies are located, such that risk capital will be allocated in the most efficient way, thereby leading to a lower cost of capital for the best performing companies.

Consequently, IFRS can be described as essentially ‘investor focused’. The rationale underlying this investor focus is set out in the Framework and is ultimately that if the financial information produced satisfies the needs of investors, it should also, by definition, meet most of the needs of other users of the financial statements.

This ‘investor focus’ can be seen in some of the fundamental concepts underlying IFRS – specifically:

- **Balance sheet approach:** IFRS can be described as balance-sheet-focused, in that the intention is to provide a statement of the financial position of a company at a specific point in time to enable an investor to make an investment decision. Thus the historic performance record of the company (i.e. the profit and loss (P&L) account) can almost be seen as a by-product,⁴ as opposed to the central focus of the financial statements.
- **Use of fair values:** In assessing the financial position of a company, the focus is very much on the ability of the company to generate cash and cash equivalents – and the timing and certainty of these – as they are the fundamental drivers of the value of the business. Consequently, there is significant use of the fair value concept in IFRS as this is regarded in some quarters as a more reliable measure of this cash-generation ability than historic cost.
- **Substance over form approach:** Investors are concerned with the economic position of a company, not legal form. Accordingly, IFRS are

concerned with the economic substance of transactions rather than their legal form and therefore the provisions contain certain substance over form concepts (such as derecognition of financial assets and liabilities under IAS 39).

The tax-related questions that therefore arise are: (a) Are the objectives of the IASB consistent with those of tax authorities? and (b) Are the fundamental principles underlying IFRS appropriate from a tax perspective?

Dealing with the first of these questions, it is clear that the objective of the IASB is to ensure that the financial statements of a company provide capital markets users with information to help them make economic decisions – e.g. ‘Do I invest in this company or not?’⁵ It can therefore be regarded as a forward-looking objective. This can be contrasted with the objective of a tax authority, which is to determine the correct amount of tax to be paid by a company that, in many cases, will be determined by reference to its past performance. Accordingly, given that a tax authority is not making a forward-looking economic decision in the same way as

⁴ Although it should be noted that accruals is still an underlying assumption (as it gives relevant financial information for the prediction of future cash flows) and so there is still some focus on performance.

⁵ However, at paragraph 13 of the Framework it is noted that ‘...financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information’.

The significant use of fair values within IFRS is probably the area that gives rise to the most acute tension in the tax arena. A company could be put in the position of incurring a tax liability in respect of profits that have not been realised in cash terms, thereby putting the company in a position of not being able to settle its tax liabilities.

a capital market participant, it is questionable whether financial information produced to serve the needs of the latter will meet their requirements.

Turning to the second question, it is appropriate to examine this having regard to some of the fundamental principles underlying IFRS referred to above.

'Balance sheet' – based approach

Regarding the 'balance sheet'-based approach of IFRS, this is a reflection of the investor-focused nature of IFRS. As discussed above, the basis of the tax computation is generally the historic performance record of a company (i.e. the P&L account). Accordingly, to the extent that the central focus of the financial statements is the balance sheet and not the P&L account, it is questionable whether the information contained within the financial statements will necessarily satisfy the needs of the tax authorities.

In this connection, it is also worth noting that this balance sheet-focused approach may also result in a different level of materiality being applied in the financial statements compared with the tax computation. Specifically, where the

financial statement amounts involved are very large (as will generally be the case in relation to financial sector institutions), this is likely to mean that the materiality level will be set at a similarly high value.

In contrast, the tax calculation will generally have a very low level of materiality (as small as one currency unit). Therefore, there is clearly a question mark over whether the high-value materiality adopted in the financial statements will meet the needs of a tax authority which may be seeking a tax calculation based on a historical performance with a low level of materiality tolerance.

Use of fair values

The significant use of fair values within IFRS is probably the area that gives rise to the most acute tension in the tax arena. Specifically, 'fair' tax systems are generally founded on the central principle of 'ability to pay', i.e. a taxpayer must not be put in a position where she/he is unable to settle her/his tax liabilities. This principle is clearly at risk of being violated to the extent that tax is computed by reference to the fair value of assets reflected in a company's financial accounts, since a company could be put in the position

of incurring a tax liability in respect of profits that have not been realised in cash terms, thereby putting the company in a position of not being able to settle its tax liabilities⁶.

This cash flow uncertainty can have a very extreme impact in relation to certain types of financial sector business, such as special purpose vehicles (SPVs) in securitisation arrangements. In these arrangements, an SPV will acquire a pool of financial assets (such as mortgage or credit-card receivables) and will fund the purchaser of those assets through an issuance of bonds in the capital markets. The income from the underlying receivables is then used to fund the interest and principal repayments due under the bonds issued. In this type of structure, the expected cash flows arising at the SPV level are modelled to a high degree of accuracy at the outset, to ensure that sufficient cash will be available at all times to finance the interest and principal repayments due under the bonds, and this has a direct bearing on the credit rating of the bonds. It is not uncommon for this type of vehicle to enter into derivative arrangements (such as interest rate or currency swaps) to hedge its position.

⁶ It is worth noting at this point that IFRS is not based on the principle of realised profits.



Under IAS 39 the derivatives will be accounted for at fair value; the underlying asset and liabilities may well be held at amortised cost. To the extent that the SPV is subject to tax on a fair value basis in respect of the derivatives, but not in respect of the underlying hedged assets and liabilities, the SPV can be placed in a position where it has a tax liability in respect of a fair value profit, which is not matched by a corresponding cash inflow. Thus the vehicle can end up in a position of having unfunded tax liabilities that were not contemplated within the original cash-flow model which can therefore potentially undermine the whole structure. Indeed, this issue was perceived to be such a potential threat to securitisation SPVs in the UK that it has led to the development of a special tax regime for this type of company, which is designed to alleviate the problem.

In addition to creating potential tax cash-flow problems, taxation by reference to fair value movements can also lead to unfair tax results overall. In jurisdictions which either have no loss carryback rules or which only allow carryback for a limited period, this can cause particular issues. For example, consider a transaction

(such as an interest rate swap) which has a term of a number of years where the transaction gives rise to mark to market profits in early years which subsequently reverse in later years. A company could find itself in a position of paying tax on the mark to market profits in early years, but obtaining no effective tax relief for the losses in later years. Hence, this could lead to taxation of 'phantom' profits.

This issue can be particularly acute in relation to hedging arrangements, where only one leg of the arrangements is subject to fair value treatment. An area of particular difficulty in the financial sector concerns the position of a bank holding a loan portfolio which is hedged with one or more derivative contracts (e.g. interest rate, currency or credit default swaps). In this instance, the loan assets are often accounted for on an amortised cost basis, whereas the hedging derivative will be subject to fair value treatment under IAS 39. Consequently, the bank may find itself taxable in respect of fair value profits on the hedging derivative, but with no loss relief available for the corresponding economic loss on the hedged loan asset. Thus while the bank may have an effective

economic hedge on a pre-tax basis, it will not have an effective hedge on a post-tax basis. This is clearly an unacceptable outcome.

In those countries that have sought to embrace IFRS-based accounts within the tax system (such as the UK), dealing with the fair value issue has been one of the major problems in developing a set of tax rules that do not lead to unfair tax results. In practice, this has led to some extremely complex legislation and the prospect of a significant compliance burden for companies in the future.

Hence any country contemplating adoption of IFRS-based accounts for taxation purposes will need to consider carefully how to tackle the fair value problem, as a failure to do so could lead to tax mismatches and increased cash tax volatility, which would be unwelcome for taxpayers, tax authorities and the capital markets.

'Substance over form' approach

Tax is ultimately imposed by law and therefore as a general matter taxation law tends to focus on the legal form of transactions as opposed to their

Taxation law tends to focus on the legal form of transactions as opposed to their economic substance. There is clearly a tension between this legal form approach adopted in the tax area and the economic ‘substance over form’ approach applied under IFRS.

economic substance. While some taxation systems may contain a ‘substance over form’ principle, these tend to be relatively constrained and only apply in certain circumstances (e.g. in circumstances where tax avoidance is involved). There is clearly a tension between this legal form approach adopted in the tax area and the economic ‘substance over form’ approach applied under IFRS. Indeed, it is very difficult to see how tax legislation could be drafted in order properly to enshrine this type of ‘substance over form’ doctrine – as can be seen by the difficulties tax authorities around the world have had in introducing general anti-avoidance rules, which seek to look at the substance of transactions as opposed to their legal form.

Two of the areas where this issue can arise in the financial sector include the application of the ‘de-recognition’ rules and the rules regarding ‘embedded derivatives’, both of which are contained within IAS 39.

In summary, the ‘de-recognition’ rules consist of a set of detailed provisions that prescribe the circumstances in which a company may derecognise a financial

asset (or liability) in its balance sheet. In essence, these rules seek to ensure that the true economic owner of the asset (or liability) is the entity that recognises the asset (or liability) on its balance sheet. Thus, where, for example, a bank holds a loan asset, but has entered into an agreement (such as a sub-participation agreement) with another party under which it is contractually required to pass on all cash flows arising from the underlying loan and is prevented from transacting in the underlying loan, this could result in the bank ‘derecognising’ the loan asset on its balance sheet. This is because it is no longer the ‘economic’ owner of the loan asset, notwithstanding the fact that it remains the legal owner of the asset. Similarly, the counterparty to the sub-participation may recognise the loan asset on its balance sheet, notwithstanding that it is not legally a party to the loan. In this event, there is clearly the possibility of a disconnect between the taxation analysis, which may focus on the legal ownership of the loan asset, and the accounting analysis, which focuses on the economic ownership of the asset.

This issue is also relevant in relation to securitisation arrangements, where an originator (such as a bank) sells receivables (such as mortgages or credit-card receivables) to an SPV in return for cash consideration. Under these arrangements the originator generally retains an economic exposure to income arising from the receivables (e.g. through an entitlement to receive deferred sale consideration from the SPV in respect of the receivables, which is dependent upon the performance of the receivables, or through provision of some form of credit support to the SPV, such as a subordinated loan). In these circumstances, notwithstanding the fact that the originator may no longer have any legal interest in the receivables, it may be required to show the receivables on its balance sheet, as it retains an economic exposure to those receivables, and to reflect the sale consideration received from the SPV as a loan. Once again, this has the potential to lead to a mismatch between the taxation analysis (which may follow the legal form of the transaction and treat the transaction as a sale of the receivables) and the accounting analysis, which treats the transaction as financing.



