

# **Fiscal and commercial accounting rules on financial instruments**



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EUCOTAX Wintercourse 2011



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## Preface

This thesis is written to finalize the Master of Science in fiscal economics at Tilburg University. When I started my studies in Tilburg I intended to become an accountant. During the first year however my attention was drawn to the field of fiscal economics which I found very interesting. In my master thesis I was able to combine accounting and taxation and put it in an international perspective by participating in the EUCOTAX wintercourse. The international week at LUISS University in Rome was a great opportunity to learn about differences in tax systems between countries and cooperate with students from all over Europe and even outside of the continent. It was a great experience to become friends with these people in such a short time.

I would like to thank several people that helped me accomplish this thesis. First of all my gratitude goes to my supervisor prof. Stevens for his guidance during the entire project. Without his advice, criticism and support my thesis would not have the content that it has now. Secondly I would like to thank prof. Kemmeren, prof. Essers, drs. Peters and mr. Smit for their supervision in Rome and their contribution to the training sessions in Tilburg. Moreover, I would like to thank prof. Deak, prof. Ruggiero and mr. Bjuvberg for the discussions at LUISS and my fellow group members for the useful information on their countries. Also I would like to thank Ernst & Young for giving me the opportunity to use their expertise and facilities to write this thesis.

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## 1. Introduction

This thesis is written in the context of the EUCOTAX Wintercourse 2011 that was held in Rome, Italy. In this program students of the participating universities elaborated on the main theme ‘financial and economic crisis and the role of taxation’. The subtheme which will be discussed in this thesis is ‘fiscal and commercial accounting rules on financial instruments’.

The financial and economic crisis that started in 2007 is the worst recession in decades. It can be characterized by a housing bubble in a context of rapid credit expansion, high risk-taking and extensive financial leverage. Financial instruments have played an important role in the causes of the crisis. This thesis discusses the influence of commercial and fiscal accounting rules on financial instruments in relation to the crisis. It will include a legal comparison between EUCOTAX countries and focuses on corporations. The following problem definition will be used in this thesis:

*What are the Dutch commercial and fiscal accounting rules on financial instruments and should these be reviewed in the context of the financial and economic crisis?*

This thesis consists of three parts. The first part (chapter 2 – 5) describes the Dutch commercial and fiscal accounting framework. The second part (chapter 6) includes a comparison of accounting systems between EUCOTAX countries. In the third part (chapter 7) the accounting rules will be evaluated in the context of the financial and economic crisis.

In chapter 2 an introduction on external reporting will be given, followed by a description of the Dutch commercial and fiscal accounting principles and the influence of international accounting standards. In chapter 3 commercial accounting rules on financial instruments will be discussed in more detail. It will mainly focus on Dutch GAAP, but relevant differences with IFRS will be elaborated on. In chapter 4 fiscal accounting rules on financial instruments will be discussed. Both chapter 3 and 4 will give special attention to shares, bonds and derivatives. For derivatives, hedge accounting will be discussed and the applicability thereof for tax purposes. Chapter 5 will elaborate on the tax treatment of income from financial instruments, namely dividends, interest and capital gains. In chapter 6 a legal comparison of accounting systems between EUCOTAX countries will be presented. The accounting rules will be evaluated in the context of the financial and economic crisis in chapter 7. Special attention will be given to the proposed directive for a Common Consolidated Corporate Tax Base. A proposal for a new tax

accounting system for financial instruments will be tested against the principles of sound business practice, namely reality, prudence and simplicity. It will also be investigated if a more close connection between commercial and tax accounting would be desirable. This thesis will conclude in chapter 8 with a presentation of the main findings and an answer to the research question.

## 2. Dutch commercial and fiscal accounting framework

### 2.1 External reporting

External reporting entails the disclosure of information to external stakeholders. This disclosure of information involves primarily financial data of the entity and can take place in different forms. The most important form is the annual account.<sup>1</sup> This chapter focuses on the annual account, both from a commercial and a fiscal perspective. First an introduction on the annual account will be given, followed by a discussion of the commercial and fiscal accounting principles. This chapter finishes with an overview of the influence of international accounting standards on Dutch accounting.

The annual accounts consist of a balance sheet, a profit- and loss account and explanatory information thereof. The balance sheet gives an overview of the assets and liabilities of an entity on a certain date. The profit- and loss account provides an overview of the financial results of an entity over a certain period.

A distinction can be made between the individual annual account and the consolidated annual account. The individual account presents information on a separate entity, the consolidated account gives information on a group of entities together. In the Netherlands, there are usually two versions of the individual account, one for general external reporting purposes (also called the commercial annual account) and one for the tax authorities (also called the fiscal annual account).

The purpose of the commercial annual account is to provide information on the financial position, results and changes in financial position, that is important for a wide range of users to take economic decisions (RJ 930.12). The commercial account is intended for persons and organizations outside the entity and is an instrument to hold the board of the entity accountable for its actions. The users of the annual account vary widely, they are for example shareholders, employees, debt investors, suppliers, customers, the government and the general public (RJ 930.9). The annual account should give users such information that a proper judgment can be made on the assets, liabilities and results of an entity, including solvability and liquidity. This is known as the 'true and fair view' criteria.<sup>2</sup>

The purpose of the fiscal annual account is to determine the amount of tax an entity has to pay, based on the amount of profit that is made in a year. In contrast with the commercial annual account, the fiscal

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1 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 4.2.1.

2 Article 2:361, paragraph 1, Dutch Civil Code.

annual account only has one user, namely the tax authority. The different purpose of the commercial and fiscal annual account results in different concepts of profit.<sup>3</sup> This entails that different accounting principles are used for commercial and fiscal purposes, which will be discussed in the next section.

## **2.2 Commercial and fiscal accounting principles**

Different commercial and fiscal accounting principles underlie the different purpose of commercial and fiscal accounting. In this section these principles are discussed followed by a conclusion on the relationship between commercial and fiscal accounting.

### **2.2.1 Commercial accounting principles**

#### *Sources of commercial accounting rules*

The Dutch commercial accounting rules are laid down in book 2, title 9 of the Dutch Civil Code. Article 2:362 states that the annual account should be prepared in accordance with the norms that are acceptable in society. These norms can differ according to place, time and circumstances and therefore are flexible. The Council of Annual Reporting specifies the norms that are socially acceptable in their guidelines (*Richtlijnen voor de Jaarverslaggeving*). The council consist of three delegations; representatives of companies, users and auditors of financial external reporting.<sup>4</sup> The guidelines of the council do not have power of law, but the Enterprise Section of the High Court and the Supreme Court attaches great value to them.<sup>5</sup>

#### *Commercial accounting principles*

The Council of Annual Reporting defines in its framework two main principles for preparing the financial accounts, the accrual principle and the going concern principle. The accrual principle (RJ 930.22) states that transactions should be recognized in the period that transactions take place and not merely when cash is received or paid. Financial accounts that are prepared according to the accrual principle give not only insight in transactions that occurred in the past, but also in future obligations and receivables. The accrual principle is stated in article 2:362, paragraph 5 of the Dutch Civil Code. The going concern principle (RJ 930.23) states that the financial accounts should be prepared under the assumption that the continuity of the business is guaranteed and that the company will continue its business in the near future. Only when this assumption is clearly false or when there is serious doubt about the continuity, the going concern

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<sup>3</sup> D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, Deventer: Kluwer 2008, p. 6.

<sup>4</sup> [Http://www.rjnet.nl/RJ/Organisatie/Samenstelling/default.aspx](http://www.rjnet.nl/RJ/Organisatie/Samenstelling/default.aspx).

<sup>5</sup> S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par 1.5.

principle cannot be used. The going concern principle is stated in article 2:384, paragraph 3 of the Dutch Civil Code.

In addition to the main principles mentioned above, there are qualitative characteristics that make information in the annual accounts useful. These are comprehensibility, relevance, reliability and comparability (RJ 930.24). The use of these qualitative characteristics in the annual accounts usually leads to a fair view which is required by article 2:362, paragraph 2 and 3 of the Dutch Civil Code (RJ 930.46). In connection herewith principles as materiality, realization, matching, prudence and consistency are of importance.<sup>6</sup>

#### *Substance over form*

The principle of substance over form is also part of Dutch commercial accounting. The directives of the Council of Annual Reporting require that, in order to give a fair view on transactions and events, it is necessary that these are recorded in accordance with their economic reality and not their mere legal form (RJ 115.106). The substance over form principle is for example used for financial lease agreements. Although the lessor is legal owner of the asset, the benefits and economic risk that result from the asset are with the lessee. Therefore the lessee needs to account for the asset and the lease obligations in its balance sheet. In the case of a sale and lease back transaction, no sale is recorded when the economic risks to the asset are not transferred, even though legal ownership may be changed.<sup>7</sup>

### **2.2.2 Fiscal accounting principles**

#### *Sources of fiscal accounting rules*

The basis for taxation of companies is the concept of total profit.<sup>8</sup> This includes the aggregate amount of all income, in any name or form, that is obtained from business activities. Losses from one income category (e.g. interest) can therefore be offset against profits of another income category (e.g. capital gains). The total profit has to be divided into several annual parts during the existence of the company, the annual profit.<sup>9</sup> The sum of the annual profits forms in general the total profit. However, the limitation on

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<sup>6</sup> S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 4.4.1.

<sup>7</sup> Example derived from S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 4.4.2.

<sup>8</sup> Article 3.8 Personal Income Tax Act juncto article 8.1 Corporate Income Tax Act.

<sup>9</sup> Article 3.25 Personal Income Tax Act juncto article 8.1 Corporate Income Tax Act.

loss relief to one year carry back and nine years carry forward can result in a breach to the concept of total profit.<sup>10</sup> In that case determining the annual profit becomes of great importance.<sup>11</sup>

The annual profit is determined according to sound business practice (*goed koopmansgebruik*) and some specific regulations in tax law. Sound business practice is developed in case law and covers most rules on tax accounting. The legislator made a few additions and limitations to this case law in specific regulations.<sup>12</sup> By means of many judgments, sound business practice has become a separate accounting concept with its own content, different from commercial accounting.<sup>13</sup> The Supreme Court ruled that an accounting system based on proper business economics can be accepted for fiscal purposes, unless it conflicts with any regulation in tax law, a general intention or principle of the relevant tax law.<sup>14</sup> Therefore business economics is the starting point for tax accounting, but it has to be applied within the boundaries of tax law.<sup>15</sup> Sound business practice implies that a consistent accounting policy has to be applied that is independent of the probable outcome.

#### *Fiscal accounting principles*

The principles of reality, prudence and simplicity are leading in sound business practice, these have to be applied in balance with each other in order to determine the fiscal profit.<sup>16</sup>

The principle of reality demands that:

- the method of profit determination holds guarantees against random profit allocations between years;
- the profit in a certain year is only influenced by transactions that are wholly or partially related to that year;
- substance prevails over any legal or other construction;
- what is certain will not be questioned and vice versa.

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10 Article 20, paragraph 2, Corporate Income Tax Act

11 G.W.J.M. Kampschöer, De beperking van de verliesverrekeningstermijn, WFR 2006/785.

12 For example article 3.29b, 3.30 and 3.30a Personal Income Tax Act jo. art. 8 Corporate Income Tax Act and L.W. Sillevis, M.L.M. van Kempen, Cursus Belastingrecht Inkomenstbelasting, Deventer: Kluwer 2011, 3.2.16.B.a.

13 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, Goed Koopmansgebruik, Deventer: Kluwer 2008, p. 6.

14 Supreme Court, 8 May 1957, BNB 1957/208.

15 P.H.J. Essers, De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 11.

16 The explanation of the principles of reality, prudence and simplicity is derived from D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, Goed Koopmansgebruik, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 22.

The principle of prudence demands that:

- no profit is recognized unless it is reasonably certain that it will be realized;
- the way of profit determination acknowledges the continuity of the company.

The principle of simplicity demands that:

- the way of profit determination is practical;
- the requirements of profit determination are adjusted to the size of the company.

There is no fixed order of priority between these principles, they have to be applied in coherence with each other.<sup>17</sup> Although many principles in commercial and tax accounting law overlap each other, a different weight to each principle in the context of the different purpose of commercial and tax accounting can result in different accounting rules. For tax purposes, when the principles conflict with each other, the principle of reality is usually dominant over the principle of prudence and simplicity.<sup>18</sup> The principle of prudence can for example result in a asymmetry within sound business practice. Unrealized losses may be taken into account as soon as they become foreseeable, whereas unrealized profits can be deferred until the moment that they are actually realized.<sup>19</sup> For taxpayers it is usually beneficial to take losses as soon as possible, while deferring profits as this results in a lower taxable income. Funds that do not have to be paid immediately to the tax authority can be used for reinvestment in the company. If the asymmetry between the moment of loss and profit recognition is disproportionate, the principle of reality limits the principle of prudence. This is also the case with regard to financial instruments as will be discussed in chapter 4.

#### *Substance over form*

Substance over form is included in tax accounting as part of the principle of reality. An example is when a lessee establishes a building on leased ground, the right to depreciate is with the lessee who has the (economic) beneficial ownership, although the legal ownership is with the lessor.<sup>20</sup> The doctrine of *fraud legis*<sup>21</sup> can be seen as another example of substance over form. When saving of tax is the dominant motive

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17 A.O. Lubbers, *Goed Koopmansgebruik*, Een onderzoek naar de rol van wetgever en rechter bij de introductie en ontwikkeling van goedkoopmansgebruik, Amersfoort: SDU 2005, p. 391.

18 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 56.

19 A.O. Lubbers, *Goed Koopmansgebruik*, Een onderzoek naar de rol van wetgever en rechter bij de introductie en ontwikkeling van goedkoopmansgebruik, Amersfoort: SDU 2005, p. 301 and Lutz and Vosse, *IFRS and Derivatives Taxation, Derivatives & Financial Instruments*, IBFD IFRS Special Issue, March/April 2010, par 2.

20 Supreme Court, 19 October 1955, BNB 1955/377.

21 Fraud in law.

for entering a transaction and this is in conflict with purpose and intent of the relevant tax law, *fraus legis* becomes applicable.<sup>22</sup> This means that the transaction is disregarded or substituted by another transaction. Also for recognition and derecognition of financial instruments and classification as equity or debt, economic reality plays an important role, as will be discussed in chapter 4.

#### *Additions or limitations to sound business practice*

In certain cases, the legislator made an addition or limitation to sound business practice via specific tax regulations. For example depreciation on business assets is generally limited to 20 percent per year via a specific regulation in tax law.<sup>23</sup> For sound business practices this percentage could be larger if the economic life span of the asset is shorter than 5 years. Also the maximum depreciation on buildings is limited to a percentage of the value for the purposes of the Valuation of Immovable Property Act. This limitation cannot be found in case law entailing sound business practice. A favorable deviation for the taxpayer from sound business practice is the depreciation at will for certain business assets. This means that certain assets can be depreciated at once instead of apportioning depreciation to multiple years.<sup>24</sup>

### **2.2.3 Relationship between commercial and fiscal accounts**

Although commercial and fiscal accounting systems are both based on business economics, they have their own content.<sup>25</sup> Dutch commercial accounting rules can be found in the Dutch Civil Code and guidelines of the Council of Annual Reporting. Dutch tax accounting rules can be found in case law regarding the concept of sound business practice. There is no requirement for tax accounting purposes to adopt the principles that are used for commercial accounting purposes or vice versa. Applying the concept of sound business practice can result in a different taxable profit than the commercial profit. Therefore the relationship between commercial and fiscal accounting can be qualified as materially independent.<sup>26</sup> Although there is a link by the common starting point of business economics, commercial and fiscal accounting follow their own principles that result in materially independent systems of profit

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22 Supreme Court, 21 November 1984, BNB 1985/32.

23 Article 3.30 and 3.30a Personal Income Tax Act jo. art. 8 Corporate Income Tax Act.

24 Article 3.31 and 3.34 Personal Income Tax Act jo. art. 8 Corporate Income Tax Act.

25 G.W.J.M. Kampschöer, "IFRS en de verhouding tot het Nederlandse fiscale winstbegrip", WFR 2004/1228, part 3.1.2, and J. Doornbal, "De (dreigende) uitholling van goed koopmansgebruik", in: D.A. Albregtse en P. Kavelaars (red.), *Maatschappelijk heffen*, par. 3, Deventer: Kluwer 2006.

26 P.H.J. Essers i.a., *The influence of IAS/IFRS on the CCCTB, tax accounting, disclosure and corporate law accounting concepts : 'a clash of cultures'*, Kluwer Law International 2009, p. 35.

determination.<sup>27</sup> There is one exception to the general rule of independency; for small companies it is allowed to prepare the commercial financial accounts in accordance with fiscal principles.<sup>28</sup>

## ***2.3 Influence of international standards on Dutch accounting***

The International Financial Reporting Standards (IFRS) which aim to become a global standard for external financial reporting have influenced Dutch accounting. This section discusses the influence from a commercial and fiscal accounting perspective.