It is easy to see that mismatches of this nature could lead to both unexpected and unfair tax results from both a taxpayer and tax authority perspective. However, once again, the way in which such potential anomalies can be dealt with through tax legislation is far from clear.

The other area of potential difficulty arising from the 'substance over form' approach under IFRS is the treatment of instruments comprising 'embedded derivatives'. A common area in the financial sector where these issues arise is transactions involving 'hybrid' instruments such as convertibles, exchangeables and asset-linked structured notes. In summary, these instruments consist of debt securities under whose terms the security holder may either be entitled to receive shares in the issuing company or another company (in the case of convertibles and exchangeables respectively) or whose interest rate and/or redemption amount is linked to a reference asset or index (such as an equity share or a stock exchange index such as the FTSE 100). Under the accounting rules contained within IAS 39, in certain circumstances these types of instrument are required to be 'bifurcated'

(or separated) for accounting purposes into a plain vanilla loan (referred to as the 'host contract') and a separate 'embedded derivative' reflecting the relevant equity or asset-linked rights under the hybrid instrument. In these circumstances, the 'embedded derivative' is then accounted for in the same way as a 'real' derivative and is therefore subject to fair value treatment. Hence, the accounting rules effectively operate to treat the debt instrument as two separate transactions comprising a plain vanilla loan and a separate derivative.

However, as a matter of legal form, a hybrid instrument will generally be in the form of a debt security and the relevant equity entitlement or asset linkage features will merely be rights contained within the terms of the debt security. Accordingly, in circumstances where debt securities are subject to a specific tax regime, the tax rules may operate to tax the entire debt instrument within the debt-specific regime and may not therefore recognise the bifurcation treatment followed for accounting purposes. Once again, this can give rise to the possibility of taxation and accounting mismatches (e.g. the whole

debt instrument may be taxed on an accruals basis under the debt tax regime, but the accounting treatment requires a portion of the instrument to be fair valued). Furthermore, to the extent that a country wishes to align its tax rules with IFRS, it may require large-scale amendment of the relevant tax rules governing the treatment of debt instruments and derivatives in order to ensure that the tax rules effectively mirror the accounting treatment created by the application of the embedded derivative rules. Based on the experiences in the UK, this is by no means a simple task.⁷

The single EU market

Recently we have started to see the use by financial services groups of the 'Societas Europaea' (the 'European company').⁸ The aim behind such companies is to be able to use one corporate vehicle to conduct business in all EU member states. Such companies will typically prepare one set of financial accounts based on IFRS with attendant economies of scale. However, for taxation purposes such companies are likely to require separate taxation accounts for each country where they have operations. Such a result clearly undermines the single

⁷ The UK tax rules governing the treatment of loans and derivatives have required significant amendment in order to accommodate the embedded derivative principles contained within IAS 39.

⁸ Allianz, for example, announced the use of such a company in the UK *Financial Times* on 23 October 2006.

⁹ See, for example, the case of *Futura Participations SA and another v Administration des Contributions (C-250/95)* where the ECJ held that the requirement for a French company with a Luxembourg branch to maintain both Luxembourg and French accounts was onerous and disproportionate following the principles set out in *Gilberte Gebhard v European Parliament (T-109/96)*.

The EU Commission concluded that IFRS principles are too ‘Investor focused’ to be able to meet the requirements of taxpayers and tax authorities. However, it was subsequently concluded that it would be appropriate for IFRS principles to be used as a tool for designing a common tax base within the EU, at least as a general starting and reference point.

market aspiration. Conceivably, this requirement to produce local tax accounts in each member state may be judged to be in conflict with the EU treaty.⁹

Conclusions

As can be seen from the discussion above, there are advantages to pursuing a closer alignment between the measure of commercial profits and profits for tax purposes. However, it is at best questionable whether a wholesale adoption of IFRS-based accounts as the basis for computing taxable profits would be able to meet the objective of delivering a fair tax system from the perspective of both the taxpayer and the tax authorities. It is clear that there are some areas of fundamental tension between the principles underlying IFRS and those of taxation policy that are not easy to reconcile. It is also clear that importing IFRS principles into tax law in many cases will require some very significant legislative change and the introduction of a great deal of complexity into the tax rules. Once again, neither taxpayers nor tax authorities would welcome this.

This conclusion is consistent with the outcome of the consultation exercise

undertaken by the EU Commission in 2003, regarding the suitability of IFRS-based accounts as the basis for a common consolidated tax base for EU-wide activities of companies within the EU.¹⁰ This concluded that IFRS principles are too ‘investor-focused’ to be able to meet the requirements of taxpayers and tax authorities. However, notwithstanding this conclusion, it was subsequently concluded that it would be appropriate for IFRS principles to be used as a tool for designing a common tax base within the EU, at least as a general starting and reference point, even though ultimately any common tax base should be guided by appropriate tax principles.¹¹ Accordingly, the increased adoption of IFRS-based principles in the tax arena is likely to be a reality in most EU countries going forward, even if these may be somewhat tempered by the overlay of specific tax rules in those countries.

Finally, it is possible that the European Court could have a role to play in limiting the extent of local tax reporting based on domestic GAAP accounts where this is regarded as onerous and disproportionate (following the Futura judgement).

¹⁰ See ‘Consultation Document: The application of International Accounting Standards (IAS) in 2005 and the implications for the introduction of a consolidated tax base for companies’ EU-wide activities’ published by the European Commission in February 2003.

¹¹ See Commission Non-Paper to informal Ecofin Council, 10 and 11 September 2004, ‘A COMMON CONSOLIDATED EU CORPORATE TAX BASE’, dated 7 July 2004.



Part 2: What are the options open to tax authorities and which is the best?

So far we have discussed whether, as a conceptual tax policy matter, it is appropriate to adopt IFRS-based accounts for taxation purposes. The answer to this question seems to be somewhere in the range between 'no' and 'yes – but not entirely'.

While EU-listed companies are required to prepare their consolidated financial statements in accordance with IFRS, there is no such compulsion for tax authorities to adopt IFRS-based accounts for taxation purposes. Hence, the decision as to whether to adopt IFRS-based accounts for taxation purposes and, if so, to what extent, ultimately rests with the individual tax authorities in each EU territory. This will depend upon where the view of each tax authority is on the scale between 'no' and 'yes – but not entirely', in relation to the question posed above.

So, what are the alternative approaches available to the tax authorities in this respect and what are the pros and cons of each?

In broad terms, there are three potential approaches:

1. The 'independent' approach.
2. The 'dependent' approach.
3. The 'quasi-dependent' approach.

Let us look at each of these in turn.

The independent approach

Under the 'independent' approach, the measure of a company's taxable profits would be computed in accordance with a specified set of tax rules and would not have regard to the financial statements of the company (which would be prepared in accordance with IFRS). Thus a company would prepare an entirely independent set of 'tax accounts', which would form the basis of its measure of taxable profits. These tax accounts could, for example, continue to be prepared in accordance with the historic domestic GAAP of the territory concerned (assuming this was previously acceptable for taxation purposes).

This approach would have certain advantages:

- The tax authorities would retain full control over tax policy setting since the tax rules would govern the measure of profits entirely.
- There would be only a limited requirement for amendment of the existing tax rules (assuming they currently follow domestic GAAP principles).
- It should avoid the potential tax mismatch and cash tax volatility issues associated with adoption of IFRS principles (in particular the fair value principle).

However, this approach would also have certain disadvantages:

- It would require the effective maintenance of two sets of books – one for financial accounting and one for tax purposes – which would give rise to a very significant compliance cost to taxpayers in terms of time spent and systems expense.
- It would potentially result in more material deferred tax items being reflected in the company's financial statements.

In the short term, to the extent that individual countries continue to allow (or indeed require) legal entities to continue to prepare their legal entity financial statements in accordance with their existing domestic GAAP, an independent approach along these lines may be feasible. However, on the assumption that companies (and in particular complex financial sector organisations such as banks) are likely to want to increase accounting efficiency in the future by producing legal entity financial statements under the same principles as their consolidated financial statements, maintenance of an independent approach along these lines is likely to be unpopular with taxpayer companies. Furthermore, to the extent that the domestic GAAP of countries within the EU converge with IFRS in the future, this may also make the preservation of an independent approach unfeasible in the long term.

Although both the ‘independent’ and ‘dependent’ approaches have certain advantages, the disadvantages of both approaches make it difficult to see how either approach could be sustainable in the long term. Notwithstanding the attraction of the quasi-dependent approach on a conceptual level, the problems associated with making this approach work in practice must not be underestimated.

The ‘dependent’ approach

Under the dependent approach, the measure of a company’s taxable profits would be computed in accordance with its financial accounts. Consequently, for those countries that allow (or require) adoption of IFRS for the purposes of legal entity financial statements, this approach would effectively mean wholesale adoption of IFRS principles for tax purposes.

The advantages of this approach would include:

- Companies would need to maintain only a single set of accounts for both accounting and taxation purposes.
- It may result in fewer deferred tax items being reflected in the balance sheet.
- It would avoid the need for complex taxation laws governing the measure of income as this would be dealt with under accounting principles.
- It would be more consistent with the ‘dependent’ taxation systems which have been adopted by many EU countries in the past.¹²

However, wholesale adoption of IFRS-based accounts for taxation purposes would give rise to the issues outlined above in relation to use of fair value, substance over form, etc. In practice, this could lead to significant tax mismatches

and increased cash tax volatility, which may ultimately be too high a price to pay (for both taxpayers and tax authorities) compared with the potential advantages.

Furthermore, on a practical level, tax authorities are unlikely to be willing to surrender their tax policy-making power entirely to the accounting standard setters as this may not be in the best interests of the country’s taxpayers or tax authorities.

The ‘quasi-dependent’ approach

Under the quasi-dependent approach, IFRS-based accounts would be used as the starting point for computing taxable profits, although with specific departures allowed under tax law where there are good policy reasons for doing so (such as encouraging investment in specific areas or asset classes through accelerated tax depreciation allowances, countering tax avoidance, avoiding tax mismatches etc.).

The advantages of this approach include:

- It would allow a single set of accounts to be used for accounting and taxation purposes, albeit with the overlay of certain specified adjustments required for taxation purposes.
- It should be possible to address the most acute problem areas where there is

tension between IFRS and tax principles (e.g. fair value and substance over form) through specific tax legislation, such that tax mismatches and cash tax volatility can be minimised.

- It would allow the tax authorities to maintain control over tax policy matters.
- It would facilitate the creation of a uniform EU tax base in the future (since all EU countries would have the same measure of profits as a starting point for their tax calculations).

The principal disadvantage of this approach is that it is likely to result in highly complex tax legislation, as evidenced by the experience in the UK. The UK government has pursued a quasi-dependent approach along these lines and has amended UK tax legislation in order to require the accounting profits and losses of companies used as a starting point for tax calculations to be computed in accordance with either UK GAAP or IFRS.

The UK government has also sought to address some of the acute tax mismatches arising from the use of IFRS-based accounts through specific tax legislation. For example, specific rules¹³ have been introduced in order to address potential tax mismatches relating to hedging arrangements. These include where a derivative (such as an interest

¹² Many EU countries – particularly those in Continental Europe – may be regarded as having ‘dependent’ tax systems since the local GAAP financial accounts form the basis of the tax computation. However, in many cases the profits reflected in the financial accounts are then also subject to adjustment under specific tax rules in order to arrive at the taxable profits. Hence, the systems are not wholly ‘dependent’ in nature.

¹³ The ‘Disregard Regulations’ issued in 2004 and amended in 2005 and 2006.



rate swap) is used as a hedge in relation to an underlying loan asset or liability. Under old UK GAAP, the hedging derivative and the related hedged asset or liability could be accounted for together on an accruals basis and taxed accordingly. However, under IFRS, unless it meets the very strict hedge effectiveness criteria within IAS 39, the derivative must be fair valued, while the hedged loan asset or liability continues to be accounted for on an amortised cost basis. In these circumstances, without any specific tax legislation to address the issue, economically the hedge would be effective on a pre-tax basis, but not on a post-tax basis. In order to address the issue, the specific UK tax rules effectively operate to recompute the profits in relation to the derivative contract in order to bring these into line with the treatment that would have applied under UK GAAP, if it had continued to apply, thereby avoiding the tax mismatch.

Although addressing this issue would seem to be a relatively straightforward matter in principle, arriving at an appropriate set of tax rules which address the issue in practice in a way that is satisfactory to both taxpayers and the UK tax authorities has proven to be a very difficult task – so much so that the tax rules in question have taken over two years to develop and have been the subject of numerous amendments.

In addition to seeking to address some of the tax mismatches arising from the adoption of IFRS accounts for tax purposes, adopting a quasi-dependent approach also means adjusting taxation law in order to reflect IFRS principles. Once again, the experience in the UK has shown that this is by no means an easy task. As discussed above, the UK tax rules have required substantial amendment in order to accommodate the ‘embedded derivative’ principles contained within IAS 39 and, once again, these rules are highly complex and have taken some considerable time to develop.

This importation of accounting principles into the tax legislation also means that, on a practical level, it is often necessary to understand the accounting treatment of an item before it is possible to determine the tax treatment. This means that any tax department or tax adviser will now need both to understand the tax law and to be familiar with accounting concepts in order to advise on the taxation treatment of transactions.

In summary, therefore, while the quasi-dependent approach has some considerable advantages, it clearly comes at a cost, in terms of complexity in tax legislation and tax compliance, which should not be underestimated by either taxpayers or tax authorities.

So which is the best approach?

On balance, from a conceptual perspective, the ‘quasi-dependent’ approach would seem to be the preferred approach. From a taxpayer perspective it offers the synergies of being able to use a single set of accounts for both financial reporting and tax purposes while avoiding the tax mismatch and cash tax volatility issues. From a tax authority’s perspective it allows the tax authority to maintain complete control over tax policy setting.

Although both the ‘independent’ and ‘dependent’ approaches have certain advantages, the disadvantages of both approaches make it difficult to see how either approach could be sustainable in the long term.

Notwithstanding the attraction of the quasi-dependent approach on a conceptual level, the problems associated with making this approach work in practice must not be underestimated. If the experience in the UK is anything to go by, the sheer scale and complexity of the amendments required for domestic tax law to accommodate IFRS principles in a way that will deliver a fair tax system mean that any tax authority wishing to pursue this route should prepare itself for a great deal of work, and will need to allocate the necessary time and resources accordingly. For tax departments and tax advisers, it means mastering both the tax

From a taxpayer perspective, it is important to ensure that the transition period does not result in losses or expenses, which would otherwise be deductible for taxation purposes, falling to be non-deductible as a result of the transition. In contrast, from a tax authority perspective, the desire is to ensure that no profits or gains fall out of charge to tax over the transition date.

law and accounting principles, neither of which is an easy task.

What about transition?

To the extent that a tax authority takes a decision to move towards a dependent or quasi-dependent approach, the question of transition, and of how to deal with transitional adjustments, inevitably arises.

From a taxpayer perspective, it is important to ensure that the transition period does not result in losses or expenses (such as general bad debt provisions, which become specific impairment losses under IAS 39), which would otherwise be deductible for taxation

purposes, falling to be non-deductible as a result of the transition. In contrast, from a tax authority perspective, the desire is to ensure that no profits or gains (e.g. where an asset is accounted for on an accruals basis prior to transition, but on a fair value basis thereafter) fall out of charge to tax over the transition date.

In addition to ensuring that no items fall out of charge to tax over the transition date, the other issue that needs to be addressed is how to deal with transitional adjustments, given their potentially very large scale. This is particularly the case for financial sector institutions where the transitional adjustments in relation to asset or liability positions (e.g. as a result of a move from

accruals to fair value based accounting treatment) can be very significant.

The question of the taxation of transitional adjustments was one of the main areas of debate in the UK and much of this focused on the treatment of adjustments in relation to financial instruments (in particular debt instruments and derivatives) under IAS 39. Ultimately, the UK government resolved that transitional adjustments in relation to financial instruments would be spread over a 10-year period for tax purposes. The seemingly arbitrary nature of this 10-year spreading treatment highlights the difficulties posed by the transition process.

SUMMARY TABLE: What are the alternative approaches which tax authorities could adopt in relation to IFRS and tax?

	Approach	Advantages	Disadvantages
1	'Independent' approach: Prepare independent set of 'tax accounts' (e.g. based on local GAAP)	<ul style="list-style-type: none"> • Domestic control over tax policy retained • Limited change in tax rules • Avoids tax mismatch and volatility issues 	<ul style="list-style-type: none"> • Cost • Major deferred tax issues • Dislocation for 'dependent' territories
2	'Dependent' approach Adopt IFRS at an entity level for tax purposes	<ul style="list-style-type: none"> • Single set of accounts • Uniform EU tax basis • Limited deferred tax 	<ul style="list-style-type: none"> • Tax mismatch issues and volatility • Loss of control over tax policy setting
3	'Quasi-dependent' approach Use IFRS accounts as a basis for computing taxable profits with specific departures allowed under tax law where there are good policy reasons to do so	<ul style="list-style-type: none"> • Single set of accounts • Potential for uniform EU tax basis • Minimise tax mismatch and volatility issues • Retain control over tax policy 	<ul style="list-style-type: none"> • Complex tax rules • Increased deferred tax



Part 3: The current picture across the EU

In this part we will look at the approaches currently being adopted by tax authorities within the EU in relation to the adoption of IFRS-based accounts for taxation purposes. In light of this, we will go on to consider what this will mean in terms of the way in which the adoption of IFRS for financial accounts purposes will manifest itself in the tax arena in these countries.

The current picture across the EU

A detailed summary of the current approaches being adopted in the following EU countries in relation to the use of IFRS-based accounts for taxation purposes is contained in the appendix to this paper:

- Austria
- Belgium
- Cyprus
- Czech Republic
- Denmark
- Estonia
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- Poland
- Portugal
- Slovakia
- Slovenia
- Spain
- Sweden
- United Kingdom

Details of the approach being adopted in the following EEA member countries are also included in the appendix:

- Iceland
- Norway
- Switzerland

The manner and extent to which the migration to IFRS accounts for financial statements will impact in the tax arena is dependent upon whether the country has a ‘dependent’, ‘quasi-dependent’ or ‘independent’ tax system and whether the country requires or allows adoption of IFRS-based accounts at legal entity level.

How will the adoption of IFRS manifest itself for tax purposes in these countries?

As can be seen from the information contained within the appendix, there are a range of approaches being pursued in relation to adoption of IFRS accounts for tax purposes across the countries previously highlighted. Notwithstanding this diverse array of approaches, it is possible to group the various countries into certain broad categories for the purposes of assessing how the migration to IFRS accounts will manifest itself in the tax arena in these countries going forward.

In essence, the manner and extent to which the migration to IFRS accounts for financial statements will impact in the tax arena is dependent upon two factors:

- i. Whether the country has a ‘dependent’, ‘quasi-dependent’ or ‘independent’ tax system
- ii. Whether the country requires or allows adoption of IFRS-based accounts at legal entity level (since in most ‘dependent’ or ‘quasi-dependent’ systems the tax computation is based on the legal entity financial statements as opposed to consolidated financial statements).

At one end of the spectrum, where a country has a dependent (or quasi-dependent) tax system and requires or allows adoption

of IFRS accounts at legal entity level, the migration to IFRS accounts is likely to have a material effect on cash tax liabilities, since it will have a direct impact on the tax computation. Accordingly, both tax authorities and taxpayers in these countries will need to take immediate action to ensure that the tax system is capable of dealing with the adoption of IFRS principles in a way that will preserve a fair system. This means addressing the potential problem areas discussed in Part 1 (see above) and determining which of the three approaches discussed in Part 2 (see above) they wish to follow going forward.

At the other end of the scale, where a country has an independent tax system, or a dependent tax system but does not allow adoption of IFRS accounts at legal entity level, the migration to IFRS for accounts purposes is unlikely to have a material effect on cash tax liabilities. Rather, in these countries the migration to IFRS for accounts purposes will largely manifest itself in terms of increasingly complex deferred tax positions at the consolidated accounts level. Thus in these territories, there may be only limited change required to the underlying tax system. However, this may only be a temporary reprieve in certain countries. In particular, for those countries that have a dependent system, but do not allow adoption of IFRS accounts at legal entity

level at the present time, to the extent that domestic GAAP in those countries converges with IFRS in the future, this will result in the cash tax issues emerging as the convergence takes place. However, this time delay and the more gradual process of convergence, as opposed to ‘big bang’ adoption of IFRS, may provide tax authorities with the necessary time to adjust the tax system to accommodate IFRS principles in a coherent and sensible manner.