### **2.3.1 Influence of IFRS on Dutch commercial accounting**

The IFRS are established under the authority of the International Accounting Standards Board (IASB), a private institute on which the European Union (EU) has no decisive influence. In order to interfere when IFRS develops in a direction that is not desired within the EU, an endorsement mechanism has been developed for approving IFRS standards and interpretations. Only endorsed IFRS regulations have power of law within the EU.<sup>29</sup> At this moment, all IFRS are approved by the endorsement mechanism, except for certain articles of IAS 39 on financial instruments.<sup>30</sup> As of 2005, listed companies within the EU are obliged to use IFRS for their consolidated account. Listed companies are entities whose securities are admitted to trading on a regulated market of any member state. This is decided in EC Regulation 1606/2002, also known as the IAS Regulation.<sup>31</sup>

The Dutch legislator has chosen to give corporations as much freedom as possible in applying IFRS. This means that listed companies are not obliged to use IFRS for the individual accounts, but it is compulsory for their consolidated accounts. Listed companies are allowed to use IFRS for the individual account and non-listed companies are allowed to use IFRS for the consolidated accounts or for both the annual and consolidated account.<sup>32</sup> The following scheme gives an overview of the Dutch accounting methods that are allowed for listed and non-listed companies. This overview is based on RJ 100.104 and article 2:362, section 7 of the Dutch Civil Code.

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27 A.O. Lubbers, *Goed koopmansgebruik*, blz. 407, Amersfoort: SDU 2005 and P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 15.

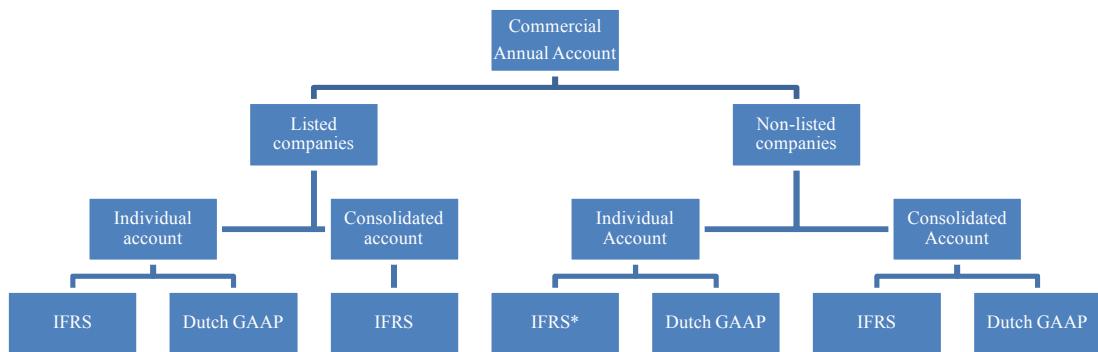
28 Article 2:396, section 6 Dutch Civil Code.

29 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 3.3.

30 L.G. van der Tas, *Tijdschrift Fiscaal Ondernemingsrecht 2010/125*, par. 1.5 and. S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 3.3.

31 EC regulation 1606/2002, 19 July 2002, article 5.

32 Article 2:362, paragraph 8 Dutch Civil Code.



\* It is not allowed to base the individual account on IFRS when the consolidated account is based on Dutch GAAP.

Even when IFRS is not applied, its influence is noticeable in Dutch GAAP. The structure and content of the Guidelines of the Council of Annual Reporting are usually based on IFRS, with additional opportunities and exemptions. IFRS is usually more rule based which means that deviations from specific rules are hardly possible. Dutch GAAP is more principle based, which entails that valid reasons can exist which allow deviations from the rules.<sup>33</sup>

### 2.3.2 Influence of IFRS on Dutch fiscal accounting

The IAS Regulation that obliges listed companies to use IFRS in their consolidated account has an indirect effect on tax accounting. The basis for taxation is the annual account of an individual entity for which there is no obligation to use IFRS. Even when the company chooses to use IFRS for its individual commercial account, there will still be a separate account for tax purposes that is based on sound business practice. Also in the case of a fiscal unity, the group accounts will be based on the sum of the individual accounts corrected for group purposes and not on the commercial consolidated accounts.<sup>34</sup> Since all companies have to base their tax return on the fiscal annual account regarding sound business practice,

33 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 3.7 and 3.8.

34 M.A. van Hoepen, *Goed koopmansgebruik en IFRS*, *Maandblad Belasting Beschouwingen* 2007/9, p. 297.

there is no special tax treatment for IAS adopter companies. However IFRS is of indirect importance for tax purposes as part of the ‘norms that are acceptable in society’ of article 2:362, section 1 Dutch Civil Code, that influences the fiscal concept of sound business practice.<sup>35</sup>

In literature it is stated that IFRS can influence fiscal accounting in three ways. Firstly, via the civil legislator, secondly via the tax legislator and thirdly via autonomous development of the fiscal concept of sound business practice in case law.<sup>36</sup> Influence via the civil legislator means that under influence of IFRS, some accounting methods that are currently allowed under Dutch GAAP, will no longer be permitted. If such methods are no longer allowed for commercial accounting, they may also change the view on proper business economics and fall outside the scope of sound business practice. The only safeguard for fiscal purposes is then a specific tax regulation that allows the method. For example under IFRS it is no longer allowed to depreciate on goodwill, instead there is a yearly impairment test. Currently Dutch GAAP does still allow depreciation on goodwill, but if this is changed in the future, this will possibly have consequences for tax accounting.<sup>37</sup> Influence via the tax legislator means that specific fiscal regulations on sound business practice are changed under influence of IFRS. An example is article 3.29b Personal Income Tax Act that was introduced in 2007; it obliges to use the percentage of completion method for work in progress that is derived from IFRS.<sup>38</sup> Autonomous development of sound business practice means that as a consequence of IFRS, the open norm of sound business practice that is developed in case law will be affected in areas where there is no specific regulation in civil or tax law. An example is the 80 – 125 percent coherence norm that the Supreme Court uses for applying hedge accounting on financial instruments.<sup>39</sup> The Supreme Court based this percentage on IAS 39 on financial instruments.

The goal of IFRS is to present a true and fair view on the financial position of a company. There is an emphasis on ‘fair value’, which is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction (IAS 39.9). When assets are valued at fair value, this implies that unrealized changes in value are accounted for in the profit- and loss account. The prospective model of performance reporting that IFRS uses can be in conflict with the fiscal profit

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35 M.A. van Hoepen, IFRS en fiscale winstbepaling, Tijdschrift Fiscaal Ondernemingsrecht 2005/89, p. par. 5.

36 M.A. van Hoepen, Goed koopmansgebruik en IFRS, Maandblad Belasting Beschouwingen 2007/9, p. 298.

37 P.H.J. Essers, De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 23 and S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 22.2.3.

38 That is of importance for corporate income tax purposes via art. 8 Corporate Income Tax Act.

39 This was determined in the cacao bean judgment, which will be elaborated on in section 4.5.

determination where principles of prudence, realization and liquidity are of importance.<sup>40</sup> It will therefore be likely that the introduction of IFRS for a company will further diverge the commercial and fiscal annual account.<sup>41</sup>

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40 H.P.W. Snijders, 'Salderen, salderen en nog eens salderen', WFR 2004/6601, p. 1735-1743.

41 P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 24.

### **3. Commercial accounting rules on financial instruments**

This chapter focuses on the commercial accounting rules on financial instruments. A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity (RJ 940). This includes primary financial instruments like receivables and liabilities and secondary financial instruments (derivatives) like options, futures and swaps (RJ 290.101). For Dutch GAAP, the rules on financial instruments are stated in RJ 290, general definitions are given in RJ 940. First the general commercial accounting rules on financial instruments will be discussed followed by a more in depth review of accounting rules applicable to shares, bonds and derivatives.

#### **3.1 General commercial accounting rules on financial instruments**

This section discusses the general commercial accounting rules on financial instruments. First the rules of recognition and derecognition of financial instruments will be described. Second the classification criteria for equity and debt, guidelines for offsetting financial assets and liabilities and general methods of valuation will be discussed. This section will conclude with a description on disclosure requirements.

##### **3.1.1 Recognition and derecognition of financial instruments**

The moment of recognition and derecognition of financial instruments is important for determining the period in which profits or losses are accounted for. In doing so the principle of substance over form and economic reality play an important role as will be discussed below.

###### *Recognition*

A company needs to account for a financial asset or liability at the moment contractual rights or obligations with regard to that instrument arise (RJ 290.501). An asset needs to be recognized, when it is likely that future economic benefits will accrue to the company and the asset's value can be reliably calculated. A liability needs to be recognized when it is likely that the settlement of the current obligation involves an outflow of economic resources and the amount of the settlement can be reliably calculated. The 'likely' criteria has been satisfied if the chances of inflow or outflow of economic resources is larger than 50 percent. When a company has for example a receivable on a debtor and there is no indication that it will not be paid, the receivable has to be recognized in the balance sheet. The 'reliable' criteria has been satisfied if the amount of the receivable or liability can be accurately determined. A legal claim can for example fulfill the 'likely' criteria because it is likely that the case will be won, but the amount of

compensation is unsure which makes that it cannot be recorded as a receivable.<sup>42</sup> Assets and liabilities that don't meet the 'likely' and 'reliably' criteria need not to be recognized (RJ 115.104 and 115.105). A financial asset or liability can be either recognized on the date a binding agreement is entered (trade date) or on the moment of exchange (settlement date). Per category of financial instruments this has to be applied systematically (RJ 290.703). For some transactions the trade date and the settlement date are the same. However, when this is not the case and these dates fall in between different book years, the difference can be of importance (RJ 290.703). It can be the case that an asset needs to be accounted for on the balance sheet, although the entity does not have legal ownership. In that case this needs to be explained in the explanatory notes (RJ 115.112).

#### *Derecognition*

An asset or liability needs to stay on the balance sheet if a transaction does not lead to important changes in economic reality with regard to that item. In order to determine if an important change in economic reality has occurred, the economic benefits and risks that will likely occur need to be taken into account (RJ 115.109). An asset or liability does not need to be recognized any longer if a transaction causes all or nearly all rights on economic benefits or all or nearly all risks with regard to the asset or liability to be transferred to a third party. The results of the transaction need then to be accounted for in the profit- and loss account (RJ 115.110 and 290.702). When only part of the economic rights and risks are exchanged, the economic reality determines which part of the asset or liability needs still to be accounted for and which part can be taken into the profit- and loss account (RJ 115.111).

In Dutch GAAP and IFRS economic reality plays an important role in the recognition and derecognition of assets and liabilities. IFRS however has more detailed guidelines on this matter than Dutch GAAP. Next to 'risk and rewards', the issue of 'control' plays an important role in IFRS. When risk and rewards remain with the original owner, but control is transferred, the item needs to be derecognized under IFRS. In this respect, control is not important in Dutch GAAP, the economic benefits and risks are decisive.<sup>43</sup>

#### **3.1.2 Classification as equity or debt**

When a company issues a financial instrument, it needs to be determined if the instrument should be classified as equity or liability. The directives of the Council of Annual Reporting state that for classification in the individual account the legal form is decisive (RJ 240.209). When a financial

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42 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 4.6.1.

43 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.3.2.

instrument has the legal form of equity, it needs to be classified as equity in the financial statement. However, the sum of equity financial instruments that can be characterized as debt based on economic reality, must be presented separately within equity (RJ 240.207). An example is to be paid back share capital, that has the legal form of equity (shares), but the economic form of a liability (the obligation for payback). When a financial instrument has the legal form of a liability, it needs to be classified as a liability in the financial statement. Possible equity elements within the liability need not to be presented separately (RJ 240.208). An example of a financial instrument that has the economic reality of equity, but the legal form of a liability, is the mandatory convertible bond.

In contrast with the individual account, in the consolidated account not the legal form, but the economic reality is of importance when classifying an instrument as equity or liability (RJ 240.302). The defining characteristic to distinguish a financial liability from an equity instrument is the existence of a contractual obligation for one party to transfer a financial asset to the other party or to exchange a financial instrument under conditions that are potentially unfavorable for the issuer (RJ 290.802 and 290.803). The Council of Annual Reporting advises to value the different components of a financial instrument separately (RJ 290.813). When the liability and equity component of a hybrid is not classified separately, the instrument must be classified by the predominant characteristics as either equity or liability. In the explanatory notes needs to be stated in which way these instruments are accounted for (RJ 290.813). In contrast with Dutch GAAP, in IFRS the economic reality is prevailing over the legal form for both the individual and consolidated account.

### **3.1.3 Offsetting financial assets and liabilities**

In the Dutch Civil Code there is a general prohibition to offset assets and liabilities against each other.<sup>44</sup> However, there can be circumstances when financial assets and liabilities must be offset against each other. This is the case when an entity currently has a legally enforceable right to offset the recognized amounts and intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously (RJ 290.837).

### **3.1.4 Methods of valuation of financial instruments**

Financial instruments can be valued at either cost price, amortized cost price or fair value. These methods of valuation will be discussed below in general. Specific application of these methods to shares, bonds and derivatives will be described in more detail in the next sections. Initial recognition of financial instruments

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44 Article 2:363, paragraph 2, Dutch Civil code.

is always at fair value, which is the (amortized) cost price at that time. Future valuation depends on the accounting method that is applied.<sup>45</sup>

#### *Cost price*

Cost price is the acquisition price of an asset or liability. Cost price is mainly of importance with investments in equity instruments and derivatives. Transaction costs are included in first valuation (RJ 290.501). Valuation at cost price always implies that when fair value is below initial cost price, a downward revaluation needs to take place.<sup>46</sup> Therefore valuation at cost price can also be characterized as ‘cost price or lower fair value’.

#### *Amortized cost price*

Amortized cost price is mostly applicable to receivables and debts. It is the acquisition price of an asset or liability minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility (RJ 940). Transaction costs are included in first valuation; by using the effective interest method these costs are amortized in the profit- and loss account (RJ 290.501). A receivable can be acquired at a premium or at a discount; a premium arises when the remuneration on the bond is higher than the market rate of interest at the moment of first recognition. A discount arises when the remuneration on the bond is lower than the market rate of interest at the moment of first recognition. In case of a premium, cost price is higher than the nominal amount; in case of a discount, cost price is lower than the nominal amount. The yearly benefit in the profit- and loss account of the investor is equal to the market interest rate at the time of first recognition of the receivable by amortizing the premium or discount over the term of the receivable on an annuity basis; this is called the effective interest method.<sup>47</sup> Instead of the effective interest method, linear amortization is allowed when this does not lead to significant differences compared with the effective interest method (RJ 273.201 and 290.418).

The following example explains the application of the amortized cost price method. A company buys a bond on 1 January 2011 with a nominal value of € 100 million. The coupon interest rate is 4 percent and the term is 3 years. Interest is received at the end of each year and the market interest rate is 5 percent. The amortized cost price of the bond is calculated at € 97.28 million, this is the present value of discounted

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45 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 26.4.1. and 26.4.2.

46 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 26.4.3.

47 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 26.4.4.

cash flows of future interests and payment of nominal amount at maturity. The amortized cost price and interest gain are as follows:

year	amortized cost price 1/1	interest profit	interest received	amortized cost price 31/12
2011	97.28	4.86	4.00	98.14
2012	98.14	4.91	4.00	99.05
2013	99.05	4.95	4.00	100.00

The interest that is recognized in the profit- and loss account is 5 percent of the amortized cost price. The difference between the received interest and the interest profit increases the amortized cost price. When applying linear amortization, an interest of 4.91 is recognized in 2011, 2012 and 2013.

#### *Fair value*

Fair value is a term that is becoming increasingly important for external reporting purposes. In IFRS fair value currently means: 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.'<sup>48</sup> In the exposure draft of the IASB on fair value measurement a new definition of fair value is given: 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price)'.<sup>49</sup>

The IASB established a valuation hierarchy for determining fair value that consists of three levels:<sup>50</sup>

- Level 1: valuation is based on quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2: valuation is based on fair value of similar instruments for which a reliable fair value can be appointed.
- Level 3: valuation is based on generally accepted valuation models and techniques, there are no observable inputs.

In Dutch civil law, fair value is elaborated on in the decree current value.<sup>51</sup> In this decree, current value is based on current market prices or on facts that on the date of valuation are relevant for determining the

48 IFRS 3, appendix A.

49 IASB Exposure Draft May 2009, ED/2009 5. Fair Value Measurement, p. 6.

50 IFRS 7.27A and S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.4.5.

51 Besluit Actuele Waarde, 14 June 2005. Stb. 2005, 321.

value.<sup>52</sup> Current value can be based on replacement value, going-concern value, market value or net realizable value.<sup>53</sup> *Replacement value* is the amount that would be necessary to obtain another asset that has economically the same position in the business. *Going-concern value* is the discounted amount of future cash flows that can be attributed to the asset. *Market value* is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. *Net realizable value* is the amount for which an asset can be sold less future costs.<sup>54</sup> For Dutch accounting rules on financial instruments market value is of most importance since this reflects the term fair value that is used by the Council of Annual Reporting. Market value can therefore be used as a synonym of fair value (RJ 290 and 940). It is used for valuating different types of financial instruments, as we will see in the next sections. When a reliable fair value cannot directly be determined, this has to be derived from the market value of a similar instrument for which a reliable market can be found and by using generally accepted valuation models and techniques. When fair value cannot be reliably determined, financial instruments have to be valued at cost price.<sup>55</sup>

Changes in fair value are accounted for in the profit- and loss account or directly into equity, depending on the subcategory in which the financial instrument is included and choices of the company.<sup>56</sup> When included in the profit- and loss account, this entails that unrealized profits and loss can be reported for. The regime on transaction costs when valuating at fair value depends on the fact if increases or decreases in value are accounted for in the profit- and loss account or directly into equity. Transaction costs need to be accounted for in the profit- and loss account if changes in value will be accounted for in the profit- and loss account. If decreases or increases in value are accounted for directly into equity, transaction costs need to be recognized in the balance sheet at first recognition (290.501).