The position of the countries referred to above is illustrated in Figures 1 to 3.

Figure 1 (overleaf) summarises the approaches currently adopted by each country in relation to the ability to prepare legal entity financial statements in accordance with IFRS. Specifically, it identifies whether the preparation of legal entity financial statements under IFRS is optional, obligatory or not permitted under the local law in each territory.



FIGURE 1: Application of IFRS to stand-alone accounts instead of local GAAP

Country	LISTED COMPANIES			NON-LISTED COMPANIES		
	Option	Obligatory	Not permitted	Option	Obligatory	Not permitted
Austria			✓			✓
Belgium			✓			✓
Cyprus		✓			✓	
Czech Republic		✓				✓
Denmark	✓ ⁽¹⁾	✓ ⁽²⁾		✓		
Estonia		✓		✓	Banks/Ins co	
Finland	✓			✓		
France			✓			✓
Germany			✓ ⁽³⁾			✓ ⁽³⁾
Greece		✓		✓		
Hungary	✓ ⁽⁴⁾			✓ ⁽⁴⁾		
Iceland		✓		✓		
Italy	✓ 2005	✓ 2006		✓	Banks ⁽⁵⁾	
Ireland	✓			✓		
Latvia		Banks	✓		Banks	✓
Lithuania		✓			Banks	
Luxembourg	✓			✓		
Malta		✓			✓	
Norway	✓			✓		
Poland	✓ ⁽⁶⁾			✓ ⁽⁷⁾		
Portugal	✓	Banks/Ins co ⁽⁸⁾		✓	Banks/Ins co ⁽⁸⁾	
Slovakia		✓			✓ ⁽⁹⁾	
Slovenia		✓			Banks ⁽¹⁰⁾	
Spain		Banks			Banks	✓
Sweden	✓ ⁽¹¹⁾			✓ ⁽¹¹⁾		
Switzerland			✓			✓
The Netherlands	✓			✓		
United Kingdom	✓			✓		

⁽¹⁾ Denmark: for stand-alone accounts.

⁽²⁾ Denmark: For consolidated accounts.

⁽³⁾ Germany: IFRS stand-alone accounts may be prepared for information purposes only.

⁽⁴⁾ Hungary: Only the Hungarian companies belonging to EU-listed groups can apply for the option
⁽⁵⁾ Italy: Banks/ listed insurance companies not subject to consolidated accounts and certain other financial companies.

⁽⁶⁾ Poland: Companies located in Poland can apply IFRS if they are listed or in IPO process in European Economic Area.

⁽⁷⁾ Poland: Only companies forming part of a group where the parent company prepares group financial statements in accordance with IFRS.

⁽⁸⁾ Portugal: Banks must adopt adjusted IAS ('NCA').

⁽⁹⁾ Slovakia: Applying to financial institutions and some other companies.

⁽¹⁰⁾ Slovenia: Expected to be extended to insurance companies.

⁽¹¹⁾ Sweden: Both listed and non-listed companies have the option to apply 'adjusted' IFRS principles.

Where a country has a dependent (or quasi-dependent) tax system and requires or allows adoption of IFRs accounts at legal entity level, the migration to IFRS accounts is likely to have a material effect on cash tax liabilities. Where a country has an independent tax system, the migration to IFRS accounts will largely manifest itself in terms of increasingly complex deferred tax positions at the consolidated accounts level.

Figure 2 then divides these countries into three groups:

- i. Group A: Countries with 'dependent' tax system based on legal entity financial accounts.
- ii. Group B: Countries with a 'quasi-dependent' tax system based on legal entity financial statements.
- iii. Group C: Countries with an 'independent' tax system not based on legal entity financial statements.

It should be noted that the division of the countries into these three broad groups is – consistent with all summary approaches – an oversimplification of the position. For example, many of the countries identified as having 'dependent' tax systems may

also have features consistent with being 'quasi-dependent'. However, for the purposes of illustrating the position in broad terms we have made some generalisations, which we trust you will accept.

Figure 2 also divides the relevant countries into those that require or permit adoption of IFRS for the purposes of legal entity financial statements and those that do not permit adoption of IFRS for legal entity financial statements purposes.

It is worth noting that certain countries have somewhat altered their position in relation to their level of 'dependence' as a result of the introduction of IFRS. Specifically, the UK and Ireland have effectively migrated from having an historic 'independent' tax system to now having more of a 'quasi-dependent' system.

In contrast, Norway has moved from having a historic 'dependent' approach to more of an 'independent' system with effect from 1 January 2005. Other historically 'dependent' countries, such as Sweden, are also reconsidering their position in this respect. This table could therefore look somewhat different in the future.

FIGURE 2: Relationships between tax and accounts – European Picture

	Group A 'Dependent'		Group B 'Quasi-dependent'		Group C Independent
Adoption of IFRS Is optional or obligatory	Cyprus Greece Lithuania Slovenia (Latvia)	Czech Republic Hungary Luxembourg Switzerland	Denmark Iceland Italy Malta Slovakia UK	Finland Ireland Portugal Spain	Estonia The Netherlands Norway Poland
No option to adopt IFRS	Austria France Sweden	Belgium Germany			



In order to complete the picture, **Figure 3** then shows how it is anticipated that the adoption of IFRS for financial statement purposes is likely to manifest itself for tax purposes in the various territories. Specifically, it seeks to show whether this will result in a cash tax liability impact (shown in red) or in a deferred tax liability impact (shown in burgundy), or potentially both. For example, for those countries that pursue an independent tax system (such as the Netherlands), it can be expected that the impact will primarily be felt in the deferred tax area with little or no impact in the cash tax area. Similarly, this is also likely to be the case (at the consolidated accounts level) in relation to those countries with a dependent system, but which do not

permit adoption of IFRS for legal entity financial statements purposes.

In contrast, for those countries that have a 'dependent' or 'quasi-dependent' system and which permit or require adoption of IFRS at legal entity level, it is likely that the adoption of IFRS will have an impact on both cash tax and deferred tax. The extent to which adoption of IFRS impacts in cash tax terms or deferred tax terms will depend upon the approach taken in each country. At one extreme, where a country with a dependent system migrates entirely to IFRS-based accounts, the impact is likely to be felt primarily in cash tax terms, since the adoption of IFRS will have a direct impact on the computation of taxable profits.

(Similarly, deferred tax would be reduced since there will be more correlation between the measure of commercial profits and taxable profits.) In contrast, where a country with a 'quasi-dependent' system takes steps to readjust the IFRS-based accounting profits for tax purposes in order to deal with some of the anomalies discussed in this paper, this would result in the adoption of IFRS for accounts purposes having both a cash tax and a deferred tax impact. In summary, therefore, the level of impact in cash tax terms versus deferred tax terms will ultimately depend upon how far each individual tax authority is willing to go in terms of embracing IFRS principles in the tax law.

FIGURE 3: How will the tax impact of IFRS manifest itself?

	Group A 'Dependent'		Group B 'Quasi-dependent'		Group C 'Independent'
Adoption of IFRS Is optional or obligatory	Cyprus Greece Lithuania Slovenia (Latvia)	Czech Republic Hungary Luxembourg Switzerland	Denmark Iceland Italy Malta Slovakia UK	Finland Ireland Portugal Spain	Estonia Netherlands Norway Poland
No option to adopt IFRS	Austria France Sweden	Belgium Germany			

Key: Deferred Tax ■ Current Tax ■

In summary, the level of impact in cash tax terms versus deferred tax terms will ultimately depend upon how far each individual tax authority is willing to go in terms of embracing IFRS principles in the tax law.

Although this summary is by its nature somewhat crude, it hopefully provides a broad indication of the impact one might expect the adoption of IFRS to have in these countries. One can then determine what actions should be taken by tax authorities and taxpayer companies in these territories in order to address the issue.

What does this mean for these countries in practice?

For those countries in Groups A and B which currently permit or require the adoption of IFRS at legal entity accounts level, it will be necessary for the tax system to be reformed in order to accommodate IFRS principles and to address some of the anomalies highlighted in this discussion paper so as to preserve a fair tax system. Based on the experience in the UK, this will be no easy task, and the necessary resources will need to be applied by tax authorities at an early stage.

For those countries in Group C and the countries in Group A where adoption of IFRS accounts at legal entity level is not currently permitted, taxpayer companies will need to be able to deal with the complex deferred tax positions in their consolidated financial statements, and tax directors of these companies will need to be able to explain these positions to their CFO and to the external analyst

community. In the longer term, those countries in Group A where IFRS is not currently permitted at the entity level and where there is convergence of domestic GAAP with IFRS in the future, may find themselves with a stark choice – either conversion to a wholly independent tax system based on historic GAAP principles or adoption (or partial adoption) of IFRS principles into the tax system. Accordingly, as the other countries in Group A and those in Group B have already found, for these countries the transition to IFRS may not always be a matter for the accountants alone!

PricewaterhouseCoopers LLP
November 2006



Appendix: Detailed overview

A. European Union

Austria

Adoption of IFRS in statutory accounts

Austrian entities are not allowed to adopt IFRS in their stand-alone accounts and currently there is no clear intention to allow such an option.

Gradual convergence of local GAAP with IFRS

Currently there are no plans to change the accounting system in Austria to converge with IFRS.

Taxation

The taxable income of an Austrian company is computed based on the Austrian GAAP accounts subject to certain tax adjustments which are mandatory under Austrian tax law.

Belgium

Adoption of IFRS in statutory accounts

It is not yet anticipated that Belgian entities (including banks and insurance companies) will be allowed to produce their statutory accounts under IFRS owing to potentially adverse consequences under tax and company law. In particular, a company law concern is that while local Belgian GAAP is essentially aimed at protecting the company's creditors by preventing it

from overestimating its assets and profits, the adoption of fair value principles in IFRS in stand-alone accounts could impact on estimates of the distributable profits and the net assets of the company, with ramifications for the capital maintenance criteria and other capital thresholds.

Gradual convergence of local GAAP with IFRS

Future opinions on accounting standards from the Belgian Accounting Standards Commission will be modelled on IFRS in so far as they are neutral from a Belgian income tax perspective.

With respect to small and medium-sized enterprises, the Minister of Finance has commissioned feasibility studies on the transition from local GAAP to IFRS.

Taxation

The Belgian tax base of Belgian corporate taxpayers derives directly from their stand-alone accounts under local GAAP.

Cyprus

Adoption of IFRS in statutory accounts

Since Cyprus is an EU Member State, all Cypriot companies listed on an EU/EEA securities market have followed IFRS since 1 January 2005. However, since the Institute of Certified Public Accountants of Cyprus adopted IFRS in 1981, all

companies in Cyprus must follow IFRS, not just listed companies.

Taxation

IFRS forms the basis for computing taxable income subject to any adjustment required by tax law (e.g. exemption of unrealised profits, diverging tax depreciation period).

Czech Republic

Adoption of IFRS in statutory accounts

All listed Czech companies must apply IFRS to their stand-alone accounts as of 1st January 2005.

Gradual convergence of local GAAP with IFRS

It is expected that Czech GAAP will be amended so as to converge gradually with IFRS.

Taxation

Taxation is based on profits, which must be calculated under Czech GAAP. Therefore, companies using IFRS must provide the tax authorities with a reconciliation of the differences between the two accounting frameworks. The level of assurance to be given to these reconciliation accounts is currently debated.

Denmark

Adoption of IFRS in statutory accounts

As of 1 January 2005, IFRS is only required for the consolidated accounts prepared by a company with listed shares.

IFRS is not required for stand-alone accounts. However, this is required from 1 January 2009. Furthermore, companies with listed debt securities are required to convert to IFRS from 2007.

IFRS are allowed as an alternative to local GAAP for all companies, including stand-alone accounts for listed companies and all non-listed companies.

Gradual convergence of local GAAP with IFRS

There are no plans to converge fully with IFRS. However, some changes may be made if this is deemed necessary.

Taxation

The Danish tax system is based on the statutory accounts, using the profit before tax as the starting point, and then making any necessary adjustments for tax.

Estonia

Adoption of IFRS in statutory accounts

All Estonian companies have the option to apply either Estonian GAAP or IFRS to their stand-alone accounts, unless required to apply IFRS by either the Stock Exchange or the Financial Supervision Authority.

Gradual convergence of local GAAP with IFRS

Estonian GAAP is fully compliant with IFRS, although requiring less disclosure and, in some rare cases, allowing for simplified methods to be applied. In cases not regulated by Estonian GAAP, IFRS application is recommended, but not mandatory.

Taxation

The Estonian corporate tax system is based on the taxation of distributed profits. The amount of distributable profit is currently determined based on the consolidated accounts of the company. Thus, an adoption of IFRS in statutory accounts does not have a direct effect on the tax base.

Finland

Adoption of IFRS in statutory accounts

Finnish companies that have an authorised auditor (APA or a certified HTM auditor) auditing their accounts have an option to apply IFRS for the preparation of their stand-alone accounts.

Gradual convergence of local GAAP with IFRS

Finnish GAAP has already been amended in some areas to bring it more into line with IFRS, but there are currently no plans to harmonise it further.

Taxation

There is a close connection between commercial and tax accounts in Finland. IFRS adopted in stand-alone accounts would serve as a basis for the preparation of tax returns, subject to certain tax adjustments arising e.g. from unrealised gains and losses for IFRS purposes (see below).

However, this option to apply IFRS in stand-alone accounts is unlikely to be used extensively until the time a tax reform addresses certain issues in cases where the accounting position fully impacts the tax position. For example:



- The Finnish group relief regime (not applicable for banks, insurance companies and pension institutions) can be used for profit and loss pooling. A group contribution received is taxable in the hands of the recipient and a group contribution given is tax deductible in the hands of the contributor, under certain circumstances. One of the requirements for a tax-deductible group contribution is that the parties recognise the contribution given/received as expense/income in their income statements. This would not be possible under IFRS.
- The current fixed assets depreciation method cannot be applied in IFRS-compliant financial statements since the accounting linkage forms an integral part of this. The Finnish GAAP is more flexible than IFRS in this respect.

The Working Group created by the Ministry of Finance has examined the need to make changes to corporate tax legislation as a result of the introduction of IFRS. The Working Group holds the view that unrealised gains should not, in principle, be legislated as taxable income. As an exception to this rule, unrealised gains or losses on financial assets or liabilities recognised at their fair value through profit or loss are proposed to be legislated to constitute taxable income or tax-deductible expense. Other unrealised gains/losses would not be taxable/tax deductible until realisation.

Furthermore, the Working Group proposes that the tax depreciation method used for fixed assets should be reformed so as to correspond to the accounting depreciation. The pool basis declining balance method of depreciation of machinery would be abolished. For companies preparing stand-alone accounts in compliance with IFRS, the accounting linkage governing depreciation would be abolished. The proposal to reform the current accelerated depreciation system which applies to fixed assets has met with strong resistance, and it is possible that the above proposals would not be implemented in the tax legislation in its current form.

For certain corporate transactions, IFRS requires the measurement of transferred assets and liabilities at fair value, whereas Finnish tax legislation requires this transfer to take place at book value. The Working Group therefore proposes that the tax treatment of corporate transactions would no longer require adherence to the consistency concept, but that the consistency of values would only be applied to taxation. Effectively this means that the link between accounting and tax is to be abolished, as otherwise this could lead to difficulties with future transactions due to the difference in the accounting and tax requirements. Concerning the current group relief regime, the Working Group holds the view that the present system should be replaced by a system where specific accounts would be prepared for taxation purposes.

France

Adoption of IFRS in statutory accounts

IFRS are not applicable to the statutory stand-alone accounts. French GAAP remains fully applicable to the determination of the accounting income and, once adjusted, to the determination of the taxable income of taxpayers.

Gradual convergence of local GAAP with IFRS

French accounting rules have been amended, to converge, to some extent, with IFRS rules regarding certain reserves, assets, components method for repair and maintenance costs, valuation and amortisation of assets. The issue of the convergence has not yet been addressed regarding the other IFRS rules (e.g., derivatives, pensions, financial statements, etc.).

Taxation

French GAAP remains a base to determine the taxable income, subject to certain adjustments.

Some changes have been introduced in French accounting and tax legislation mainly to ensure that convergence of French GAAP with IFRS has a neutral effect on French corporate income tax. For instance, for industrial companies, while the accounting depreciation of their buildings (offices, plant) is now computed over the asset life, the tax rules according to which these assets can be amortised

over a much shorter period remain unchanged and a specific reserve has been allowed for accounting and tax purposes to match the two rules (NB: the rule has been changed for real estate investments (*'immeuble de placement'*)).

Germany

Adoption of IFRS in statutory accounts

Currently IFRS is not used for the preparation of companies' stand-alone accounts. Companies are still subject to the obligation to prepare their stand-alone or statutory accounts following the Local GAAP ('HGB') rules.

Gradual convergence of local GAAP with IFRS

The HGB is influenced by the IFRS developments. Furthermore, a new provision in the HGB (Paragraph 325.2a) gives an option for German companies to apply IAS/IFRS for disclosure purposes. Companies which use this option are able to produce IFRS-compliant accounting disclosures which are used for information purposes only.

The reasons for not implementing IFRS as the local GAAP at present are explained in the commentaries to the draft of the Commercial Reform Act dated 24 June 2004.

According to the German legislator, IAS/IFRS are not adequate to serve as a

basis to determine the amount of distributable profits and the tax base.

In particular, the following reasons were formally set out:

- i. As IAS/IFRS is based on fair-value principles, the valuation of certain balance sheet items on the fair value basis may lead to distributions of unrealised profits which would damage the protection of creditors.
- ii. The volatility of results under IFRS is unwelcome from the tax perspective as both the taxpayer and the tax authorities want a consistent and easily calculable tax burden. The tax authorities especially are looking for reliability in revenue planning.
- iii. Possibly the major factor that causes the resistance to using IFRS-based accounts is the concern that the adoption of IFRS in statutory accounts may result in an associated indirect transfer of national legislative autonomy on taxation. As the legislative authority for the IAS is the IASB, which is an international body, any IASB decisions and modifications to IFRS would have an indirect effect on German taxation

Taxation

The HGB-based accounts remain the basis to determine taxable profits. It is, however, generally admitted that IFRS could be the starting point for calculating the taxable income in the future.

Greece

Adoption of IFRS in statutory accounts

From 1 January 2005 adoption of IFRS in statutory accounts is mandatory for listed companies and is optional for other entities.

Gradual convergence of local GAAP with IFRS

There are currently no plans to change the accounting system in Greece to converge with IFRS.

Taxation

The taxable basis closely follows the statutory accounts prepared under Greek GAAP. The tax authorities require that the financial statements include a separate section showing the differences between IFRS and Greek GAAP.

Amendments to the Greek tax legislation which have been introduced up to now relate mainly to bookkeeping requirements, such as a requirement to reconcile profits or losses under IFRS with the profit or loss under Greek tax legislation.

No comprehensive impact analyses have been carried out up to now to assess the impact of IFRS implementation on Greek companies. Presumably this will be the case when the first financial statements based on IFRS are published. At that time, a reform in the Greek tax legislation in order to approach the IFRS rationale will probably become inevitable.



The major issues that relate to the adoption of IFRS are the following:

- i. Provisions for contingencies, the set up of which is mandatory in accordance with IFRS, are not treated as a deductible expense for Greek tax purposes. The same issue exists with the payment provision for leavers, which, in accordance with Greek income tax law, is deductible only up to the amount concerning staff members eligible for retirement within the next accounting year.
- ii. Revaluation and impairment of assets. Currently, only realised gains/losses deriving from the sale or destruction of assets are recognised for tax purposes.
- iii. Deferred taxation. At present there is no distinction between current and deferred taxes in accordance with Greek Income Tax legislation. Moreover, in accordance with IFRS, income tax is considered to be an expense, while for Greek tax purposes it constitutes an element that decreases the profits available for distribution to the shareholders.

At present the Greek tax authorities plan to reform the Greek Code of Books and Records (P.D.186/1992) in order to comply with the needs of IFRS (more simplified regulations are expected to be introduced).

Hungary

Adoption of IFRS in statutory accounts

As of 1 January 2005, Hungarian companies, which are members of EU-listed groups have the option to apply IFRS to their statutory accounts.

Gradual convergence of local GAAP with IFRS

Hungarian GAAP is expected to be amended gradually to converge with IFRS, however the relevant amendments to Hungarian GAAP have currently been postponed.