#### *Net asset value*

Valuation at net asset value is used for valuating shares. It is the value of a subsidiary based on its value of assets and liabilities valued against the methods that the participating company applies for its own assets and liabilities. These methods can for example be (amortized) cost price or fair value. The participation is

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52 Article 1, paragraph 1, Decree Current Value.

53 Article 1, paragraph 2, Decree Current Value.

54 Article 2,3,4 and 5 Decree Current Value and RJ 290.

55 Article 10, Decree Current Value and RJ 226.209.

56 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.4.5.

initially recognized at the share of the participating company in the equity of the participation, the carrying amount in the future is increased or decreased by changes in equity of the participation (RJ 214.307).<sup>57</sup>

### **3.1.5 Requirements for disclosing information**

Dutch law and directives of the Council of Annual Reporting require extensive disclosure on financial instruments. In general, for every category of financial assets and liabilities, either on or off balance, disclosures are required. Information on the size and nature of financial instruments, including important contractual provision that can influence amount, timing and level of assurance of future cash flows must be provided. Further, information on valuation and determination of results, including criteria for recognition of financial instruments in the balance sheet and applicable methods of valuation needs to be presented (RJ 290.906). Also disclosures on interest risk, credit risk, liquidity risk, market risk, fair value and hedge accounting can be required.<sup>58</sup>

## **3.2 Shares**

Shares can be recorded on the asset or liability side of the balance sheet, depending on their nature. When a company acquires an interest in another entity, shares will appear on the asset side of the balance sheet. When a company issues shares, these will appear on the liability side of the balance sheet. First shares as an asset will be discussed, followed by shares as a liability.

### **3.2.1 Shares as a financial asset**

In Dutch law, there is no specific definition of shares as a financial asset. They can however be divided into two categories, shares that constitute a participation (article 2:367, sub a and b Dutch Civil Code) and shares that do not constitute a participation (article 2:367, sub e and article 364, paragraph 3 Dutch Civil Code). In IFRS there is no uniform equivalent of the Dutch term participation; investments in subsidiaries, joint ventures, associates and equity instruments can all qualify as a participation.<sup>59</sup> There is a participation if capital is provided for its own risk and there is an enduring relation that serves the activities of the entity that owns the participation.<sup>60</sup> All shares that do not constitute a participation can be classified as securities (RJ 214.203). Depending on their duration, they will be classified as financial fixed assets or current assets. The accounting regimes for participations, securities and a special regime for fixed income stocks will be discussed in this section.

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57 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 8.2.6.

58 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 26.9.

59 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 8.1.4.

60 Article 2:24c Dutch Civil Code and RJ 214.202.

### *Participations*

When the acquiring entity has 20 percent or more of the capital of the other entity, there is a legal presumption that a participation exists. However, this presumption can be proved wrong when on the basis of facts capital is not provided for own risk or there is no enduring relation that serves the activities of the entity that owns the participation.<sup>61</sup> For methods of recognition, valuation and profit determination, it is important to distinguish between participations on which the acquiring entity can and cannot exercise significant influence. It depends on factual circumstances and contractual relationships if significant influence can be exercised on the business and financial policy of a participation (RJ 214.303). There is a legal presumption that significant influence can be exercised when the acquiring entity can exercise 20 percent or more of the voting rights.<sup>62</sup> This legal presumption can be countered on the basis of facts, for example when the participating company owns less than 20 percent of the shares but is represented in the board of the participation and has involved in the policy of the company (RJ 214.302). Because the legal presumptions of a participation (based on share in capital) and the presumption of significant influence (based on share in voting rights) are so similar, most participations will be participations where significant influence can be exercised.<sup>63</sup>

When significant influence can be exercised, the participation needs to be recognized on the moment of acquisition. This is the date from which the acquiring entity has effective significant influence on the business and financial policies of the participation (RJ 214.307 and 510.111). These participations need to be valued on the basis of the net asset method.<sup>64</sup> Under this method, the investment in a participation is initially recognized at fair value; when fair value of the participation is higher or lower than the acquisition price, the difference is recognized as positive or negative goodwill (RJ 214.327/333/336). Positive goodwill can be depreciated under Dutch GAAP, under IFRS an impairment test is applied. After first recognition, the carrying amount of the participation is increased or decreased to recognize the investor's share in the results of the participation less received dividends (RJ 214.502). In order to determine the valuation of assets and liabilities of the participation after the moment of first recognition, the accounting methods of the participating company need to be used. The change in carrying amount of the participation result in a profit or loss for the investor (RJ 214.307).

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61 Article 2:24c Dutch Civil Code, RJ 214.202 and S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 8.1.4.

62 Article 2:389 paragraph 1, Dutch Civil Code.

63 S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 8.2.2.

64 Article 2:389, paragraph 1, Dutch Civil code and RJ 214.309.

When the acquiring entity has no significant influence on the participation, the moment of acquisition is the date when control over the asset can be exercised, derived from the general criteria of recognition of assets.<sup>65</sup> For these participations, the ground for valuation and profit determination can be based on cost price or current value.<sup>66</sup> The cost price method entails that at first recognition, the acquisition price of the participation should be stated on the balance sheet and future declared dividends will be accounted for in the profit- and loss account (RJ 214.504). The current value method implies that valuation on the balance sheet needs to take place at current value, changes in current value will be accounted for in a revaluation reserve. When the revaluation reserve becomes negative, the negative part will be accounted for as a loss in the profit- and loss account. Declared dividends will lead to income in the profit- and loss account (RJ 214.504). Current value can consist of replacement value, going concern value, market value and net realizable value.<sup>67</sup> Usually current value is connected with the term market value as described in RJ 940. In practice, current value will usually be based on the net value of equity based on the fair value of the assets and liabilities of the participation. Also the market value of the company on a stock exchange can be of importance. Current value is therefore a broader term than fair value.<sup>68</sup>

#### *Other securities*

When shares do not constitute a participation, they can be categorized as securities. The moment of recognition of a security is the moment on which a contractual obligation to transfer the security is entered or the moment on which the security is actually transferred (RJ 290.703). At first recognition, securities need to be measured at fair value, which at an arms' length transaction is usually equal to cost price (RJ 260.201). Future valuation depends on whether the security is listed or not. Listed securities should be valued at fair value, whereas non-listed securities can be valued either at cost price or fair value.<sup>69</sup> For securities that are valued at fair value, the increase or decrease of value can be directly accounted for in the profit- and loss account or in the revaluation reserve. This is a balance sheet item in equity in which unrealized profits are recorded. When using the revaluation reserve, a negative balance has to be accounted for in the profit- and loss account. The revaluation reserve is released into the profit- and loss account when the security is sold.<sup>70</sup> When measured at cost price, the declared dividend, impairment and realized changes in value will be accounted for in the profit- and loss account. (RJ 226.205).

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65 See section 3.1 and S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 8.2.1.

66 Article 2:384 , paragraph 1, Dutch Civil code.

67 Article 1 -5 Decree Current Value.

68 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 8.2.5.

69 Article 2:384, paragraph 1 Dutch Civil Code and RJ 226.204.

70 Article 2:390, Dutch Civil Code and RJ 226.204, 226.205.

### *Fixed income stocks*

In case of fixed income stocks, valuation needs to account for the special nature of the stocks. The question is to what extent these shares bare the same rights on the equity and results of the company as regular shares. If fixed income stocks do not constitute rights on equity reserves, valuation at cost price will often be the most appropriate method (RJ 214.326).

### **3.2.2 Shares as a financial liability**

When a company issues shares, these will be recorded on the liability side of the balance sheet, in the item share capital. The share capital can consist of different types of shares, for example normal shares, preference shares or priority shares. Preference shares give priority in profit distributions, priority shares give priority in voting rights.<sup>71</sup> The shares will be recorded for their nominal value, when the company receives more than the nominal amount, the surplus will be recorded in the premium reserve (RJ 240.202 and 940). In case a company wants to buy back its own shares, a special regime exist which will be described below.

#### *Purchase of own shares*

A special accounting regime exists for a company's own shares, also called treasury shares. Treasury shares are company shares that are bought by the company itself, including certificates of these shares (RJ 940). There a number of ways in which a company can acquire its own shares, the possibilities are for example merger, inheritance, exchange or buying of shares.<sup>72</sup> As a rule, a company may not account for its own shares as an asset.<sup>73</sup> Equity needs to be decreased with the acquisition price of the bought own shares and certificates. This decrease may not take place within the item issued share capital.<sup>74</sup> It is also not allowed to account for own shares that are held by a participation as an asset. The value of the participation needs to be adjusted by the acquisition price or book value of the own shares that are held by the participation.<sup>75</sup> In the explanatory notes needs to be stated from which item of equity the acquisition price or book value of the own acquired shares are deducted. Deduction can only take place from items that can be classified as free reserves, for example share premiums, other reserves and to be distributed

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71 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 8.2.5. Preference shares must be accounted for as a liability in the consolidated account if there is a mandatory repayment (RJ 290.803).

72 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 12.3.1.

73 Article 2:382, paragraph 5, Dutch Civil Code.

74 Article 2:373, paragraph 3, Dutch Civil Code.

75 Article 2:382, paragraph 5, Dutch Civil Code.

profit.<sup>76</sup> The reason for acquisition, the number of shares, the nominal amount, the agreed price and the percentage of capital it represents needs to be stated.<sup>77</sup>

### **3.3 Bonds**

Bonds can be qualified as an asset or debt, depending on its nature. If a company acquires a receivable on another entity this will be presented on the asset side of the balance sheet. If a company issues own bonds, these will be presented as debt. First bonds as an asset will be discussed, followed by bonds as a liability.

#### **3.3.1 Bonds as a financial asset**

Bonds that are bought by the company can be categorized as securities within the financial assets.<sup>78</sup> Depending on their duration, they will be classified as financial fixed assets or current assets. The moment of recognition of a security is the moment on which a contractual obligation to transfer the security is entered or the moment on which the security is actually transferred (RJ 290.703). At first recognition, securities need to be measured at fair value, which at an arms' length transaction is usually equal to cost price (RJ 260.201). Future valuation depends on the fact if bonds are held to maturity. When this is the case, they need to be valued at amortized cost price (RJ 226.206). When bonds are not classified as held to maturity, listed bonds must be valued at fair value and non-listed bonds against amortized cost price or fair value. When valued at fair value, changes in valuation will be accounted for in the profit- and loss account or in the revaluation reserve. When using the revaluation reserve, a negative balance has to be accounted for in the profit- and loss account. The revaluation reserve is released into the profit- and loss account when the security is sold (RJ 226.207 and 226.208).

#### **3.3.2 Bonds as a financial liability**

A financial liability is an obligation to transfer liquid assets or another financial asset to another party or to exchange financial assets and obligations with another party on conditions that are potentially disadvantageous (RJ 290.404). When a company issues a bond, this needs to be recognized as a liability.<sup>79</sup> In principle bonds need to be valued at fair value on the moment of the transaction. In a transaction at arm's length, this will usually be equal to cost price. After first recognition valuation usually needs to take place at amortized cost price. Valuating bonds at fair value is possible if these are held for trading. A liability is held for trading if it is acquired or incurred principally for the purpose of selling or

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76 Article 2:378 paragraph 2, Dutch Civil Code.

77 Article 2:378 paragraph 3, Dutch Civil Code.

78 Article 2:367, sub e, article 364, paragraph 3 Dutch Civil Code and RJ 214.404.

79 Article 2:375, paragraph 1 Dutch Civil Code.

repurchasing it in the near term or on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking (RJ 290.508).

### **3.4 Derivatives**

A derivative is a secondary financial instrument that has the following characteristics (RJ 940):

- the value changes as a result of changes in market factors like interest rate, price of a financial instrument, prices of goods, exchange rate, price indexes, credit rate or other variables (sometimes called 'underlying value');
- there are no or little initial investments required compared to other similar contracts that react in a similar way to aforementioned market factors;
- it will be settled in the future.

The main derivatives are forwards, futures, options and swaps. A *forward contract* is an agreement between a buyer and a seller in which the buyer has the right and obligation to buy a specified asset on a specified date and at a specified price.<sup>80</sup> The seller is also obliged to perform as agreed in the contract. A *future* is similar to a forward contract, the difference is that futures are standardized contracts that trade on organized exchanges and are subject to a daily settlement procedure. This means that investors who incur losses pay the losses every day to the counterparty that makes a profit.<sup>81</sup> *Options* are also a form of forward contracts in which the buyer has a right, but not the obligation to exercise the right to buy or sell at a specified price.<sup>82</sup> Different combinations of the basic instruments of forward contracts, futures and options are possible. One of the most popular form is the *swap*, which is a contract in which two parties agree to exchange cash flows.<sup>83</sup>

In principle derivatives need to be valued on a separate basis.<sup>84</sup> However, derivatives can be used to hedge multiple risks that a company is exposed to; e.g. exchange rate risk, interest risk, credit default risk and commodity price risk. When risks are hedged by using derivatives, hedge accounting becomes of importance. Hedge accounting aims to present the results of the hedge instrument (a specific derivative) and the hedged position simultaneously in the profit- and loss account. The goal is to present a true and

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80 S.S.S. Kumar, Financial Derivatives, New Delhi: PHI Learning Private Limited 2007, p. 2.

81 M. Chance, Introduction to Derivatives and Risk Management, Mason: South-Western 2010, p. 3.

82 S.S.S. Kumar, Financial Derivatives, New Delhi: PHI Learning Private Limited 2007, p. 2.

83 M. Chance, Introduction to Derivatives and Risk Management, Mason: South-Western 2010, p. 5.

84 Article 2:385 Dutch Civil Code.

fair view on the hedging of the risk in the annual account. When certain conditions are met, hedge accounting can be applied, otherwise the general accounting rules on financial instruments have to be used.<sup>85</sup> First accounting rules without applying hedge accounting will be discussed, followed by a description of accounting rules that make use of hedge accounting.

### **3.4.1 Without hedge accounting**

When no hedge accounting is used, a distinction has to be made between derivatives of which the underlying value is listed on a stock exchange and derivatives of which the underlying value is not listed. Derivatives which are listed are valued at fair value, changes in fair value are accounted for in the profit-and loss account (RJ 290.512). For derivatives that are not listed, the fair value method can be used or the company can choose to value the derivative at cost price (RJ 290.513). This choice has to be consistent for all derivatives for which there is no listed underlying value. The underlying value is listed when there is a stock exchange where the underlying value is being traded. Securities that are traded on over the counter markets are not listed, independent of how active these markets are. In IFRS, all derivatives are valued at fair value, the option in Dutch GAAP that non-listed derivatives can be recorded at cost price does not exist in IFRS.<sup>86</sup>

### **3.4.2 With hedge accounting**

Hedge accounting can be used when a mismatch occurs between results from the hedge-instrument at one hand and the hedged position at the other hand. This can be as a consequence of timing and valuation differences. A hedge-instrument is a by policy designated financial instrument of which the change of fair value or cash flow will probably compensate the fair value or cash flow of the designated hedged position. A hedge instrument can be a derivative or in the case of exchange rate hedging a financial asset in a foreign currency (RJ 290). The provisions of hedge accounting aim to incorporate the results of the hedge instrument together with the hedged position in the profit- and loss account (RJ 290.601). Hedge accounting can be applied when the following conditions are met (RJ 290.613 - 290.616):

- the entity describes the hedging strategy and documents how the hedge relationship fits within the goals of risk management and the expected effectiveness of the hedge relationship;
- the entity describes all hedge-instruments that are involved in the hedge relationship;
- the ineffectiveness of the hedge-instrument needs to be accounted for in the profit- and loss account.

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85 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.5.1.

86 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.4.8.

Applying hedge accounting is optional, a company can also opt to use the standard accounting methods for financial instruments (RJ 290.601 and 290.602). The Council of Annual Reporting states that hedge accounting can be applied in two ways: on the basis of overall documentation or on the basis of documentation per individual hedging relationship. When applying hedge accounting on the basis of overall documentation, all risks need to be accounted for in a consistent way. This means that there is no choice to apply hedge accounting for an individual hedging relationship, this choice has to be made for all hedging relationships in general. When using documentation per individual hedging relationship the choice to use hedge accounting can be made on a case by case basis.<sup>87</sup> Hedge documentation in advance is obligatory for two reasons. Firstly it makes it possible to judge if the hedge fits the requirements for hedge accounting. Secondly and most important, it prevents from making the decision to apply hedge accounting after the results of the hedge instrument and/or hedged position are known. This would mean that the results of the company can be improperly influenced, by making a posterior choice for an accounting method that fits the interest of the board of the company best at that moment.<sup>88</sup>

#### *Effectiveness*

In IFRS, specific requirements are stated for the effectiveness of the hedge when applying hedge accounting. The expected (anterior) and realized (posterior) effectiveness of the hedge needs to be within a range of 80 – 125 percent (IAS 39 AG 105). This means for example when the profit on the hedge instrument is 500 and the loss on the hedged assets is 450, the effectiveness is  $500/450 = 111$  percent and  $450/500 = 90$  percent. This entails that the hedge is highly effective and hedge accounting can be applied. When the effectiveness falls outside this range, hedge accounting can no longer be applied. In contrast with IFRS, the council of Annual Reporting does not require a minimal effectiveness of the hedge in order to apply hedge accounting. It is only stated that the expected effectiveness needs to be documented and that the ineffectiveness needs to be accounted for in the profit- and loss account (RJ 290.614 and 290.615). The guidelines state that the effectiveness of hedge accounting can be measured in different ways, for example by (RJ 290.616):

- the comparison of fair value change of a hedge-instrument and the hedged position within a certain period or cumulative from entering the hedging relationship;
- the comparison of critical characteristics of the hedge-instrument and the hedged position, the extent to which these correspond with each other can be an indication of effectiveness;

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<sup>87</sup> S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.5.1.

<sup>88</sup> S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.5.2

- applying a regression analysis on the changes of fair value of the hedge-instrument and the hedged position.

Even when hedge accounting can be applied, the extent of which the hedge is ineffective needs to be accounted for in the profit- and loss account. The amount of ineffectiveness that needs to be accounted for is dependent on the method of hedge accounting that is applied.<sup>89</sup> The methods allowed under Dutch GAAP are fair value hedge accounting, cash flow hedge accounting, hedging of net-investment in a foreign entity and cost price hedge accounting (RJ 290.617 – 290.618). These different methods will be described below.

#### *Fair value hedge accounting*

When applying fair value hedge accounting, the hedge-instrument is being valued at fair value, with changes in fair value accounted for in the profit- and loss account. The hedged position will also be valued at fair value, in so far as the change in value can be allocated to the hedged risk. An example is the hedging of the interest risk of a fixed interest receivable; when the interest rate changes, the fair value of the receivable changes, but this can be compensated by the fair value change of an interest rate swap (the hedge-instrument) in which a fixed interest is received and a variable interest has to be paid (RJ 290.618, sub a). When applying fair value hedge accounting, change in fair value of the derivative and the hedged position will be accounted for directly in the profit- and loss account (RJ 290.619). In case of a 100 percent effective hedge, the changes are equal in amount and opposite to each other, in which case the net effect on the profit- and loss account will be zero. In the case of a partial ineffective hedge, the ineffectiveness will be accounted for in the profit- and loss account. In case of the example where the profit on the hedge instrument is 500 and the loss on the hedge position is 450, a profit of 50 will be accounted for. Hedge accounting needs to stop when the hedge-instrument expires, ends or is being sold or exercised; the hedge does no longer meet the requirements for hedge accounting or the company does no longer choose for applying hedge accounting (RJ 290.620).

#### *Cash flow hedge accounting*

Cash flow hedging is applied for hedging future uncertain cash flows, for example hedging of variable interest payments or payments in a foreign currency with regard to purchases or sales. In the case of cash flow hedge accounting, the hedge-instrument needs to be valued at fair value.<sup>90</sup> The part of the profit and

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89 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.5.2

90 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.5.5.

loss that is attributable to the hedge-instrument that can be qualified as effective, needs to be accounted for directly into equity. On the moment the results of the hedged position are recognized in the profit- and loss account, the related amount that was booked into equity needs to be transferred to the profit- and loss account. This is for example the case when a payment in a foreign currency is received with regard to a sale of goods. The exchange rate result in the sale is then simultaneously recorded with the result on the hedge-instrument. The ineffective part of the profit and loss on the hedge-instrument needs to be directly accounted for in the profit- and loss account (RJ 290.625). When the change of value of the hedge-instrument is larger than the change in value of the future cash flow (over-hedge), the amount of additional hedge needs to be accounted for directly in the profit- and loss account. When the change of value of the hedge-instrument is smaller than the change in value of the future cash flows (under-hedge), the ineffectiveness will only be accounted for when the future cash flows will be settled. Hedge accounting needs to be terminated when the hedge-instrument expires or is being sold, ends or exercised; the hedge does no longer meet the requirements or the company does no longer choose for applying hedge accounting (RJ 290.632).

#### *Hedging of net-investment in a foreign entity*

A net-investment in a foreign entity is the amount of the stake that a company has in the balance of assets and liabilities of a foreign entity (RJ 940). When this foreign entity is reporting in a functional currency that is different from the currency of the reporting company, changes in value of the net-investment due to changes in exchange rate will be accounted for directly into equity and not in the profit- and loss account (RJ 122.211). The foreign exchange rate can be hedged and when hedge accounting is applied, the hedge-instrument will be valued at fair value, in which the changes in value will be accounted for directly into equity as far as the hedge is effective (RJ 122.217). This hedge accounting is very similar to cash flow hedge accounting.

#### *Cost price hedge accounting*

Cost price hedge accounting can be used when the hedged position is valued at cost price. The hedging-instrument (derivative) can then also be valued at cost price (RJ 290.633, sub a1). This way the results of the hedge-instrument and the hedged position will be recorded in the period. Since IFRS demands that all derivatives are valued at fair value, cost price hedge accounting is only possible when Dutch GAAP is applied. As a result of cost price hedge accounting, changes in value of the hedge-instrument usually stay off-balance. An exception is a monetary item in a foreign currency, then the hedge-instrument will be valued at the exchange rate on balance sheet date to offset the exchange rate results of the hedged position

(RJ 290.633, sub a3). In order to present the ineffective part of the hedging relationship in the right period in the profit- and loss account, the company needs to compare the amount of risk in the hedged position and the effectiveness of the hedge-instrument. When the hedge-instrument is larger than the hedged position (over-hedge), the ineffective part need to be valued at fair value with changes in valuation accounted for in the profit- and loss account (RJ 290.634). When a premium is paid for a derivative that is valued at cost price, the premium will appear on the balance sheet, but other changes in value will not. Companies that apply Dutch GAAP in their annual account mostly use cost price hedge accounting for their financial instruments because this is the most simple method. Usually no bookkeeping entries need to be made until the moment of settlement of the hedge.<sup>91</sup>

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91 S Böhmer, M.N. Hoogendoorn, F. Krens, Handboek Jaarrekening 2010, Kluwer: Rotterdam 2010, par. 26.5.7.

## 4. Fiscal accounting rules on financial instruments

This chapter focuses on the fiscal accounting rules of financial instruments. First the general fiscal accounting rules on financial instruments will be discussed, followed by a more in depth review of accounting rules applicable to shares, bonds and derivatives.

### 4.1 General fiscal accounting rules on financial instruments

The tax legislator has established no specific rules and regulations on financial instruments. Therefore valuation is left to the concept of sound business practice, which is an open system that is mainly developed in case law. The principles of reality, prudence and simplicity are of importance when accounting for financial instruments.<sup>92</sup> Specific case law is relevant for certain types of financial instruments, which will be discussed in the following sections.

#### 4.1.1 Recognition and derecognition of financial instruments

The moment of recognition and derecognition of financial instruments defines the period in which profit or losses are included in the taxable profit. In correspondence with commercial accounting rules, economic ownership plays a key role in tax accounting. Profit realization can for example be deferred until the moment of legal transfer of the asset, unless economic ownership is transferred before that date. In that case the date of economic transfer is decisive.<sup>93</sup>

#### 4.1.2 Classification as equity or debt

For tax purposes it is of great importance to distinguish between equity and liabilities. For the debtor, the remuneration on equity is not tax deductible, while the remuneration on liabilities is (subject to anti abuse rules).<sup>94</sup> For the creditor, income received from equity may be exempt under the participation exemption, while income received from debt is taxable under the concept of total profit.<sup>95</sup> A financial instrument is in principle considered as debt or equity for tax purposes if it is classified as such for civil law purposes. The most important characteristic for a financial instrument to qualify as debt is the obligation to repay the nominal value, regardless if this is subject to certain conditions. When there is no payback obligation, the

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92 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, Deventer: Kluwer 2008, p. 22.

93 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 5.

94 Article 10,1,a , 10,1,b, 10,1,c, and 10,1,d Corporate Income Tax Act.

95 Article 13, Corporate Income Tax Act. (participation exemption) and article 3.8 Personal Income Tax Act juncto article 8.1 Corporate Income Tax Act (concept of total profit).

financial instrument will generally be qualified as equity.<sup>96</sup> However, the Supreme Court ruled that financial instruments that are regarded as debt for civil purposes should be reclassified as equity for tax purposes if the following conditions are met:<sup>97</sup>

- the parties intended to provide equity rather than debt (sham loan)
- the loan is entered into under such conditions that the creditor should reasonably have known that the loan will never be repaid (bottomless pit loan); or
- the loan is entered under such conditions that the creditor is considered to participate in the entity of the debtor (profit participating loan). This is the case when the loan is profit participating, subordinated and has a perpetual term. The loan is profit participating if the remuneration is almost completely dependent on the profit of the company in a certain year. The loan has a perpetual term if the loan has a term exceeding fifty years and the loan can be called in prematurely by the lender only in the event of liquidation, suspension of payments or bankruptcy of the borrower.<sup>98</sup>

When a loan is established under such conditions that it functions as equity for the taxpayer, remuneration on the loan may not be tax deductible.<sup>99</sup> Benefits derived from a loan that is deemed to function as equity can qualify for the Dutch participation exemption.<sup>100</sup> Case law has only addressed situations in which liabilities should be reclassified into equity. For the inverse situation where equity should be reclassified as a liability, no case law is available.<sup>101</sup>

#### **4.1.3 Offsetting financial assets and liabilities**

Dutch tax accounting follows the general prohibition in Dutch GAAP to offset assets and liabilities against each other. However, in certain cases the income that is derived from financial assets and liabilities needs to be offset against each other as a result of hedge accounting. The net amount of unrealized profit can be deferred whereas the net amount of unrealized losses can be taken into account.<sup>102</sup> This will be elaborated on in section 4.4.

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96 Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 4.1.

97 Supreme Court, 27 January 1988, BNB 1988/217.

98 Supreme Court, 11 March 1998, BNB 1998/208 and 25 November 2005, BNB 2006/82.

99 Article 10, section 1, sub d Corporate Income Tax Act.

100 Article 13, section 4, sub b Corporate Income Tax Act.

101 Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 4.1.

102 L.A. Lutz and W.J.W. Vosse, *Het cacaobonen-arrest: nadere regels met betrekking tot (verplichte) samenhangende waardering*, Maandblad Belasting Beschouwingen, February 2010, par. 2.3.

#### **4.1.4 Methods of valuation of financial instruments**

For tax purposes, financial instruments can be valued at cost price, amortized cost price, market value, intrinsic value, net asset value, going concern value or a combination thereof. These methods of valuation will be discussed below in general, specific application of these methods to shares, bonds and derivatives will be described in more detail in the next sections.

##### *Cost price*

Cost price is the price for which an asset is acquired. The cost price method is a basic valuation system which means that there are circumstances in which it cannot be applied. When there is a substantial decrease in value for an asset, an impairment needs to take place when that value drops below cost price.<sup>103</sup> Therefore the cost price method is not applied separately, but in conjunction with lower market value, intrinsic value or going concern value.<sup>104</sup> Transaction costs are included in cost price.<sup>105</sup>

##### *Amortized cost price*

Amortized cost price is mostly applicable to bonds. The method is similar to the commercial method described in section 3.1. Although amortization of the premium or discount on the basis of the effective interest method is theoretically most correct, the tax administration generally allows amortization on the basis of the linear method.<sup>106</sup> Transaction costs are also included in amortized cost price, these are amortized over the duration of the contract.<sup>107</sup>

##### *Market value*

Market value is used for valuation of shares and bonds. It can be characterized as the direct profitability value of an asset separate from the business activities.<sup>108</sup> It is the price at which the security is quoted on a stock exchange, taking transaction costs into account.<sup>109</sup> For assets, market value reflects the amount that

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103 Supreme Court 30 March 1955, BNB 1955/183.

104 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 15.1.3, 15.5.1, 15.5.2, and 16.1.4.

105 W. Bruins Slot, *de invloed van afgeleide financiële instrumenten op de fiscale jaarwinst*, WFR 1995/179, par. 2.2.1. and P.G. Kroon, S.F.M. Niekel and J.W. Tangelde, *wisselskoersveranderingen en fiscus*. Deventer: Kluwer 2000, pag. 105.

106 Conclusion A-G Van Kalmthout, Supreme Court 6 December 2002, BNB 2003/136, point 10.

107 A. de Birk en L.H. Storm van 's Gravesande, *de converteerbare obligatielening aan de debetrijde, fiscaal en IFRS*, WFR 2010/453, note 6.

108 G.T.K. Meussen, *Bedrijfswaarde*, FED, Deventer: Kluwer 1997, p. 35.

109 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 15.1.2., 15.1.3, 16.1.3 and 16.1.4.

can be received when selling the asset, less transaction costs. For liabilities, market value reflects the amount that has to be paid to settle the obligation plus transaction costs.<sup>110</sup>

#### *Intrinsic value*

The intrinsic value is mostly used for valuating shares, it is the value that can be attributed to a share on the basis of the equity of the entity, that is derived from the fair value of assets and liabilities. This is the estimated market value of the company by continuation going concern. This means that in addition to the tax value of assets and liabilities, the fair value of obligations and any hidden reserves need to be accounted for.<sup>111</sup>

#### *Net asset value*

The net asset method is derived from the commercial accounting method. It is the value of a subsidiary based on its value of assets less debts valued against the methods that the participating company applies for its own assets and liabilities. The participation is initially recognized at the share of the participating company in its equity, the carrying amount in the future is increased or decreased by changes in equity of the participation.<sup>112</sup> The difference with the intrinsic value method is that all assets at the intrinsic value method are valued at fair value whereas at the net asset method this can also be at for example cost price.

#### *Going concern value*

Going concern value is a method for valuating financial instruments. It is the value which an acquirer would give to a separate asset, when taking into account the value of the company as a whole and continuing the business.<sup>113</sup> Going concern value is usually equal to the indirect profitability value, it is the current value of future cash flows attributable to the asset.<sup>114</sup>

### **4.1.5 Requirements for disclosing information**

There are no specific requirements in tax law for disclosing information on financial instruments. However, there is an obligation to supply all relevant information which can be of relevance for determining the taxable profit. This means that the taxpayer has to disclose books, documents and

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110 J.C.M. van Sonderen, *Fiscale Aspecten van opties*, Deventer: Kluwer 1993, par. 5.4.1 and 5.5.1.

111 L.W. Sillevius, M.L.M. van Kempen, *Cursus Belastingrecht Inkomstenbelasting*, Deventer: Kluwer 2011, 5.4.1.L.c5.

112 Note N.H. de Vries, Supreme Court, 23 September 2009, BNB 1993/60 and S Böhmer, M.N. Hoogendoorn, F. Krens, *Handboek Jaarrekening 2010*, Kluwer: Rotterdam 2010, par. 8.2.6.

113 G.T.K. Meussen, *Bedrijfswaarde*, FED, Deventer: Kluwer 1997, p. 1.

114 G.T.K. Meussen, *Bedrijfswaarde*, FED, Deventer: Kluwer 1997, p. 35 and p.208.

correspondence which could influence the tax position of the entity.<sup>115</sup> When the information provided is insufficient or inaccurate, the burden of proof for the taxable profit shifts to the taxpayer.<sup>116</sup>

## **4.2 Shares**

For the tax treatment of shares, a distinction has to be made between shares that constitute a participation and shares that do not constitute a participation. The criteria for qualifying as a participation are different in civil and tax law. The civil requirements are discussed in section 3.2, this section will focus on the fiscal criteria. First shares that qualify as a participation will be discussed, followed by a description of the tax treatment of shares that do not constitute a participation.

### **4.2.1 Participation**

One can speak of a participation for tax purposes if the taxpayer holds at least 5 percent of the nominal paid-up share capital of a company with a capital dividend into shares.<sup>117</sup> If the requirements of article 13 CITA are met, all income that is derived from the participation is exempt. This means that dividends, capital gains and capital losses realized with respect to the qualifying participation are not taxed at the level of the mother company. The participation exemption aims to prevent double taxation of business profits at different corporate levels and will be discussed in more detail in chapter 4. Because all income from qualifying participations is exempt, valuation of participations for tax purposes is of less importance. Changes in value will have no influence on taxable income due to the exemption. However, it can result in a change of the fiscal equity, which is for example of importance for thin capitalization rules.<sup>118</sup> The State Secretary mentioned that in principle every valuation method of participations is allowed, on the condition that it is in accordance with sound business practice following consistent accounting principles.<sup>119</sup> Participations are in principle valued at cost price or lower going-concern value.<sup>120</sup> Sound business practices obliges the company to value at lower going-concern value when this is lower than cost price. In case the value rises again, the participation needs to be revalued up to the level of cost price again.<sup>121</sup> Also, valuation at cost price or lower intrinsic value is allowed,<sup>122</sup> as well as valuation at fair value<sup>123</sup> or higher

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115 Article 47, General Law on Taxation.

116 Article 25, General Law on Taxation.

117 Article 13 , paragraph 2, Corporate Income Tax Act.

118 Fiscal equity is for example of importance for the thin cap regulation of article 10d Corporate Income Tax Act.

119 Dutch Parliamentary History, NAV, 2005/06, 30 752, number 8, p. 91.

120 Supreme Court, 1 December 1971, BNB 1972/16.

121 Supreme Court, 9 January 1964, BNB 1964/185.

122 Supreme Court, 10 February 1960, BNB 1960/108 .

intrinsic value.<sup>124</sup> Valuation of a participation on the basis of the net asset method is forbidden, as this could lead to losses that are not actually incurred.<sup>125</sup> The net asset method based on fiscal book values does not include hidden reserves of the company. Also valuation at nominal value is not allowed as this could lead to profits or losses that are not actually realized. By valuation at nominal value, premiums or discounts on the shares are wrongly not accounted for.<sup>126</sup>

#### **4.2.2 Other shares**

When shares do not constitute a participation, they can be qualified as other shares. Because no participation exemption applies for these shares, valuation is of importance. Readily marketable shares will normally be valued at cost price or lower stock exchange price, also valuation at stock exchange price is in accordance with sound business practice.<sup>127</sup> Not readily marketable shares will be valued at cost price, because another value is difficult to determine.<sup>128</sup>

### **4.3 Bonds**

A bond can be described as an acknowledgement of debt that is traded on a stock exchange.<sup>129</sup> For valuation purposes a distinction has to be made between bonds that are intended to be held to maturity or bonds that are intended for sale before the maturity date.