It should be noted that Hungarian GAAP contains certain similarities with IFRS. For example, fair market valuation could be applied to derivatives and fixed assets. In such cases, the tax law allows adjustments so as to avoid the taxation of unrealised gains.

Taxation

The Hungarian tax system is based on a close connection between the statutory and tax accounts. No tax reform has yet been undertaken to address the adoption of IFRS in statutory accounts.

It is therefore unlikely that an option to adopt IFRS in statutory accounts will be exercised on a large scale.

Ireland

Adoption of IFRS in statutory accounts

Irish companies have the option to prepare their individual entity accounts under either Irish GAAP or IFRS. However, if the option to use IFRS is taken then it must, with limited exceptions, be followed for all subsequent accounting periods. Also, there is a group consistency requirement, so that, with certain limited exceptions, the same financial reporting framework (i.e. either IFRS or Irish GAAP) must be applied in the individual accounts of an Irish parent and all of its Irish subsidiaries unless there are good reasons for not doing so.

Gradual convergence of local GAAP with IFRS

The process of convergence of Irish accounting standards with Irish GAAP is ongoing, and substantial convergence has already been achieved in certain areas, e.g. IAS 39 has been incorporated into Irish accounting standards. There is an ongoing debate regarding the scope and timing of future convergence, e.g. whether full IFRS will be applied to all Irish companies or whether there will be alternative arrangements for certain companies, e.g. small companies.

Taxation

The tax position in relation to IFRS became a lot clearer following the enactment of specific tax legislation dealing with IFRS in 2005. In broad terms, this legislation:

- Clarifies that IFRS accounts are an acceptable basis for computing taxable trading profits subject to any adjustment required by tax law.
- Provides for the taxation of gains/losses on financial assets and liabilities (whether realised or unrealised) which are reflected in the income statement under IFRS.
- Sets out how the transition to IFRS is to be treated for tax purposes, including a special regime for dealing with bad debts on the transition.
- Maintains tax relief for R&D expenditure and interest costs notwithstanding that these items are capitalised under IFRS.
- Disallows fair value charges relating to share-based payments for tax purposes (however, arm's length cross-charges from a parent to its Irish subsidiary in respect of shares issued by the parent to the employees of the Irish subsidiary remain tax deductible, as do arm's length payments for the acquisition of shares for provision to employees).
- Introduces a measure to deal with concerns regarding the tax treatment of securitisation companies ('Section 110 companies') following adoption of IFRS.
- Contains an anti-avoidance measure to prevent the exploitation of a tax advantage on intra-group transactions between companies using different accounting frameworks.

The tax rules, while dealing with the changeover to IFRS, also deal with the tax issues arising from the convergence of Irish accounting standards with IFRS.

A number of further changes to the tax rules were introduced in 2006 in order to deal with outstanding issues, e.g. provisions were introduced to clarify the tax treatment of leasing.

While the tax legislation dealing with IFRS is quite extensive, it was always accepted that the tax implications of IFRS could not be comprehensively dealt with by legislation alone. With this in mind, the Irish Revenue have supplemented the tax legislation with detailed guidance notes.

In addition, there is an ongoing consultation process with industry groups and the large accountancy practices with a view to identifying areas where additional clarification on the tax position may be needed.

Italy

Adoption of IFRS in statutory accounts

The legislative decree n. 38 dated 28 February 2005 amended the local legislation according to the IAS/IFRS principles. In particular, the legislative decree n. 38/2005 identified the entities concerned by the application of the IAS/IFRS principles and the relative timing of adoption.

From 1 January 2005 the following companies are required to draw up their statutory accounts in accordance with the IAS/IFRS principles:

- Listed companies.
- Companies which offer financial instruments to the public;
- Italian banks, Management Company (SGR), Investment servicing company (SIM) and other financial entities (at certain conditions);
- Some insurance companies.

Insurance companies have the obligation to draw up statutory accounts in accordance with the IAS/IFRS principles only if they do not draw up consolidated accounts and if they are listed.

For other companies, the drawing up of consolidated accounts and statutory accounts in accordance with the IAS/IFRS principles is optional and the law does not establish the date of application (a specific decree – to be issued – should provide for such date of implementation).

The legislative decree n. 38/2005 aims to coordinate the principles provided for under domestic legislation and IAS/IFRS principles. In particular:

- If the IAS/IFRS principles are incompatible with the correct representation of the financial position, companies have the option not to apply them.



- In principle, income and reserves obtained with the 'fair value' method cannot be distributed.

Gradual convergence of local GAAP with IFRS

There are no current plans to converge Italian GAAP with IFRS.

Taxation

Taxation is based on profits per the accounts, whether these are prepared under Italian GAAP or IFRS.

The legislative decree n. 38/2005 does not involve a general restructuring of the Italian corporate taxation (Corporate Tax – IRES – and Regional Tax – IRAP). In particular, the above mentioned decree has provided for two basic principles and some specific amendments (limited to the tax regime of such operations that have a significant accounting impact under IAS/IFRS, i.e. financial leasing transactions):

- Derivation Principle (*'Principio della Derivazione'*): the taxable base of companies is determined starting from the net income arising from the Profit and Loss, increased or decreased by items directly booked to equity pursuant to the application of IAS/IFRS. To such 'rectified' income the general tax adjustments set forth by the Corporate Tax Law apply (this principle is applicable also to FTA components).
- Principle of Neutrality (*'Principio della Neutralità'*): this principle, not endorsed in the text of the law, but only reported

in the Explanatory Relation to the Legislative decree, aims to grant (as long as it would be possible) an equal treatment for those companies adopting IAS/IFRS and those companies still accounting under Italian GAAP.

With regard to specific amendments introduced for operations where adoption of IFRS had a significant impact, the main measures relate to the following aspects:

- leasing transactions;
- transactions charged in foreign currency;
- certain transitory rules (e.g. cost configuration for stocking);
- costs not more capitalised under IAS/IFRS; and
- derivative instruments contracts.

The absence of a full reform of the Corporate Tax Law and of clarifications from tax authorities has caused many uncertainties in the applicable tax treatment under IAS/IFRS.

The most relevant tax impacts of IFRS are as follows:

- On FTA and upon continued application of IAS/IFRS, adjustments or recognitions of transactions made in equity are relevant for tax purposes, to the extent that such items are in compliance with general tax principles.
- In principle, accounting criteria introduced by IFRS are relevant for tax purposes (e.g. amortised cost principle),

to the extent that such criteria are in compliance with general tax principles.

- At certain conditions, unrealised profits and losses recognised in the profit and loss account become taxable and deductible (e.g. fair value on securities other than AFS, HTM and participations, on derivatives transactions not concluded for hedging reasons, etc.).
- Depreciation and amortisation are permitted within the rates provided by the tax authorities, independently by the amounts booked. For example, the abolition of the imperative systematic depreciation of the goodwill and its substitution by the goodwill's review for impairment, does not affect the tax deduction of the goodwill amortization that should be made solely for tax purposes.

It is expected that a number of amendments will be implemented into the Italian Corporate Tax Law in order to adapt domestic provisions to impacts derived from the international accounting standards.

Latvia

Adoption of IFRS in statutory accounts

Latvia has not implemented the EU regulation option to extend IFRS to stand-alone accounts. Therefore Latvian companies apply Latvian GAAP, except for banks and insurance companies which must prepare their statutory accounts under IFRS.

Gradual convergence of local GAAP with IFRS

Currently there are no plans to converge fully to IFRS. However, Latvian GAAP is developed based on the requirements of IFRS.

Taxation

Latvian GAAP (or IFRS for banks and insurance companies) forms the basis for the preparation of the tax return, subject to certain adjustments. The Latvian tax authorities are known to have challenged the accounting treatment and, therefore, the taxation of certain expenses.

Lithuania

Adoption of IFRS in statutory accounts

In Lithuania, IFRS are generally not applied to stand-alone accounts. However, all companies whose securities are traded in regulated markets as well as banks must apply IFRS in their accounting. For listed companies, IFRS are applicable as of 1 January 2005.

All other companies should comply with Lithuanian Business Accounting Standards (hereinafter 'LBAS'), effective 1 January 2004 for statutory reporting. LBAS are similar to IFRS, as they were drafted based on IFRS.

Gradual convergence of local GAAP with IFRS

The Lithuanian Accounting Institute (LBAS-issuing body) recently made several amendments to the LBAS (e.g., introduction of investment property). Even

though these amendments have increased the similarities between the two accounting frameworks, a certain number of differences remain: e.g., under LBAS, goodwill is amortised, while under IFRS it cannot be amortised and is only subject to annual impairment test. There is no strategy to bring LBAS into line with IFRS.

Taxation

- i. The tax basis is dependent on LBAS or IFRS (banks and listed companies) accounts. The main tax adjustments to be aware of are:
- ii. Almost all provisions are treated as non-deductible for tax purposes.
- iii. Accounting for non-current assets differs for financial accounting and for tax purposes. The main differences relate to the assessment of the acquisition value, depreciation rates and methods used, accounting for revaluation, etc.
- iv. Local Tax Authorities are analysing any differences between Lithuanian Business Accounting Standards and tax legislation. As Lithuanian Business Accounting Standards are similar to IFRS, this analysis could be used as a background for further investigations.

There are no plans for any major tax reform in the near future in Lithuania, although certain amendments may be introduced in the tax law.

Luxembourg

Adoption of IFRS in statutory accounts

Two laws applicable in the banking and insurance sectors have introduced three options for the preparation of statutory accounts as from 1 January 2005.

These options are as follows:

- use Luxembourg GAAP;
- use IFRS; and
- use Luxembourg GAAP with IAS options.

The third option was introduced to encourage progressive convergence to IFRS. Under this option banks and insurance companies are allowed to cherry pick in relation to the following IFRS accounting aspects:

- fair value measurement of most of the financial assets;
- revaluation of intangible assets;
- restrictions on provisions;
- introduction of a cash flow statement;
- alternative presentations of the balance sheet and the income statement; and
- removal of the condition of participating interest for the determination of a subsidiary.

It is expected that the three accounting options will soon be offered to non-financial institutions once an accounting committee is set up.



Gradual convergence of local GAAP with IFRS

It is expected that Luxembourg GAAP will be amended to converge gradually with IFRS.

Taxation

Taxation is based on profits prepared under Luxembourg GAAP.