#### *Intended for sale before maturity date*

For bonds that are intended to be sold before the maturity date, market circumstances have to be taken into account for valuation purposes. Readily marketable bonds can be valued at cost price or lower going-concern value, also valuation at stock exchange price or cost price or lower stock exchange price can be in accordance with sound business practice.<sup>130</sup> Not readily marketable bonds will be valued at cost price, because another value is difficult to determine.<sup>131</sup> If a bond can be qualified as readily marketable depends

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123 Supreme Court, 8 February 1933, B. 5374 and A.O. Lubbers, *Goed Koopmansgebruik, Een onderzoek naar de rol van wetgever en rechter bij de introductie en ontwikkeling van goed koopmansgebruik*, Amersfoort: SDU 2005, p. 138.

124 Supreme Court, 14 June 1978, BNB 1979/181.

125 Supreme Court, 23 September 1992, BNB 1993/60.

126 Supreme Court, 15 October 1947, B. 8410.

127 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 15.1.1 – 15.1.3.

128 L.W. Sillevius, M.L.M. van Kempen, *Cursus Belastingrecht Inkomstenbelasting*, Deventer: Kluwer 2011, 3.2.18.G.b1.

129 Van Dale Groot Woordenboek der Nederlandse Taal, 2011.

130 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 16.1.1 – 16.1.4.

131 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 16.1.

on the fact if it is traded on a regular basis and market prices are available. Changes in market interest rate, currency exchange rates and bad debt exposure can affect the valuation of the bonds. Even when bonds are valued at cost price, changes in market circumstances need to be taken into account when the value of the bond drops below cost price.

#### *Intended for held to maturity date*

For held to maturity bonds, the amount of interest and nominal value that will be received is of importance. These factors are included in the amortized cost price method that is obligatory for these bonds.<sup>132</sup> In literature it is stated that when bonds are bought below par, the profit should be gradually recognized over the term of the bond.<sup>133</sup> When a bond is bought above par, the premium has to be accounted for as an asset and depreciated gradually over the year.<sup>134</sup> A linear amortization of the premium or discount instead of the effective interest method is allowed for tax purposes.<sup>135</sup> Changes in market interest rate will not affect the value of a held to maturity bond, since this does not affect the to be received interest and nominal amount. Changes in currency exchange rate can however affect the income that will be received from the bond if the bond is noted in a foreign currency. Also possible default of the company that issued the bond can affect the proceeds from the bond. Since the amortized cost price method is still a cost price method, valuation at (amortized) cost price cannot be upheld if there is a substantial drop in value of the bond due to certain risks. In that case a downward revaluation is obligatory.<sup>136</sup>

#### **4.4 Derivatives**

In Dutch tax law, there are no specific rules for computing income of secondary financial instruments called derivatives. Therefore, sound business practice is the only guidance which defines the boundaries that a system of profit determination cannot cross. In three judgments, the Supreme Court tried to define the tax treatment of derivatives.<sup>137</sup> In principle valuation of assets and liabilities needs to take place on an individual basis.<sup>138</sup> However, if this is in conflict with the principle of reality, a combined valuation (hedge accounting) must be applied.

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132 Supreme Court, 10 June 1970, BNB 1970/177.

133 J.M. van der Heijden, 'Tijdstip van winstrealisatie', WFR 1999, p. 121-134 . par. 3 and R. Hein, 'Over banken, obligaties en overvoorzichtigheid', WFR 1995, p. 1820-1830

134 Supreme Court, 13 November 1991, BNB 1992/109.

135 Supreme Court, 6 December 2002, BNB 2003/136.

136 J.A.C.A. Overgaauw a.o. Fiscale Encyclopedie De Vakstudie Inkomenbelasting, Deventer: Kluwer 2011, article 3.25, par. 16.1.

137 Supreme Court, 23 January 2004, BNB 2004/214, 16 November 2007, BNB 2008/26, 10 April 2009, BNB 2009/271.

138 See for example: Supreme Court, 7 February 2003, BNB 2003/173, point 5.0.4. See also article 2:385 Civil code.

#### 4.4.1 Individual valuation

In general, the principles of sound business practice recognize two valuation methods for financial assets: historic cost price or market value. For financial liabilities valuation at historic income price or market value is used.<sup>139</sup> When valuating at cost price, a downward revaluation needs to take place when market value drops below historic cost/income price. This means that an unrealized loss has to be taken into account. When market value rises above historic cost/income price, an upward revaluation does not have to take place when valuating at cost price. This means that unrealized gains can be deferred until they are realized. These valuation rules in principle apply to all secondary financial instruments, regardless of whether these derivatives serve as a hedge for a corresponding asset or liability. This means that in principle valuation can take place without considering the relationship with a possible corresponding asset or liability. However, when the derivative and the underlying asset or liability function as a specific hedge for fiscal purposes, valuation in coherence can be obligatory, as will be discussed in this section. Although valuation in coherence is optional for Dutch commercial accounting purposes, it can be obligatory for Dutch fiscal accounting purposes.<sup>140</sup>

#### 4.4.2 Applying the principles of sound business practice on derivatives

As stated in section 2.2, sound business practice is based on the principles of reality, prudence and simplicity. Let's see how these principles would be applied in case of a derivative that is used as a hedge-instrument. For example a company that reports in euro's and owns a bond for which the principle is received on 31 December 2013 at the amount of \$ 100,000. To hedge the exchange rate risk, the company has entered into a currency swap in which it will pay \$ 100,000 and receive € 100,000 on 31 December 2013. The exchange rate will be as follows:

- 31 December 2011:    \$ 1 = € 1.00
- 31 December 2012:    \$ 1 = € 0.90
- 31 December 2013:    \$ 1 = € 0.80

Based on sound business practice, the bond can be valued at cost price or lower stock exchange price.<sup>141</sup> The depreciation of the dollar on 31 December 2012 will lead to a fall in stock exchange price which will

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<sup>139</sup> Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 3. and J.C.M. van Sonderen, Fiscale Aspecten van opties, Deventer: Kluwer 1993, par. 5.4.1. and 5.5.1.

<sup>140</sup> Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 3.

<sup>141</sup> J.A.C.A. Overgaauw a.o. Fiscale Encyclopedie De Vakstudie Inkomstenbelasting, Deventer: Kluwer 2011, article 3.25, par. 16.1.4.

cause a loss of € 10,000 ((€ 0.90 -/ € 1.00) \* € 100,000) on the bond in 2012 that can be accounted for in the profit- and loss account based on the principle of prudence. However based on the same principle of prudence a gain on the currency swap need not to be recognized because it is not realized yet. The currency swap increased in value because there is a right to receive € 100,000 for \$ 100,000 while at the current exchange rate it would only receive € 90,000. The swap therefore has a value of € 10,000. By applying separate accounting the company would present a loss that will actually never be incurred, because the transaction is fully hedged. The principle of reality will in certain situations prevail over the principle of prudence in which case a combined valuation (hedge accounting) needs to be applied. In the following description of case law will be discussed which guidelines the Supreme Court set out.

#### 4.4.3 Case law on valuation in coherence

In recent case law, the Supreme Court developed rules for the treatment of financial instruments. The rules that can be deduced from these judgments will be described below.

##### *Hedge judgment*

The hedge judgment<sup>142</sup> originates from 23 January 2004. X BV owns a receivable of \$ 295 million that is attributable to a permanent establishment in Switzerland. To hedge the exchange rate risk, X BV entered into a currency swap with its mother M BV. X BV has to pay \$ 295 million to M BV in return for 620 million guilders.<sup>143</sup> The term of the receivable is three year, whereas the term of the swap is five year.<sup>144</sup> When visualized in a balance sheet, the facts of the case can be presented as follows:

##### **Balance sheet X BV**

Receivable	\$ 295	Swap payable M BV	\$ 295
Swap receivable M BV	fl. 620		

The Supreme Court considers that when a receivable in a foreign currency offsets a payable in the same currency, the change in exchange rate of that currency will have no effect on the net financial position. Valuation of the payable and receivable may therefore not be applied separately. Because the term of the receivable and the swap are not the same, ultimately an non hedged position will arise. However, in the years that there is a hedge position, it is not allowed to present a loss or profit that can be compensated by

142 Supreme Court, 23 January 2004, BNB 2004/214

143 The guilder was the legal currency in the Netherlands before the introduction of the euro in 2002. The guilder is abbreviated as fl (florijn).

144 Legal ground 5.3.4.

the same profit or loss on the opposite currency position. The currency risk arises first when after repayment of the liability or collection of the receivable, a currency item is no longer hedged.<sup>145</sup>

From the hedge judgment follows that when there is a receivable and a payable in the same currency, a change in exchange rate cannot affect the receivable and payable separately. In other words, it is not allowed to take a loss on the receivable and delay a gain on the payable. The company has to use a common valuation for assets and liabilities as long as there is a closed position. When there is no longer a closed position, individual valuation of the asset and liability has to be applied. In the cacao bean judgment the Supreme Court elaborated on the criteria for a closed position, which will be discussed below.

#### *Option judgment*

The Supreme Court passed the option judgment<sup>146</sup> on 16 November 2007. BV X wrote a call option on shares that were in its possession that were listed on a stock exchange. The shares were valued at cost price or lower stock price, the obligations that result from the written option were valued at the received remuneration or higher market value of the call option. With regard to the rise in stock exchange, a loss is calculated on the option obligation. BV X argued that it did not intend to hedge the risk, but that it merely wanted to realize additional income by cashing option premiums.<sup>147</sup>

#### **Balance sheet X BV**

valued at cost price or lower stock price	Written call option	valued at received remuneration or higher market value
Listed shares		

When an obligation arising from a written call option is fully hedged by the possession of the relevant shares, a loss on the option will be compensated with a rise in value of the shares. This is why a rise in price of the call option and consequent rise or the obligation thereof, will have no net effect on the financial position. The Supreme Court has decided that it is not in accordance with the principle of reality of sound business practice, that the option obligation is not valued in coherence with the relevant shares. This means that both the shares and the written call option need to be valued at cost price or both on stock

145 Legal ground 4.4.

146 Supreme Court 16 November 2007, BNB 2008/26.

147 Legal ground 4.5, conclusion Advocate General and comment R.P.C. Cornelise, point 2 of his note by BNB 2008/26.

exchange price if the latter leads to a lower valuation.<sup>148</sup> The Supreme Court attaches no value to the fact that BV X did not intend to hedge the risk related with the shares and the call option. This would mean that a historic-causal relationship is not required to force a taxpayer to use hedge accounting.<sup>149</sup>

#### *Cacao bean judgment*

The cacao bean judgment dates from 10 April 2009.<sup>150</sup> BV X produces cacao products for the chocolate- and food- industry. The sale of cacao products is conducted by means of pre sales. The purchase of cacao beans is for approximately 90 percent conducted by means of pre purchases. Because the forward sales are ahead in time of the forward purchases, the company is always in a short position where more is sold than bought. To mitigate the price and currency risk, the company uses cacao bean futures and foreign currency futures. A future is a standardized contract between two parties to buy or sell a specified asset (in this case cacao beans) of standardized quantity and quality at a specified future date at a price agreed today. This future is also used by analogy with foreign currencies as a foreign currency future to mitigate the exchange rate risk on forward sales, forward purchases and cacao bean futures. In dispute was if the company was allowed to account for the unrealized losses of the sales and purchase contracts, cacao bean futures and foreign currency futures in the profit- and loss account while unrealized profits were deferred until realization. The tax authorities argued that only the net balance of unrealized losses and profits should be considered. This means that when the balance is an unrealized loss, this would be tax deductible, whereas an unrealized gain could be deferred until realization.<sup>151</sup>

The Supreme Court ruled that as far as the price risk on cacao is concerned a) there is a correlation between the pre sales and the pre purchases and futures or the presence of a technical inventory and b) this price risk on balance sheet date is effectively hedged, the principle of reality of sound business practice demands that these pre sales, pre purchases, futures and technical inventory need to be valued in coherence.<sup>152</sup> If there is a correlation as mentioned at point a) needs to be judged by the circumstances. Value can be attached to the nature of contract, in the light of the risks and the intention to hedge these risks. This can be deduced from the records, the annual account and/or the economic goals of the

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148 Legal ground 3.3.1.

149 Comment R.P.C. Cornelise, point 2 at BNB 2008/26.

150 Supreme Court, 10 April 2009, BNB 2009/271.

151 Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 5.3.

152 Legal Ground 5.3.1.

company.<sup>153</sup> A price risk that is effectively hedged as mentioned at point b) exists if at balance date can be expected that the value development of value of cacao that is included in the different items probably will correlate within a bandwidth of 80 to 125 percent. For this test data over het value development of items in the past can play a role, even as the nature of the hedge contract.<sup>154</sup> In the case of valuation in coherence as mentioned above, an unrealized loss on the pre sales will only be allowed if and as far as the hedge instrument and hedged position will incur a net unrealized loss.<sup>155</sup>

#### *Conclusion on judgments*

Hedge accounting is optional for commercial accounting purposes, nevertheless the Supreme Court made it obligatory for tax accounting purposes when certain conditions are met. Taxpayers will usually not voluntarily choose for hedge accounting for tax purposes since individual valuation of the hedge instrument and hedge position lets them benefit optimally from the asymmetry of sound business practice. By separate valuation, unrealized losses on the hedge instrument can be taken whereas unrealized gains on the hedged position can be deferred until actual realization. This affects the annual profit downwards which leads to lower taxation. In the hedge and option judgment, the Supreme Court ruled that a valuation in coherence can be obligatory in case of certain specific hedges. Although in the option judgment hedge accounting was obligatory even though the management of the company stated that it did not intend to hedge a specific risk, in the cacao bean judgment the general the intention of the taxpayer is of influence to judge if valuation in coherence is obligatory.<sup>156</sup> In the cacao bean judgment it was decided that hedge accounting can also be obligatory in the case of certain global hedges. The 80 to 125 percent criteria that is introduced in tax accounting by this ruling seems to be based on the hedge condition as stated in IAS 39. Although in IAS, this criteria has to be met retrospective and prospective, in the cacao bean judgment only a prospective approach is used.<sup>157</sup>

Although the rulings of the Supreme Court clarified the norms for applying hedge accounting, some questions still exist:

- Does hedge accounting need to be applied if the hedge instrument is exempt for corporate income tax and the hedged position is not or vice versa? This is for example the case when the exchange rate risk of a participation in a foreign entity is hedged. Income from the participation is exempt

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153 Legal Ground 5.3.2.

154 Legal Ground 5.3.3.

155 Legal Ground 5.3.4.

156 Legal ground 5.3.2. and S.F.M. Niekel, Een multidisciplinaire analyse naar aanleiding van het cacaobonenarrest, WFR 2010/576, par. 6.5.

157 S.F.M. Niekel, Een multidisciplinaire analyse naar aanleiding van het cacaobonenarrest, WFR 2010/576, par. 5.1.1.

whereas income from the hedge instrument is taxable.<sup>158</sup> The goal of hedge accounting is to account for opposite changes in value of the hedge instrument and the hedged position in the same period. Since one of these value changes is exempt, the goal of hedge accounting can never be reached. Therefore I agree with Lutz and Vosse that the taxpayer cannot be forced to apply hedge accounting in that situation.<sup>159</sup>

- Does hedge accounting need to be applied when the hedge instrument is part of a foreign permanent establishment and the hedged position is not or vice versa? This can result in double taxation or double non-taxation depending on the way the hedge is treated in the country of the permanent establishment. Forcing valuation in coherence can lead to an unfair outcome when there is for example a positive income on a hedge instrument in the permanent establishment, but valuation in coherence has to be applied with a hedged position with a negative income that is not attributable to the permanent establishment. This will negatively affect the profit from the permanent establishment for Dutch tax purposes, which lowers the exemption for foreign income. From the perspective of the country of the permanent establishment, the loss on the hedged position is not taxed, whereas the positive income that is recognized in the country of the permanent establishment from the hedge instrument is.<sup>160</sup>
- Does hedge accounting need to be applied in the case of global hedges on the level of a group of companies. In this case hedging is done on a group level in which the hedge instrument can be in entity A whereas the hedged position is in entity B. There is no case law available if hedge accounting should be applied in that case. In literature it is argued that hedge accounting should not be applied since taxation has to take place per separate entity.<sup>161</sup> I think this is correct since it is the basis of taxation that profits of one company cannot be offset against losses of another company, unless there is fiscal unity.<sup>162</sup>
- How does hedge accounting need to be applied in the case of cash flow hedging? The judgments of the Supreme Court are related to the hedge of future changes in value and not at the hedge of future changes in cash flow. In commercial accounting, cash flow hedge accounting is then applied as

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158 In this example the entity did not choose for the option of article 13, par. 7 Corporate Income Tax Act. This option exempts the income from exchange rate hedges if certain conditions are met.

159 L.A. Lutz and W.J.W. Vosse, *Het cacaobonen-arrest: nadere regels met betrekking tot (verplichte) samenhangende waardering*, Maandblad Belasting Beschouwingen, February 2010, par. 4.1.

160 L.A. Lutz and W.J.W. Vosse, *Het cacaobonen-arrest: nadere regels met betrekking tot (verplichte) samenhangende waardering*, Maandblad Belasting Beschouwingen, February 2010, par. 4.2.

161 Supreme Court, 21 October 2005, BNB 2006/126, point 3.4. and L.A. Lutz and W.J.W. Vosse, *Het cacaobonen-arrest: nadere regels met betrekking tot (verplichte) samenhangende waardering*, Maandblad Belasting Beschouwingen, February 2010, par. 4.3.

162 Article 15 Corporate Income Tax Act.

discussed in section 3.4. A hedge of cash flow is for example relevant when a receivable with a variable interest rate is swapped to a fixed interest rate. By applying individual valuation, an increase in interest rate leads to a loss on the swap. No gain on the receivable is recognized, since changes in interest rate do not affect the value of a receivable with a variable interest rate. The judgments of the Supreme Court cannot be applied to force the taxpayer to use hedge accounting, since the loss on the swap is not compensated by a rise in value of the receivable with a variable interest rate. The loss on the swap is compensated by future higher cash flows on the receivable due to a rise in interest rate. Future case law should give more clarity on this matter.<sup>163</sup> In my opinion no gain or loss on the swap should be recognized since the change in interest rate does not affect the net income of the swap and the receivable together. This means that the swap should be either valued at cost price or at fair value with changes in value directly into equity. Future higher proceeds on the receivable can then be offset by transferring the related amount that was booked into equity back to the profit- and loss account. This way a net fixed interest rate is recognized in the income statement.

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163 S.F.M. Niekel, Een multidisciplinaire analyse naar aanleiding van het cacaobonenarrest, WFR 2010/576, par. 6.1.

## 5. Tax treatment of income from financial instruments

In the previous chapters, the commercial and fiscal accounting rules on balance sheet items of financial instruments were discussed. The accounting methods that are used for valuation of these items influence the amount of income that is recorded in the profit- and loss account. This chapter focuses on the fiscal treatment of income that is generated by means of financial instruments, e.g. dividend, interest and capital gains. In principle all income is taxable as normal business profit under the concept of total profit. For certain types of income however, special provisions can apply, that are described below.<sup>164</sup> For insurance companies special provisions apply, these will not be elaborated on since they fall outside the scope of this thesis.<sup>165</sup>

### 5.1 Recognition of income from financial instruments

The moment when profits or losses with regard to financial instruments have to be recognized is determined according to sound business practice. Usually profits or losses are realized when an asset or liability is transferred in something else.<sup>166</sup> This is generally the case in respect of a transfer of legal title although this is not decisive, but may serve as an indicator. Tax law has its own concept of ownership based on case law which may deviate from the legal concept of ownership. From this case law can be concluded that the legal owner of an asset must be considered as the owner, unless the entire economic interest in the asset rests with another party pursuant to a contractual arrangement between the legal owner of the asset and that other party.<sup>167</sup> The following principles are leading when determining the moment of profit and loss recognition<sup>168</sup>:

- realization principle (benefits): profit that is realized in a certain year, needs to be accounted for in that year;
- matching principle (expenses): expenses need to be accounted for in the year where profits related to these expenses are realized.
- causal principle (expenses): expenses need to be accounted for in the year when there is a causal relationship with business operations.

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164 Article 3.8 Personal Income Tax Act juncto article 8.1 Corporate Income Tax Act.

165 Article 29 Corporate Income Tax jo. decree profit determination and reserves insurance companies 21 December 2000.

166 J.A.C.A. Overgaauw a.o. *Fiscale Encyclopedie De Vakstudie Inkomstenbelasting*, Deventer: Kluwer 2011, article 3.25, par. 5.

167 Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 3.

168 Advocate-General Overgaauw, Conclusion nr. 39 905, BNB 2005/250.

These principles have to be applied next to the general principles of reality, prudence and simplicity as mentioned in section 2.2. For financial instruments that are valued on an individual basis, the timing of profit and loss is dependent on the valuation method. When valuating at cost price, profit or loss is recognized when the instrument is transferred in another asset. In case of valuation at market price, profit or loss is recognized on a yearly basis. By applying valuation at cost price or lower market value, profits need only be recognized when they are actually realized, whereas cost can be recognized when the market value drops below the cost price. In case of apply hedge accounting, a net loss on the hedge instrument and the hedged position can be taken into account whereas a net profit can be deferred.

## ***5.2 Tax treatment of dividend income***

A dividend is any distribution by a company which is not a repayment of the fiscal paid-up capital. A classical system is applied in the Netherlands, which means that corporate profits are fully taxed, followed by full taxation of dividends that are distributed. These dividends are not deductible from taxable income.<sup>169</sup> However, for certain distributions of dividend to corporate shareholders an exemption system exists that will be described below. For certain portfolio corporate shareholders a credit is granted for foreign profit tax which will also be elaborated on. This section will conclude with a review of hidden distributions of profits and measures on dividend stripping.

### **5.2.1 Substantial corporate shareholders**

In case of qualifying distributions to corporate shareholders, double taxation is prevented by means of the participation exemption. The participation exemption regime exempts income, such as dividends and capital gains, realized with respect to a qualifying participation held by a Dutch shareholder. In order to qualify for the participation exemption, the taxpayer needs to hold at least 5 percent of the nominal paid-up share capital of a company with a capital dividend into shares.<sup>170</sup>

The participation exemption applies to participations that qualify as non-portfolio investments.<sup>171</sup> In order to determine if a participation qualifies as a non-portfolio investment, the motive test needs to be satisfied. The motive test is generally satisfied if the shares in the subsidiary are not held merely for a return that may be expected from normal asset management. Also, a participation is not held as portfolio investment if the business conducted by the participation is in line with the business of the taxpayer. This is for

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169 IBFD, Corporate Taxation, Netherlands, par. 6.1.1.

170 Article 13, Corporate Income Tax Act.

171 Article 13, section 9, Corporate Income Tax Act.

example the case when the taxpayer, as a holding company, performs an essential role with regard to the business activities of the group to which it belongs. A holding company is considered to perform an essential role within the group if the holding company establishes a link between the business activities of the parent company and its subsidiaries. If the motive test is satisfied, the participation exemption is applicable to the participation. However, if the motive test is not satisfied, the participation exemption may still be applicable if the participation qualifies as a ‘qualifying portfolio participation’.<sup>172</sup>

A portfolio participation is regarded as a qualifying portfolio participation if the ‘subject to tax’ test or the ‘asset’ test is satisfied.<sup>173</sup> The threshold for determining whether the ‘subject to tax test’ is satisfied, is set at a profit tax rate of the participation of at least 10 percent, calculated on a taxable basis which is reasonable according to Dutch principles. The ‘asset’ test requires that generally less than 50 percent of the assets of the participation are, directly or indirectly, low-taxed free portfolio investments. A portfolio investment is regarded low-taxed if the asset is not subject to taxation which is reasonable to Dutch tax standards.<sup>174</sup>

The Supreme Court ruled in the Falcons judgment that the participation exemption can also apply for income from an option contract.<sup>175</sup> This is the case when the option contract bears rights with respect to shares which qualify, or, upon exercise of the relevant option will qualify, for the participation exemption. The option premium and the result on the option are in that case exempt for corporate income tax purposes.<sup>176</sup> The purposes and intent of the participation exemption regime is the avoidance of economic double taxation in respect of the taxable result of a participation. Since options bear similar economic rights to a company as shares, it seems reasonable that income from options is treated the same as income from shares.

The Supreme Court also judged that the participation exemption can apply to certain elements of a convertible bond. A convertible bond comprises a debt element and an equity element. The principal plus interest on the principal constitute the debt element whereas the conversion right which is basically an

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172 W.P.J. van Schramade a.o. *Fiscale Encyclopedie De Vakstudie Venootschapsbelasting*, Deventer: Kluwer 2011, Article 13, par. 14.1.7. and C.W.A. van Suchtelen, *An introduction to Dutch tax law 2010*, Ernst & Young 2010, par. 3.2.3.

173 Article 13, section 10, Corporate Income Tax Act.

174 W.P.J. van Schramade a.o. *Fiscale Encyclopedie De Vakstudie Venootschapsbelasting*, Deventer: Kluwer 2011, Article 13, par. 17 and 18 and C.W.A. van Suchtelen, *An introduction to Dutch tax law 2010*, Ernst & Young 2010, par. 3.3.

175 Supreme Court, 22 November 2002, BNB 2003/34.

176 Lutz and Vosse, *IFRS and Derivatives Taxation, Derivatives & Financial Instruments*, IBFD IFRS Special Issue, March/April 2010, par 4.2.1.

option on new shares constitutes the equity element. The Supreme Court ruled that the value of the conversion right constitutes a taxable benefit and any future value developments after first recognition can fall within the scope of the participation exemption. This is the case when the shares that would be acquired by exercising the conversion right would apply for the participation exemption.<sup>177</sup>

### **5.2.2 Portfolio corporate shareholders**

For portfolio investments for which the participation exemption does not apply, any dividends that are distributed are included in the total profit of the shareholder. Any Dutch dividend tax levied can be credited against the corporate income tax that has to be paid.<sup>178</sup> Also, the legislator introduced a fiction that the participation is submitted to a 5 percent taxation. Therefore the gross income of the participation is set at 100/95 by means of article 13aa Corporate Income Tax Act. Secondly 5 percent of this amount may be credited against the corporate income tax of the investor. As far as the gross income consists of profit distributions from EU or EEA non-qualifying participations, the actual amount of profit tax may be credited when certain conditions are met. In that case it is possible to credit more than 5 percent of the gross income.<sup>179</sup>

### **5.2.3 Hidden distribution of profits**

A hidden distribution of profit is an advantage to a shareholder that does not look like a dividend, for example when selling an asset to a shareholder at a price below market value.<sup>180</sup> One can speak of a distribution of profit if there is a transfer of wealth from the company to its shareholder.<sup>181</sup> A deemed dividend distribution is recognized when a transaction between the company and its shareholder is not at arm's length and can only be explained by the shareholders relationship. The company needs to deliberately give an advantage to the shareholder and the shareholder has to know he is been treated favorably.<sup>182</sup> When a deemed dividend is recognized, this leads to a correction in the calculated profit of the company and its shareholder.<sup>183</sup> Also, dividend tax is levied on the hidden distribution of profit based on art. 2 jo. art. 3, section 1, sub a, Dividend Tax Act. Hidden distribution of profit can take place in different forms, for example a loan to a shareholder at conditions that are not at arm's length, a loan that is not being paid

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177 Supreme Court, 12 October 2007, BNB 2008/6 and Lutz and Vosse, IFRS and Derivatives Taxation, Derivatives & Financial Instruments, IBFD IFRS Special Issue, March/April 2010, par 4.2.2.

178 Article 25 Corporate Income Tax Act.

179 Article 23c jo. 13aa Corporate Income Tax Act.

180 O.C.R. Marres, P.J. Wattel, Dividendbelasting, Fiscale Studieserie, Deventer: Kluwer 2006, par. 14.4.2.

181 Supreme Court, 18 Februari 1959, BNB 1959/124.

182 Supreme Court, 4 May 1983, BNB 1983/233.

183 Based on article 3.8 Personal Income Tax Act, jo. art. 8 and 8b Corporate Income Tax Act.

back, a transfer of assets by the shareholder to the company at a too high price or a transfer of assets from the company to the shareholder at a too low price.<sup>184</sup>

#### **5.2.4 Dividend stripping**

Dividend stripping or dividend washing means that a shareholder that has no or little right to exemption or reduction of dividend tax lets the dividend accrue to a shareholder that has such right. Secondly, the value of the dividend will flow from the shareholder that receives the dividend to the first mentioned shareholder with no or little taxation.<sup>185</sup> There are several ways to achieve this dividend stripping. The shares can for example be sold before declaration of dividend (cum dividend) to a company that has a right to exemption or reduction and bought back after declaration of the dividend (ex dividend). This way the dividend is transformed into a capital gain for the shareholder that uses the sale and buy back construction.<sup>186</sup> In jurisdictions where capital gains are taxed at a low rate, this can be advantageous. In 2002, measures have been taken to prevent dividend stripping. The legislation stipulates that a taxpayer can only obtain a refund or credit of withholding tax if that taxpayer was the ultimate beneficiary of the distribution.<sup>187</sup>

### **5.3 Tax treatment of interest income**

Interest income is included in the concept of total profit and taxed accordingly.<sup>188</sup> There are no special provisions for interest income received by a Dutch resident taxpayer. For interest that is paid to another entity no withholding tax is levied, however some special provisions exists regarding foreign tax liability which will be discussed in section 6.2.

### **5.4 Tax treatment of capital gains**

Capital gains and losses are included in the concept of total profit and treated as normal business profit.<sup>189</sup> All assets of a company can produce a capital gain on disposal, and such gains are taxed as business profits. Realized capital gains are recognized for tax purposes if so warranted by sound business practice. Unrealized capital gains are not included in taxable income, unless previous losses on the same assets have been deducted from taxable profits.<sup>190</sup> Capital gains and losses are computed as the difference between the sales price and the book value of the asset. In the case capital gains meet certain criteria, these

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184 O.C.R. Marres, P.J. Wattel, *Dividendbelasting*, Fiscale Studieserie, Deventer: Kluwer 2006, par. 14.4.2.

185 O.C.R. Marres, P.J. Wattel, *Dividendbelasting*, Fiscale Studieserie, Deventer: Kluwer 2006, par. 2.4.1.

186 O.C.R. Marres, P.J. Wattel, *Dividendbelasting*, Fiscale Studieserie, Deventer: Kluwer 2006, par. 2.4.1.

187 Article 25, section 2, Corporate Income Tax Act.

188 Article 3.8 Personal Income Tax Act jo. article 8.1 Corporate Income Tax Act.

189 Article 3.8 Personal Income Tax Act, jo. art. 8 and 8b Corporate Income Tax Act.

190 Supreme Court, 18 March 1992, BNB 1992/186.

may be placed in a reinvestment reserve on the basis of article 3.54 Personal Income Tax<sup>191</sup> or on specific case law regarding reinvestment.<sup>192</sup> In that case the income from the sale of an asset can be entirely used for reinvestment since there is no taxation on the profits.

#### **5.4.1 Reinvestment reserve article 3.54**

The reinvestment reserve can only be applied when reinvesting in a business asset. A distinction has to be made between durable and non durable business assets. For durable business assets, the acquired asset needs to have the same economic function as the transferred business asset, this requirement does not apply for non durable business assets. Financial instruments that are held as an investment do not qualify as a business asset in the first place.<sup>193</sup> The Supreme Court ruled that an insurance company that wanted to reinvest shares that belonged to an investment portfolio could not place the profit in a reinvestment reserve since the shares did not qualify as an business asset.<sup>194</sup> Also shares that constitute a participation are explicitly excluded from the reinvestment reserve.<sup>195</sup> It can be concluded that a reinvestment reserve can generally not be applied when selling securities.

#### **5.4.2 Case law regarding reinvestment**

Case law regarding reinvestment is based on the prudence principle. Since the acquired asset is economically the continuation of the transferred asset, no profit has been realized. The condition that the acquired asset is of the same nature as the transferred asset and has economically the same function in the business has to be met. The Supreme Court ruled that an insurance company that wanted to reinvest shares that belonged to an investment portfolio, could not place the profit from the sale in a reinvestment reserve since the different shares in the portfolio do not have the same economical function.<sup>196</sup> When shares in one entity are replaced with shares in another entity, profit realization is obligatory since these shares do not have economically the same function.<sup>197</sup> Also when bonds are sold and replaced by other bonds, the proceeds cannot be placed in a reinvestment reserve.<sup>198</sup> In literature it is concluded that in the case of selling securities, the reinvestment reserve can only be applied in very limited cases.<sup>199</sup>

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191 Which is of importance for Corporate Income Tax via article 8 CITA.

192 Called the 'ruilarresten' in literature.

193 Article 3.54, paragraph 7,a.

194 Supreme Court, 23 June 1999, BNB 1999/321.

195 Article 8, paragraph 13 Corporate Income Tax Act.

196 Supreme Court, 23 June 1999, BNB 1999/321.

197 Supreme Court, 28 December 1951, B. 9129.

198 Supreme Court 7 February 2003, BNB 2003/173.

199 J.A.C.A. Overgaauw a.o. Fiscale Encyclopedie De Vakstudie Inkomstenbelasting, Deventer: Kluwer 2011, article 3.25, 3.2.16.B.c3.

Since primary financial instruments (e.g. shares and bonds) are generally excluded from the reinvestment reserve, both based on article 3.54 and case law, it can be concluded that secondary financial instruments (derivatives) will also not qualify since these are similar in this respect. Although capital gains on financial instruments generally cannot be placed in a reinvestment reserve, gains realized on qualifying participations may be exempt under the participation exemption<sup>200</sup> and capital gains realized upon mergers may be exempt under special provisions.<sup>201</sup>

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200 Article 13, Corporate Income Tax Act.