Under current tax law, numerous tax adjustments would be required if IFRS were adopted in statutory accounts. In certain cases, the adoption of IFRS has an adverse tax impact on the tax position in certain areas where currently the tax law is closely aligned with accounting. For example, corporate reorganisations (such as mergers, divisions, etc.) enjoy certain tax benefits provided that the companies that remain after these reorganisations keep the assets and liabilities which are transferred at book value in their accounts. Under IFRS, however, such assets and liabilities may need to be fair valued. In the absence of any changes to tax legislation, the tax benefit granted will therefore no longer be available.

The difficulties are numerous and relate also to leasing transactions, the tax regime governing exchange transactions, own shares transactions and hybrid financial instruments. This explains why it is unlikely that banks and insurance companies will opt out to use full IFRS for their statutory accounts. At this stage it would seem that the option to use Luxembourg GAAP with some IFRS options would be a better fit from the tax perspective as some challenging tax amendments could then be avoided.

The authorities are working on the necessary adaptation of the tax law with the objective of preserving tax neutrality. In this context, they may enact anti-abuse provisions to avoid mismatches between Luxembourg companies subject to different accounting frameworks.

Malta

Adoption of IFRS in statutory accounts

Since Malta is an EU Member State, all companies listed on an EU/EEA securities market will follow IFRS from 1 January 2005. However preparation of stand-alone accounts under IFRS has been required for all companies in Malta since 1995.

Taxation

IFRS accounts are the basis for the preparation of tax returns, subject to certain adjustments. As an example, unrealised gains are generally reversed, subject to certain exceptions (e.g. unrealised gains on derivatives used for hedging purposes).

Poland

Adoption of IFRS in statutory accounts

Only two categories of companies have the option to apply IFRS for the preparation of statutory accounts:

- Companies with listed securities traded within the European Economic Area.
- Companies which form part of a group which prepares consolidated accounts in accordance with IFRS.

Companies that are not required to report in accordance with IFRS or choose not to report in accordance with IFRS are required to report in accordance with Polish Accounting Standards (PAS).

Gradual convergence of local GAAP with IFRS

The latest amendment to the Polish Accounting Act, which took effect in 2002, did introduce some convergence with IFRS at that time. Changes to IFRS from that date were not introduced to local GAAP, except for the option to adopt IFRS for statutory purposes, as described above. It is not anticipated that the Polish GAAP will be changed to converge with IFRS in the foreseeable future.

Taxation

The Polish Income Tax Law (referred to hereinafter as 'Polish CIT Law') has extensive classification rules for taxable income and tax allowable costs. These rules result in significant differences in comparison to Polish Accounting

Regulations. The starting point in calculating the tax charge is the profit before tax per the accounts, after which the adjustments need to be made. Detailed tax accounts must be prepared for supporting the filing of tax returns. Polish CIT Law has not yet addressed the adoption of IFRS in statutory accounts so that at present using IFRS substantially increases the number of reconciliations which are necessary when preparing tax accounts. The consequence of this is that often for Polish tax purposes, it is necessary to adjust financial information from IFRS to PAS and then from PAS to the requirements of the Polish CIT Law. The major tax issues associated with IFRS relate to, for example, measurement of non-financial assets (under Polish CIT Law only actual write-downs are treated as costs), tangible fixed assets (under Polish CIT Law the use of the fair value model is not permitted), and receivables (under Polish CIT Law the measurement is at the invoice amount, accounting adjustments are not recognised as taxable income/tax-deductible costs).

Portugal

Adoption of IFRS in statutory accounts

Portuguese companies have the option to apply IFRS for the preparation of their stand-alone accounts. Companies included in groups required to prepare consolidated accounts under IFRS tend to adopt IFRS in the preparation of statutory accounts.

Banks, financial companies (such as credit institutions or other financial entities) and holding companies of the banking and financial companies' groups are required to adopt adjusted IFRS ('NCA'), with some adjustments regarding credit and accounts receivable, impairment and revaluation of tangible assets.

Gradual convergence of local GAAP with IFRS

As regards companies not subject to NCA no reform has yet been announced to converge local GAAP with IFRS.

Taxation

In 2005 the taxable profits of all companies in Portugal were based under local GAAP.

According to the State Budget 2007's draft proposal, from 2006 onwards banks and other financial entities subject to the NCAs will no longer be required to prepare accounts according to local GAAP for tax purposes. However, the requirement of local GAAP accounts will be maintained as regards other companies.

Slovakia

Adoption of IFRS in statutory accounts

Effective as of 1 January 2006, the Slovak Republic implemented the EU regulation's option to extend IFRS to stand-alone accounts for companies whose securities are admitted to trading on a regulated market in the EU as of their balance sheet

date. Other entities, such as banks, security dealers, asset management companies, pension management companies, insurance companies, the Stock Exchange and the Fund for the Protection of Deposits, are also required to prepare their stand-alone accounts under IFRS principles. Furthermore, companies that meet at least two of the following criteria for at least two consecutive accounting periods also have to prepare statutory accounts under IFRS:

- Total assets exceeding SKK 5 billion (not adjusted by provisions, reserves and depreciation).
- Net revenues exceeding SKK 5 billion.
- Average number of employees in the accounting period exceeding 2,000.

For the future, one of the proposed scenarios being publicly discussed would make IFRS obligatory in all Slovakian companies' stand-alone financial statements.

As of 1 January 2007, a Slovak Office for Financial Reporting should be established. It is expected that after it begins operating, more information will become available on IFRS adoption.

Gradual convergence of local GAAP with IFRS

Slovak GAAP is moving more towards IFRS, but there are still significant differences.

Taxation

The Slovak tax system is based on Slovak GAAP and the corporate tax position is determined by taking the profit and loss



accounts prepared under Slovak GAAP and making specific adjustments for tax purposes. Companies that have to prepare their financial statements under IFRS from 1 January 2006 will have to use the IFRS transitional guidelines published by the Slovak Ministry of Finance in order to convert their accounting profit to the tax base. The IFRS transitional guidelines provide general guidance and specific recommendations on how to convert the accounting profit for Slovak tax purposes.

There is no experience yet with the use of the IFRS transitional guidelines in Slovakia. Unfortunately some of the provisions are not worded clearly, and there are no official standpoints or explanations available as yet. Therefore it is currently difficult to estimate the tax impact on entities that report under IFRS. The main impact could be timing differences, where some transactions accounted for under IFRS in one accounting period would be accounted for under Slovak GAAP in a different accounting period, with the IFRS transitional guidelines not specifically addressing how they should be treated for tax purposes.

Slovenia

Adoption of IFRS in statutory accounts

As of 1 January 2005, companies listed on the Ljubljana stock exchange which are obliged to produce consolidated accounts, must produce, in addition to local financial statements, their stand-alone accounts under IFRS. This obligation is also now in

place for all banks from 1 January 2006, and expected to be extended to insurance companies from 1 January 2007.

Gradual convergence of local GAAP with IFRS

There are no current plans to converge Slovenian GAAP with IFRS.

Taxation

IFRS does not yet form the basis for the preparation of the taxable basis, which is still derived from the local financial statements.

A tax reform is expected to provide further clarification on the transition from local accounting standards to IFRS. The major tax issue for banks is the tax payable on the release of loan impairment provisions, which are more conservative under local accounting requirements than under IFRS.

Spain

Adoption of IFRS in statutory accounts

As from 1 January 2005, listed or non-listed Spanish credit entities have to adopt IFRS in their statutory accounts. However, the Spanish banking regulator (Bank of Spain) has not required credit entities to apply the IAS and IFRS Regulations approved by the European Commission. Instead, in December 2004, the Bank of Spain issued a specific accounting regulation for credit entities (contained in its Circular 4/2004) which is,

in the view of the Spanish regulator, compatible with IFRS, and which is adapted to the specific accounting environment of banking entities. These regulations extend as well to consolidated accounts, for which the accounting principles are the same as those applicable to stand-alone accounts.

As an exception, Spanish branches of EEA credit entities may choose to adopt, fully or partially, the accounting standards applicable in their country of origin. Because of the close dependency of Spanish Corporate Tax on the stand-alone accounts (see more details below), this potential election creates uncertainties as regards its corporate tax impact.

It should be noted that under the local version of IFRS (under Circular 4/2004), most (although not all) of the unrealised fair value profits and losses are not credited/debited to distributable reserves, but to a newly created and non-distributable category of equity account 'Valuation Adjustments'. This category of equity is distinct from the 'own funds' category, which includes distributable reserves. Unrealised profits or losses in the 'Valuation Adjustment' equity include those arising from financial assets available for sale, certain financial liabilities at fair value, cash flow hedges, foreign business investment hedges, foreign exchange and fixed assets available for sale.

Gradual convergence of local GAAP with IFRS

This year, the government submitted draft amendments to company law to the parliament, which is the preliminary step for the approval of new local GAAPs. These GAAPs will converge with IFRS and apply to the stand-alone accounts of most entities. These new standards will come into force in 2008.

Under these draft amendments to the company law, the new GAAPs would not fully converge with IFRS. This means that all banking groups, which also control non-banking Spanish entities, will continue to have to apply two different accounting standards in stand-alone accounts, and hence they will have two different criteria for determining the corporate tax base.

The Spanish insurance regulator is also working on a specific draft accounting regulation for insurers.

Taxation

The Spanish corporate tax system is primarily based on the link with stand-alone accounts.

The adoption of IFRS-based principles in stand-alone accounts thus directly impacts the taxable basis. Two legislative actions were taken by the Spanish government during 2005 to adapt the corporate tax to the new accounting environment. These measures were isolated and did not aim to fully adapt the corporate tax rules to the new accounting standards.

The first consisted in allowing credit entities not to calculate the first Corporate Tax payment on account (due in April 2005) by following the new accounting standards, but the abolished ones. This measure aimed to prevent a situation where credit entities may not have readily converted their accounts to the new standards by that date. Also, the Bank of Spain joined in the effort by agreeing that in stand-alone accounts, the new principles were applicable as from 1 July 2005, although with retroactive effect to 1 January.

The second measure was to enact new tax regulations on the deduction of bad debt reserves, since once the new accounting rules became effective, the existing tax regulations became inapplicable in practice.

The conversion of Spanish credit entities to IFRS-like local rules, in the absence of a full adaptation of the Corporate Tax Law, has caused many uncertainties in the applicable tax treatment. A number of rulings were issued by the tax authorities at the request of the banking industry during 2005 and 2006 to clarify the matter.