201 Article 14, Corporate Income Tax Act.

## 6. Comparison of accounting systems between EUCOTAX countries

This chapter will give a comparison of the accounting methods used for financial instruments in the EUCOTAX countries. This comparison will include Austria, Belgium, Brazil, France, Germany, Italy, the Netherlands, Poland, Sweden and the United States of America.<sup>202</sup> Since Brazil and the United States of America are not member states of the European Union, they did not implement the 4<sup>th</sup> directive on harmonization of accounting laws.<sup>203</sup> This will often result in a special position in the comparison with regard to other EUCOTAX countries which are part of the European Union. First the use of cash or accrual accounting will be discussed, followed by the application of IFRS in the respective countries. Thirdly the relation of commercial accounting and taxable result will be investigated. Finally, the application of fair value and accounting rules on derivatives will be elaborated on. An evaluation of this comparison in the context of the financial and economic crisis will be given in the next chapter.

### 6.1 Cash or accrual accounting

The starting point for accounting is the cash method or the accrual method. When using the cash method, revenues are recorded when cash is received and expenses are recorded when cash is paid. Financial statements created under cash basis accounting normally postpone or accelerate recognition of revenues and expenses long before or after services are delivered. They also do not necessarily reflect all assets or liabilities of a company on a particular date. Therefore, financial statements based on the cash method are not very useful to external decision makers.<sup>204</sup> When using the accrual method, revenues are recognized when they are earned and expenses when they are incurred, this is more in accordance with the true and fair view principle. Matrix 1 shows the use of the accrual or cash method in commercial and tax accounting.

**Matrix 1:Comparison of the accrual method versus the cash method in commercial and tax accounting**

	Commercial accounting	Tax accounting
Austria	Accrual Method	Accrual Method

<sup>202</sup> Hungary and Spain also participated in the EUCOTAX wintercourse. These countries were however not represented in the theme ‘fiscal and commercial accounting rules on financial instruments’ and are therefore not included in this comparison.

<sup>203</sup> Fourth Council Directive 78/660/EEC of 25 July 1978.

<sup>204</sup> Short, Libby, Libby, Financial Accounting, A Global Perspective, 5th edition 2007, McGraw-Hill International, p. 111.

<b>Belgium</b>	Accrual Method	Accrual Method
<b>Brazil</b>	Accrual Method	Accrual Method
<b>France</b>	Accrual Method	Accrual Method
<b>Germany</b>	Accrual Method	Accrual Method
<b>Italy</b>	Accrual Method	Accrual Method
<b>Poland</b>	Accrual Method	Cash Method
<b>Sweden</b>	Accrual Method	Accrual Method
<b>Netherlands</b>	Accrual Method	Accrual Method
<b>USA</b>	Accrual Method	Accrual Method

As we can see above, all EUCOTAX countries use the accrual method for commercial accounting as this has a higher informative value than the cash method. For tax purposes most countries apply the accrual method. Poland is the only country that uses the cash method for tax purposes, this means that they do not account for changes in value of financial instruments as long as no cash is paid or received.

## 6.2 Application of IFRS

This section will discuss the application of IFRS in the consolidated and individual account. All listed companies within the European Union are obliged to draw up the consolidated annual account in accordance with IFRS.<sup>205</sup> The aim is to ensure a high degree of transparency and hence an effective functioning of the internal market.<sup>206</sup> Although the use of IFRS is mandatory for the consolidated accounts of listed companies, member states have the freedom to allow or require non-listed companies to use IFRS for the consolidated or individual account and listed companies to use IFRS for the individual account.<sup>207</sup> As shown in the matrix below, the implementation of IFRS differs in the EUCOTAX countries.

205 This is required by EC regulation 1606/2002, 19 July 2002.

206 EC regulation 1606/2002, 19 July 2002, article 1.

207 EC regulation 1606/2002, 19 July 2002, article 5.

**Matrix 2: Application of IFRS in the consolidated and individual account**

	Consolidated Account		Individual Account	
	Unlisted	Listed	Unlisted	Listed
<b>Austria</b>	Option	Obligatory	Forbidden	Forbidden
<b>Belgium</b>	Option	Obligatory	Forbidden	Forbidden
<b>Brazil</b>	Obligatory	Obligatory	Obligatory	Obligatory
<b>France</b>	Option	Obligatory	Forbidden	Forbidden
<b>Germany</b>	Option	Obligatory	Forbidden	Forbidden
<b>Italy</b>	Option	Obligatory	Option	Option
<b>Netherlands</b>	Option	Obligatory	Option	Option
<b>Poland</b>	Option/forbidden	Obligatory	Option/forbidden	Option
<b>Sweden</b>	Option	Obligatory	Forbidden	Forbidden
<b>USA</b>	US GAAP	US GAAP	US GAAP	US GAAP

For the purpose of this thesis, the use of IFRS in the individual account is of most importance, since the individual account often serves as the basis for tax accounting. Even in the case of a fiscal unity, the tax return is often based on the (consolidated) sum of individual accounts. Brazil is the only country for which it is obligatory to use IFRS. In Italy, the Netherlands and Poland, the use of IFRS is optional. For Poland this is only optional if the company has the intention to become a listed company or if it is part of a group in which the parent company prepares its consolidated account in accordance with IFRS.<sup>208</sup> IFRS is forbidden in all other countries. In the next section it will be investigated in how far the use of IFRS in the commercial account is of influence on the taxable result, since the relationship between commercial accounting and tax accounting will be investigated.

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208 Polish Act on Accounting, article 55, paragraph 6; act on Accounting article 55, paragraph 7.

### 6.3 Relation of commercial accounting and taxable result

The legal relationship between commercial and tax accounting is different among countries. In general both commercial and tax accounting intend to measure wealth. For commercial accounting this has the purposes to give stakeholders a true and fair view on the performance of a company. For tax accounting this has the purposes to determine the amount of taxes that have to be paid. Both commercial and tax accounting is based on business economics. In most countries the tax return is based on the commercial account, but adjustments are made to make the financial statement suitable for tax purposes. Countries with a strong link between commercial and tax accounting can be classified as having a dependent system. Countries with a less strict link between commercial and tax accounting can be characterized as having an independent system.

**Matrix 3: Relationship between commercial accounting and tax accounting**

	Relation between commercial income and taxable income	Interaction between both
<b>Austria</b>	Dependency	Commercial result is basis for taxation
<b>Belgium</b>	Dependency	Commercial result is basis for taxation
<b>Brazil</b>	Independency	Both based on business economics, but independently defined
<b>France</b>	Dependency	Commercial result is basis for taxation
<b>Germany</b>	Dependency	Commercial result is basis for taxation, but accounting options can be exercised differently
<b>Italy</b>	Dependency	Commercial result is basis for taxation
<b>Netherlands</b>	Independency	Both based on business economics, but independently defined
<b>Poland</b>	Independency	Both based on business economics, but independently defined
<b>Sweden</b>	Dependency	Commercial result is basis for taxation
<b>USA</b>	Independency	Both based on business economics, but independently defined

In case of dependent systems, a distinction can be made between a formal and a material view. Under a formal view, when there is an accounting choice, this choice must be applied consistently within the

commercial and tax accounts. Under a material view, no identical exercise of different options is required. Austria for example applies a formal interpretation of dependency whereas Germany applies a material approach.<sup>209</sup> If we compare matrix 2 (the use of IFRS in commercial accounting) with matrix 3 (the relationship between commercial accounting and taxable result) we can see that countries that use IFRS in commercial accounting have generally an independent system for tax accounting. This is because IFRS is not regarded as universally usable for tax purposes since it heavily depends on fair value which can be in conflict with the prudence principle in tax accounting. Only Italy uses IFRS in commercial accounting and has a dependent system at the same time. However, in the Italian system, the effects of fair value are neutralized since gains and losses are only taken into account for tax purposes when the gains and losses are realized.<sup>210</sup> From the combination of matrix 2 and matrix 3 we can conclude that the direct effect of IFRS on tax accounting is limited in the EUCOTAX countries. However, the provisions of IFRS can have an indirect influence on national GAAP which can be of importance for determining the taxable result.

#### ***6.4 Application of fair value in commercial and tax accounting***

The EU has adopted a number of directives dealing with accounting matters. Of these, the 4<sup>th</sup> directive<sup>211</sup> is generally regarded as one of the most significant. It aims to harmonize accounting principles and addresses all aspects of the financial statements of individual companies.<sup>212</sup> Directive 2001/65/EC<sup>213</sup> has amended the valuation rules of the 4<sup>th</sup> directive by introducing the possibility to 'permit or require in respect of all companies or any classes of companies valuation at fair value of financial instruments, including derivatives'.<sup>214</sup> Matrix 4 shows the application of fair value for commercial and tax purposes. For commercial purposes we will focus on the application of fair value in the individual account based on national GAAP, since this often serves as the basis for tax accounting.

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209 M. Schlaechter, Paper Wintercourse 2011, p 11 and B. Schewe, Paper Wintercourse 2011, p. 14.

210 Art. 86 and 101 of the T.U.I.R. (Italian Consolidated Law on Income Tax)

211 Fourth Council Directive 78/660/EEC of 25 July 1978.

212 Shahrokh, Saudagar, International Accounting, a user perspective, third edition, 2009: CCH Wolters Kluwer Business, p. 2-57.

213 Council Directive 2001/65/EC of 27 September 2001.

214 Article 42a, Directive 2001/65/EC.

**Matrix 4: Application of fair value in commercial and tax accounting**

	Commercial Accounting		Tax Accounting	
	Application of Fair Value	Scope	Application of Fair Value	Scope
<b>Austria</b>	No	-	No	-
<b>Belgium</b>	No	-	No	-
<b>Brazil</b>	Yes	Certain financial instruments	Yes	Depends on the type of financial instrument used
<b>France</b>	No	-	No	-
<b>Germany</b>	No	-	No	-
<b>Italy</b>	Yes	-	No	-
<b>Netherlands</b>	Yes	Certain financial instruments	Yes	For financial instruments, but rarely used since optional
<b>Poland</b>	Yes	Certain financial instruments	No	-
<b>Sweden</b>	Yes	Certain financial instruments	Yes	For financial instruments, but rarely used since optional
<b>USA</b>	Yes	Certain financial instruments	Yes	Depends on the type of financial instrument used

If we combine matrix 2 (application of IFRS) and matrix 4 (application of fair value), we can conclude that all countries that use IFRS in the individual account, also allow the use of fair value in national GAAP. Next to this, also Sweden and the USA allow the use of fair value in commercial accounting. For tax purposes however, the use of fair value is much more limited. In the Netherlands and Sweden, the use of fair value for tax purposes is optional. Taxpayers will generally not choose to use fair value in the tax accounts since this can lead to taxation of unrealized gains in the case of increasing value. For taxpayers it is much more beneficial to make use of the prudence principle which allows for recording losses in case of decreasing values but no recording of gains in the case of increasing values, since this will lead to a lower taxable base. So although fair value is allowed in the Netherlands and Sweden for tax purposes, it is hardly used in practice. Only Brazil and the USA make fair value obligatory for tax purposes for certain types of financial instruments.

## 6.5 Accounting for derivatives

Financial instruments can be used on a stand-alone basis, or to hedge multiple risks that a company is exposed to. When risks are hedged by using derivatives, hedge accounting becomes of importance. Hedge accounting aims to present the results of the hedge instrument (a specific derivative) and the hedged position simultaneously in the profit- and loss account. In principle financial instruments are valued on an individual basis, only when they serve as a hedge, hedge accounting has to be applied for tax purposes. Matrix 5 shows which valuation methods are used for financial instruments in tax accounting:

**Matrix 5: Valuation method of financial instruments for tax purposes**

Austria	Belgium	Brazil	France	Germany	Italy	Netherlands	Poland	Sweden	USA
Cost price & hedge accounting	Cost price & hedge accounting	Fair value	Cost price & hedge accounting	Cost price	Cost price & hedge accounting	Fair value			

As matrix 5 shows, only Brazil and the USA use fair value to record financial instruments. This also results in a symmetric system in case the financial instrument is used as a hedge. A loss on the hedged position will be automatically offset by a gain on the financial instrument, since this instrument is always recorded at fair value. Poland always uses cost price to value financial instruments even when they serve as a hedge. From matrix 1 we learned that Poland uses the cash method for tax purposes. This means that no losses on the hedged position are taken into account if no cash transaction has taken place, in the same manner no gain on the financial instrument that serves as a hedge is recorded, since no cash is received. Therefore the Polish system can also be characterized as a symmetric system.

All other countries generally value financial instruments at cost price. If we take the example of an option, this means that generally only the premium is recorded and any value that is attached to the option over time is disregarded. Only when the financial instrument serves as a hedge, hedge accounting needs to be applied. This means that the fair value of the financial instrument has to be recognized for the amount of which the instrument serves as a hedge. In the example of a share that drops in value for 100, and a corresponding option that rises in value of 150 because of over hedging, the option only has to be accounted for at fair value for the amount of which the hedge is effective. In this case a loss of 100 on the share and a gain on the option of 100 must be recognized. In this it is very important to determine the exact moment on which hedge accounting has to be applied. Matrix 6 gives an insight to the circumstances when hedge accounting is obligatory for tax purposes.

**Matrix 6: Circumstances when hedge accounting is obligatory for tax purposes**

Austria	When it is used in the commercial accounts.
Belgium	When it is used in the commercial accounts.
Brazil	Not applicable, since hedged position and hedge instrument are always valued at fair value.
France	When it is used in the commercial accounts.
Germany	Correlation of hedged position and hedge instrument of 80-125 percent.
Italy	When it is used in the commercial accounts.
Netherlands	Correlation of hedged position and hedge instrument of 80-125 percent
Poland	Not applicable, since hedged position and hedge instrument are always valued at cost price.
Sweden	When it is used in the commercial accounts.
USA	Not applicable, since hedged position and hedge instrument are always valued at fair value.

As we learned from matrix 5 (valuation method of financial instruments) hedge accounting is of most importance for countries that value financial instruments on cost price, but switch to fair value in case of a hedge. We see that most countries only apply hedge accounting for tax purposes if it is applied in the commercial account. In the commercial account however, hedge accounting is usually optional. Only when the hedging relationship is formally designated and documented in advance, hedge accounting can be applied.<sup>215</sup> For tax purposes however, it is usually beneficial for taxpayers not to use hedge accounting, although the risk is hedged. This way the taxpayer can make optimal use of the prudence principle that exists in many jurisdictions. A loss can be reported on the hedged position although a gain on the hedge instrument does not have to be accounted for, since the hedge instrument can still be valued at cost price. This will lead to the reporting of losses that will never be incurred and results in a lower tax base which is advantageous for tax purposes. Only the Netherlands and Germany have established specific case law / rules for hedge accounting in tax accounting which can make it obligatory to use hedge accounting, even

215 This rule can be found in IAS 39, point 88. Usually similar rules are available in national GAAP of the different countries.

if it is not obligatory based on commercial accounting rules. In the Netherlands this is decided in case law<sup>216</sup>, in Germany the rule can be found in the parliamentary history.<sup>217</sup> It is decided that when the hedge instrument and the hedged position correlate within a bandwidth of 80 – 125 percent, hedge accounting needs to be applied.<sup>218</sup> This means that no loss on the hedged position can be recorded when the risk of this loss is hedged by a financial instrument. The following example can make the impact of hedge accounting on financial instruments more clear.

*On 1 December 2011, a European company sells clocks to the United States for \$1,000,000. On 31 December 2011, the annual statements are drawn up. On 1 February 2012, the company receives the amount of \$ 1,000,000. The exchange rates are as follows:*

*December 1, 2011 -      \$ 1 = € 1.00  
 December 31, 2011 -      \$ 1 = € 0.90  
 February 1, 2012 -      \$ 1 = € 0.80*

*The company entered a put option on 1 December 2011 to sell \$ 1,000,000 and receive € 1,000,000 on 1 February 2012. The exchange rate risk is therefore 100 percent hedged.*

The following matrix shows how different countries account for the receivable and the put option:

**Matrix 7: Example application of hedge accounting for tax purposes**

	Value receivable		Value put option	
	1-12-2011	31-12-2011	1-12-2011	31-12-2011
<b>Austria</b>	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
<b>Belgium</b>	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
<b>Brazil</b>	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (fair value)

216 Supreme Court of the Netherlands, 10 April 2009, BNB 2009/271.

217 Bundesrat – BR-Drs. 344/08, 129.

218 See section 4.4.3 of this thesis for a discussion on the available case law. The 80 – 125 percent rule is derived from IAS 39, AG 105.

France	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
Germany	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
Italy	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
Netherlands	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
Poland	€ 1,000,000	€ 1,000,000	€ 0	€ 0 (cost price)
Sweden	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (hedge accounting)
USA	€ 1,000,000	€ 900,000	€ 0	€ 100,000 (fair value)

Matrix 7 shows that all countries, except Poland recognize the exchange rate loss on the receivable. Poland does not recognize the loss, since it uses the cash method in tax accounting. Also for the value of the put option, all countries except Poland recognize the rise in value of the put option. Poland does not recognize the rise in value since no cash is received until the moment the put option is exercised on February 1 2012. The USA and Brazil recognize the rise in value of the put option, since they always measure financial instruments at fair value. The other countries recognize the rise in value since they apply hedge accounting because there is a 100 percent hedge. The following matrix shows the difference in outcome depending on the fact if hedge accounting is applied or not:

**Matrix 8: Example impact hedge accounting on taxable result when transaction is hedged**

		Without hedge accounting		With hedge accounting	
		1-12-2011	31-12-2011	1-12-2011	31-12-2011
<b>Value receivable</b>	€ 1,000,000	€ 900,000		€ 1,000,000	€ 900,000
<b>Value put option</b>	€ 0	€ 0		€ 0	€ 100,000
					<b>No loss</b>
					<b>Loss € 100,000</b>

Matrix 8 clearly shows the impact of hedge accounting on the taxable result. When no hedge accounting is applied, although the risk is fully hedged, a loss of € 100,000 will be presented that will never be incurred.