The most relevant impacts are as follows:

- On First Time Adoption and upon continued application of IFRS, adjustments or recognitions of transactions made in equity may follow an asymmetrical treatment under Spanish tax law under which debits are in principle deductible while

credits are not taxable. In general, the tax authorities have confirmed this asymmetry, with a few exceptions, when the adjustments or recognitions are made against distributable reserves, but not when they are made to the new non-distributable equity accounts ('Valuation Adjustments'). In the latter case, no deduction or taxation would take place.

- Unrealised profits and losses recognised in the profit and loss account become, as a general rule, taxable and deductible.
- The abolition of the imperative systematic depreciation of the goodwill and its substitution by the goodwill's review for impairment, only if it occurs, affects the tax deduction of the goodwill under qualifying mergers, since the tax deduction requires a recognition of the depreciation into the profit and loss account.
- The new rules for the recognition of dividend income into the profit and loss account (which is limited to certain interim dividends) affects the availability of the tax credits for the avoidance of economic double taxation.

Along with the reforms to company law and local GAAPs, the Government has announced a reform to Corporate Tax Law to adapt it to the forthcoming accounting standards. This reform is likely to come into force in 2008.



Sweden

Adoption of IFRS in statutory accounts

Sweden has not implemented the EU regulation options to allow IFRS to be used in the stand-alone accounts. Thus all companies will continue to apply Swedish GAAP in their stand-alone accounts.

Gradual convergence of local GAAP with IFRS

Swedish GAAP are being amended to be closer to IFRS so that companies will have the option to apply IFRS principles within the framework of Swedish GAAP. Consequently listed companies, as well as companies belonging to groups that must apply IFRS in their consolidated accounts, will have the option to apply fair market valuation with respect to certain assets.

At present Swedish GAAP accounts are the basis for the preparation of tax returns subject to certain adjustments. However, once the Swedish GAAP is amended to move closer to IFRS it is expected that the Swedish tax system will be amended to abandon the principle of close connection between the commercial and tax accounts. Under this tax reform, new tax valuation rules will avoid the taxation of unrealized gains. Currently these tax issues are the subject of a government investigation with the aim of a tax reform.

Taxation

Currently a government investigation is considering to what extent this principle of

close connection should be maintained. It is expected that the outcome of this investigation at least will result in new tax valuation rules avoiding the taxation of unrealised gains.

The Netherlands

Adoption of IFRS in statutory accounts

According to Dutch corporate law, all companies subject to external audit requirements (i.e. listed companies) will have the option to apply IFRS to their stand-alone accounts. An increasing number of companies are opting to disclose financial information under IFRS.

Gradual convergence of local GAAP with IFRS

There are no current plans to change Dutch GAAP to harmonise it with IFRS.

Taxation

In the Netherlands, there is a fundamental disconnection between the commercial and tax accounts. The tax accounts are based on what is known as the '*goed koopmansgebruik*' principle (sound business practice), which consists of an extensive set of tax valuation principles that have been developed for years through both jurisprudence and tax law. Therefore conversion to IFRS would appear to have a limited impact on the taxable income of Dutch companies. A few provisions in Dutch law do refer directly to financial statements, such as for the determination of one of the thin

capitalisation tests. In that instance, if the commercial accounts are prepared in accordance with IFRS, IFRS may directly influence the taxable income of Dutch companies.

However, in practice, the commercial accounts are typically used as a basis for determining the tax accounts. Dutch GAAP is in many instances similar to the tax valuation principles. If companies opt for IFRS, and do not maintain an accounting system in accordance with Dutch or tax GAAP separately, it is likely that the IFRS accounts will be used as a basis for determining the tax accounts.

Furthermore, the sound business practice used for tax accounting is, among other things, based on generally accepted accounting principles. If these rules are gradually replaced by IFRS, sound business practice may converge with IFRS. For example, under the sound business practice, it is currently generally acceptable to value portfolio investments at the lower of cost or market value. However, under IFRS fair market value is prescribed. Accordingly, the Dutch tax authorities are expected, sooner or later, to argue that sound business practice should now be in line with IFRS, meaning that portfolio investments should be valued at fair market value. Obviously, any increase from cost to fair market value could trigger a real tax cash cost, even without a realisation of the assets. This will then be subject to a review by the Dutch Supreme Court.

United Kingdom

Adoption of IFRS in statutory accounts

All UK companies have the option to apply IFRS to their stand-alone accounts. However, if one company in the group applies IFRS to its entity accounts, all other companies in the UK group must also apply IFRS. Exceptions to this rule are permitted if there is good commercial reason, for example if conversion of a particular company is not possible using existing IT systems.

Gradual convergence of local GAAP with IFRS

There is a project to converge UK GAAP with IFRS, with the convergence of UK standards with IAS 32 and IAS 39 being a key current development. UK entities with EU listed securities and companies that adopt fair value accounting which do not already prepare accounts under IFRS are required to adopt modified UK GAAP, which reflects key elements of IAS 32 and IAS 39. Full convergence, if it happens, is not expected before 2009.

Taxation

Taxation is based on profits prepared under UK GAAP or IFRS. As such, companies may have different tax results dependent on whether they prepare UK GAAP or IFRS accounts.

HM Revenue & Customs (HMRC) in the UK has undertaken a major exercise to ensure that the tax code accommodates the adoption of IFRS in a manner which

creates as level a playing field as possible and minimises the opportunity to avoid tax. There have been a number of working groups comprising representatives from HMRC, industry and the professions looking at key areas. For example, the IAS 39 Working Group comprises members of the financial services community and has been involved in substantial consultation regarding financial instruments. Significant changes to the legislation have arisen as a consequence.

One of the key amendments to UK tax legislation is in the area of the taxation of hedging contracts. Those companies which do adopt IFRS can choose to base certain parts of their tax computations on the IFRS accounts or on secondary calculations based on UK GAAP. The intention is that companies should not be in a worse tax position if they adopt IFRS than they would be compared with UK GAAP.

Transition to IFRS may result in a significant one-off taxable (or relievable) adjustment reflecting the cumulative difference between UK GAAP profits and IFRS on adoption. UK tax rules have been amended to spread the current tax effect of transitional adjustments on certain debt instruments and derivatives over 10 years.

There are anti-avoidance measures to prevent the exploitation of a tax advantage on intra-group transactions between companies using different accounting bases.

B. Other European Countries

Iceland

Adoption of IFRS in statutory accounts

As of 1 January 2005, only companies listed on the local stock exchange must produce their stand-alone accounts under IFRS. The other companies have an option to adopt IFRS.

Gradual convergence of local GAAP with IFRS

Icelandic GAAP has gradually changed in recent years to bring it more into line with IFRS, and this is set to continue in the future.

Taxation

Although the tax system is built on a close connection with the statutory accounts, it does provide the necessary adjustments where IFRS significantly deviates from Icelandic GAAP and domestic tax law.

Norway

The main rule is that companies covered by the Norwegian Accounting Act will have an option to apply IFRS to their stand-alone accounts and consolidated accounts from 2005. For listed companies IFRS is mandatory in the consolidated financial statements from 2005 for companies with listed equity and from 2007 for companies with listed debt instruments. Adoption of IFRS in stand-alone accounts for listed companies is



optional – the option is not dependent on whether the companies prepare consolidated accounts.

For financial institutions there are exceptions from the main rule for the stand-alone accounts, but not for the consolidated financial statements. Insurance companies are not allowed to apply IFRS in their stand-alone accounts in the foreseeable future until IFRS 4 Insurance contracts phase 2 is implemented.

Banks and other financial institutions have not been allowed to use IFRS in their stand-alone accounts for 2005 and 2006. For those banks and other financial institutions that are a part of a listed group, the regulatory authorities have suggested that it will be mandatory to use IFRS in their stand-alone accounts from 1 January 2007. For those banks and other financial institutions that are not a part of a listed group, the regulatory authorities have suggested that it will be optional to use IFRS in their stand-alone accounts from 1 January 2007.

Gradual convergence of local GAAP with IFRS

Norwegian GAAP is based on IFRS, but the implementation of IFRS in the group accounts of listed companies has shown that a number of differences exist. Norwegian GAAP is expected to be

amended further from 2006 onwards to be even closer to IFRS, but with certain simplifications as compared with IFRS.

Taxation

The implementation of IFRS is not expected to have a significant impact on the tax basis. As a consequence of the introduction of IFRS, the financial and tax accounts were disconnected as of 1 January 2005. This change was introduced in addition to the already extensive set of tax valuation rules. For banks and financial institutions, there are exceptions allowing them to deduct losses on loans and guarantees according to their financial accounts (based on Norwegian GAAP or IFRS). Also, tax deductions for technical reserves in insurance companies largely follow the financial accounts.

Switzerland

Adoption of IFRS in statutory accounts

From 1 January 2005, companies listed on the primary segment of the Swiss stock exchange (SWX) must, in addition to Swiss GAAP accounts, prepare their financials using IFRS (or US-GAAP) to meet SWX guidelines.

There is currently evidence that regulated institutions such as Swiss banks

and Swiss insurers will be able to use IFRS for their regulatory filings in the future (Swiss banks are already allowed to use IFRS for the regulatory filing of consolidated figures).

Gradual convergence of local GAAP with IFRS

A new accounting act is under evaluation by the Swiss government which would require companies exceeding a certain size to prepare their financial statements by using a 'higher' accounting standard, for example Swiss GAAP FER, IFRS or US-GAAP. However, regarding these developments, neither a concrete timeframe nor the implications for the local tax filing can be determined at present.

Taxation

Swiss GAAP accounts (stand-alone basis) are the accounts required for Swiss tax purposes. Those accounts may then be further adjusted for specific tax items.

Currently, as there are usually differences between statutory (i.e. Swiss GAAP), tax and IFRS figures, IAS 12 is raising complex issues that require an in-depth tax analysis and understanding of national and international tax concepts.

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We are extremely grateful for all the efforts of everyone listed above and also all the others who made a contribution towards making this publication happen. In particular we would like to thank: **Matthew Barling** (Banking and Capital Markets Tax UK Leader) – in relation to parts 1-3, and **Michel Guilluy** (Eurofirm IFRS Tax FS Leader) – in relation to EU content contained in the Appendix.

Notes

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