Taxpayers can make use of the asymmetric treatment of profits and losses on financial instruments due to the prudence principle. For taxpayers it is therefore very beneficial not to use hedge accounting, since this will lead to a lower taxable base. It must be mentioned that this is only a timing difference, when the transactions are settled, a corresponding gain needs to be recognized. However, timing differences can be very important for companies because of liquidity and interest aspects.<sup>219</sup> Only Germany and the Netherlands have made rules on the application of hedge accounting for tax purposes. For the other countries, applying hedge accounting is still a matter of choice. If no hedge accounting is applied in the commercial accounts it does not have to be applied in the tax return, this can lead to reporting of losses that will never be incurred. A solution for this problem could be that all countries that have an asymmetric system make clear obligatory hedge accounting rules for tax purposes. The rules that are recently established in the Netherlands and Germany could serve as an example. Another option could be to introduce fair value as a valuation method for financial instruments on an individual basis, as is done in Brazil and the USA. Introducing fair value for tax purposes could provide a better basis for the ability to pay principle. This will be investigated further in the next chapter.

## ***6.6 The Dutch accounting system compared to other EUCOTAX countries***

This section will conclude on the main differences and similarities of the accounting systems between the Netherlands and other EUCOTAX countries. The Netherlands uses the accrual method in both commercial and tax accounting as is common in most other countries. With regard to the application of IFRS, the Netherlands is very liberal. It only obliges IFRS for the consolidated account of listed companies as is required by the EC regulation.<sup>220</sup> For the consolidated account of unlisted companies as well as for the individual account of unlisted and listed companies, there is the option to apply IFRS. Other EUCOTAX countries often make the choice for the taxpayers and forbid the use of IFRS or make it obligatory. When considering the relationship between commercial and tax accounting, the Dutch system can be qualified as independent. This is quite special since most European countries have a dependent system in which commercial and tax accounting is much more linked. With regard to the use of fair value, the Netherlands is in line with most other EUCOTAX countries in the sense that it does not oblige the use of fair value for tax purposes. With regard to hedge accounting, all countries that have an asymmetric system in which the hedged position and the hedge instrument are not automatically valued the same way, hedge accounting has to be applied in case of a hedge. The Netherlands and Germany take a leading role in this, since they

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219 P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 7.

220 EC regulation 1606/2002, 19 July 2002.

have special hedge accounting rules for tax purposes. Other countries with an asymmetric system simply follow the commercial account which can lead to the presentation of losses that will actually never be incurred.

## 7. Evaluation of accounting in the context of the financial and economic crisis

The first part of this thesis consisted of a description of the Dutch fiscal and commercial accounting rules on financial instruments. The second part gave a comparison of the accounting systems within the EUCOTAX countries. It showed that financial instruments can often be valued at cost price which does not always give a fair representation of economic reality. This chapter will focus on the evaluation of accounting rules in the context of the financial and economic crisis. First the general position of taxation in the crisis will be evaluated. Secondly the role of accounting will be studied in more detail, both from a commercial and tax perspective. After this, an introduction will be given to the CCCTB with a more close look on the accounting rules on financial instruments that are prescribed. Finally a new tax accounting system for financial instruments with a focus on fair value will be introduced. The proposed system will be tested against the principles of sound business practice. Finally it will be investigated if a more close connection between commercial and tax accounting would be desirable.

### 7.1 *Role of taxation in the financial and economic crisis*

The financial and economic crisis that started in August 2007 originated from an asset price bubble that interacted with new kinds of financial instruments that masked risk.<sup>221</sup> The burst of the housing bubble in the United States caused investors to lose confidence towards all mortgage-based assets and uncertainties with regard to the financial exposure of financial institutions. The banking crisis spread to a stock market crash and a credit crunch in the real economy.<sup>222</sup> Although taxes have not generated the crisis, some aspects of tax policy are likely to have encouraged excessive leverage and other financial market problems evident in the crisis.

Some of the tax aspects related to the financial crisis that are mentioned in literature are:<sup>223</sup>

- corporate income tax favoring debt finance over equity finance. This is also present in Dutch tax law since interest is tax deductible whereas remuneration on equity is not;<sup>224</sup>

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221 Baily, M.N., Litan, R.E. and M.S. Johnson (2008). The Origins of the Financial Crisis, Fixing Finance Series Paper, 3, Brookings Institutions: 2008.

222 Hemmelgarn and Nicodeme, The 2008 Financial Crisis and Taxation Policy, taxation paper, European Commission's Directorate-General for Taxation and Customs Union, 2009, p. 39

223 Cottarelli, Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy, International Monetary Fund, 2009.

224 Article 9 and 10 Corporate Income Tax Act.

- favorable treatment of home mortgages has supported high housing prices while mortgage interest relief may have encouraged heavy household leverage. This is also the case for Dutch personal income tax;<sup>225</sup>
- divergences in national tax rates, bases, and practices create substantial opportunities for international tax arbitrage, reinforcing tax biases to debt.

The causes mentioned above apply to general tax rules, but not so much to tax accounting rules. From this it can be concluded that tax accounting rules were not a main contributor to the financial and economic crisis. The role of accounting however will be examined further in the next section.

## ***7.2 Role of accounting in the financial and economic crisis***

In this section the role of accounting in the financial and economic crisis will be investigated, both from a commercial and tax perspective. Special attention will be given to valuation of financial instruments at fair value.

### ***7.2.1 Role of commercial accounting***

Some critics argue that the use of fair value in commercial accounting exacerbated the severity of the financial crisis. Fair-value accounting involves reporting assets and liabilities on the balance sheet at fair value and recognizing changes in fair value as profits and losses in the income statement. Since valuation at fair value is more volatile than cost price, this will lead to larger changes in income. Critics argue that the use of fair value stimulated the excessive leverage of companies in good times, which brought them into trouble when the economic downturn hit. However, in literature it is generally concluded that fair value in commercial accounting did not contribute to the financial and economic crisis.<sup>226</sup> The amount of leverage that a company can get is based on market value and risk assessments, the book value of assets has nothing to do with this. Valuating assets at cost price could even made the crisis worse since it gives much less transparency which increases uncertainty about the ability of a company to fulfill its obligations.

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225 Article 3.210 Personal Income Tax Act.

226 Vanstraelen, de rol van accounting en accountingonderzoek in de economische crisis, inaugurele Maastricht University, 2009, par. 2.2.1, Het jaar 2008 verslagen, NIVRA as discussed in ‘Actuele waarde geen aanjager financiële crisis, FutD Balans aflevering 2010/03 ,Harvey Goldschmid, Hans Hoogervorst , Report of the financial crisis advisory group, 28 July 2009, p. 3, Laux, C., C. Leuz, The crisis of fair value accounting: making sense of the recent debate. Accounting, Organizations and Society, 2009, p. 1 and C. Laux and C. Leuz, Did Fair-Value Accounting Contribute to the Financial Crisis?, Journal of Economic Perspectives—2010, Volume 24, Number 1, p. 114.

### ***7.2.2 Role of tax accounting***

As stated in section 7.1, tax accounting is not mentioned in literature as one of the main tax causes to the financial and economic crisis. However, from the investigation of accounting rules in section 6.5, it can be concluded that financial instruments are not always taxed in accordance with economic reality. It is questionable if this contributed to the excessive use of risky financial instruments. The decision to use financial instruments is usually based on business economic grounds. Tax incentives can be found in the different treatment of debt and equity, but not so much in accounting. All investments are generally taxed at cost price, this means that unrealized losses can be taken into account, but gains only have to be accounted for if they are realized. In this there is no distinction between risky or non risky investments. A distinction can however be made between investments that distribute income on a periodic basis and investments that rise in value, but do not distribute income on periodic basis. Distributions of income are taxed, but rises in value of the investment itself are generally not taxed unless they are realized. It is questionable however if this difference contributed to the financial and economic crisis, since both types of investments can be risky.

Although the relationship between tax accounting on financial instruments and the financial and economic crisis is probably limited, this does not mean that tax accounting rules should not be changed. Introducing clear hedge accounting rules and fair value accounting for held for trading financial instruments could reflect the ability to pay of a company better and provide an alternative to the current practice of accounting at cost price. Before this will be investigated in more detail, a closer look will be given to the proposed accounting rules in the CCCTB.

### ***7.3 Common Consolidated Corporate Tax Base***

Currently there are 27 member states within the European Union with each different corporate income tax systems.<sup>227</sup> This creates a highly fragmented landscape for businesses and generates significant costs. Therefore the European Council intends to introduce a system of common rules for computing the tax base of companies with a taxable presence in the EU, a Common Consolidated Corporate Tax Base. It will allow for cross border loss offset for group companies, the abolishment of transfer pricing issues within the CCCTB group, a one-stop-shop concept for filing tax returns and internal reorganizations without tax consequences. On 16 March 2011, the European Commission has adopted formal proposals regarding a

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227 [http://europa.eu/abc/keyfigures/sizeandpopulation/index\\_nl.htm](http://europa.eu/abc/keyfigures/sizeandpopulation/index_nl.htm)

CCCTB, including detailed accounting rules.<sup>228</sup> The Commission estimates that the CCCTB will save business across the EU € 700 million in reduced tax compliance costs each year, and € 1.3 billion through consolidation. This section will focus on the accounting rules that are included in the proposed directive.<sup>229</sup>

The directive starts by embracing the accrual method for the CCCTB. Revenues, expenses and all other deductible items shall be recognized in the tax year in which they accrue or are incurred.<sup>230</sup> Since all EUCOTAX countries except Poland already use the accrual method instead of the cash method, this will not prove to be a change for most countries. However, with regard to financial instruments an interesting element can be found in article 22 of the proposed directive.<sup>231</sup> It states that financial assets and liabilities held for trading shall be measured at fair value. Any differences between the fair value at the end of the tax year and the fair value at the beginning of the same tax year shall be included in the tax base.<sup>232</sup> This is a breach with the current practice of most EUCOTAX countries. As can be seen in matrix 4, most countries do not allow fair value in tax accounting. The Netherlands and Sweden do allow fair value, but this is not obligatory. Only Brazil and the USA can oblige companies to value certain financial instruments at fair value for tax purposes. The use of fair value for tax purposes can lead to taxation of profits that are not actually realized. This can be in conflict with the liquidity principle because taxes have to be paid, but no cash is available since the rise in value of the financial instrument is not realized. However, the CCCTB only uses fair value for financial instruments held for trading, this implies that these instruments are easily convertible into cash and not necessary in the company itself. In this the definition of held for trading becomes of importance, it is qualified as such if (a) the asset or liability is acquired or incurred principally for the purpose of selling or repurchasing in the near term or (b) part of a portfolio of identified financial instruments, including derivatives, that are managed together and for which there is evidence of recent actual pattern of short-term profit-taking.<sup>233</sup>

The CCCTB proposal also includes rules on hedge accounting. Article 28 states that gains and losses on hedging instruments shall be treated in the same manner as the corresponding gains and losses on the hedged item. In the case of taxpayers who are members of a group, the hedging instrument and hedged

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228 EC Proposal for a Council Directive, 16 March 2011 COM 2011/121/4.

229 EC Proposal for a Council Directive, 16 March 2011 COM 2011/121/4, chapter 5, p. 25 and after.

230 Article 17, CCCTB Proposal Directive.

231 Article 22, paragraph 1, sub e CCCTB Proposal Directive.

232 Article 23, paragraph 2, sub e CCCTB Proposal Directive.

233 Article 23, paragraph 1, sub e CCCTB Proposal Directive.

item may be held by different group members. This seems right since the taxable result is also based on the consolidated accounts of different group members. The interesting part is the circumstances under which the CCCTB states that there is a hedging relationship. This is the case when (a) the hedging relationship is formally designated and documented in advance and (b) the hedge is expected to be highly effective and the effectiveness can reliably be measured.<sup>234</sup> It is interesting that the CCCTB proposal does not make hedge accounting obligatory, only hedge relationships that are formally designated and documented in advance will qualify. For a taxpayer it will be beneficial not to designate the hedge relationship in advance, since losses can then be recorded on the hedged position but no gain has to be recorded for the hedge instrument, since it can still be valued at cost price. Also hedging can only be applied if the hedge is expected to be highly effective and the effectiveness can reliably be measured. The proposed directive does not state how this effectiveness should be measured. When the rules of IFRS are followed, this is the case when there is a correlation between the hedged position and the hedge instrument of 80 – 125 percent.<sup>235</sup>

It can be concluded that some of the accounting rules in the CCCTB with regard to financial instruments are different from the current practice in many EUCTAX countries. Although financial instruments not held for trading are still valued at cost price in the CCCTB proposal directive, financial instruments held for trading should be valued at fair value, which is new to many countries. Hedge accounting is optional for tax purposes, which is in accordance with the current practice in most countries. However it is questionable if this is desirable since most taxpayers will not choose to apply hedge accounting because it is beneficial not to do so for tax purposes. Making it obligatory as is the current practice in Germany and the Netherlands would provide a better solution. Also the European Commission should state more clearly when a hedge can be qualified as effective. In the current proposal directive this is an open norm which creates legal uncertainty, following the rules of IFRS in this matter could provide a solution.

#### ***7.4 Proposed new tax accounting system for financial instruments***

Currently financial instruments in the Netherlands are generally valued at cost price. This means that a rise in value is not accounted for and therefore not taxed. It is questionable if this is in accordance with the ability to pay principle. Since many financial instruments are easily convertible into cash, a rise in value can be regarded as a realized gain. Under the accrual principle that is generally used in tax accounting this should lead to a taxable profit. Especially when the financial instrument serves as a hedge, the financial

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234 Article 28, paragraph 1, sub e CCCTB Proposal Directive.

235 IAS 39. AG 105.

instrument should be valued at fair value. As shown in section 6.5, valuation of the financial instrument at cost price in case of a hedge relationship can lead to unrealistic losses on the hedged position. Two solutions can be introduced to solve these problems: (1) introducing clear mandatory hedge accounting rules and (2) introducing fair value for financial instruments held for trading. These solutions will be discussed below and tested against the principles of sound business practice.

#### **7.4.1 Introducing clear mandatory hedge accounting rules**

The Netherlands and Germany are one of the few EUCOTAX countries that introduced mandatory hedge accounting rules for tax purposes.<sup>236</sup> In case the hedge instrument and the hedged position correlate within a bandwidth of 80-125 percent, the hedge instrument and the hedged position should be valued in coherence. In the Netherlands these hedge accounting rules are developed in case law.<sup>237</sup> However, there are still uncertainties about the application thereof, since not everything is explained in the judgments.<sup>238</sup> Although the 80-125 percent rule is derived from IFRS, the Supreme Court did not make an explicit reference to IFRS. Since clear and extensive rules and regulations on hedge accounting exist in IFRS, I would propose to follow IFRS in this matter. Only the optional system in IFRS should get a mandatory nature and specific questions with regard to taxation should be answered.<sup>239</sup> This could also be beneficial for the CCCTB directive and for countries that currently do not have mandatory hedge accounting rules in their national tax system.

#### **7.4.2 Test of hedge accounting rules against sound business practice**

In the Netherlands hedge accounting rules based on IFRS have been established in case law. Therefore they are implicitly tested against the principles of sound business practice by the Supreme Court.<sup>240</sup> An elaboration on these principles of reality, prudence and simplicity with regard to hedge accounting will be given below.

##### ***Principle of reality***

The most relevant aspects of the principle of reality with regard to hedge accounting are that economic reality should be prevailing over legal and other constructions and that what is certain should not be

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236 Matrix 6 in section 7.5.

237 The hedge judgment (2004), option judgment (2007) and the cacao bean judgment (2009), for a discussion on the judgments, see section 4.4.

238 See the questions that still exist with regard to hedge accounting and some proposed answers in section 4.4.

239 In section 4.4. some proposed answers have been given to questions that are still open after the hedge accounting judgments.

240 See section 4.4.3. for an elaboration on this case law.

questioned and vice versa.<sup>241</sup> When applying hedge accounting in case of a hedging relationship, the hedged position and the hedge instrument are valued in coherence. This does justice to economic reality and prevents taking losses that will never be incurred. The correlation percentage of 80 – 125 percent that is used in IFRS seems a good way of measuring if there is a sufficient relationship between the hedged position and the hedge instrument. Only the optional nature of hedge accounting in IFRS should be mandatory for tax purposes. If there is a hedge relationship, but the company chooses not to apply hedge accounting because it is optional and will result in a lower taxable result, this will be in conflict with the principle of reality. Only an obligatory hedge accounting system based on IFRS will be in accordance with the principle of reality.

#### ***Principle of prudence***

The relevant aspect of the principle of prudence with regard to hedge accounting is that no profit should be recorded unless it is reasonably certain that it will be realized.<sup>242</sup> Hedge accounting aims not to present losses that will never be incurred, because the loss on a hedged position is offset by a gain on the hedge instrument. Applying hedge accounting does therefore not result in presenting profits that will never be realized and is in accordance with the principle of prudence.

#### ***Principle of simplicity***

The principle of simplicity demands that the way of profit determination is practical and adjusted to the size of the company.<sup>243</sup> When a company decides to hedge a risk, it has insight in the expected correlation between the hedged position and the hedge instrument. Applying hedge accounting is then not so complicated and therefore not in conflict with the principle of simplicity.

Taking the principles of reality, prudence and simplicity into account, it can be concluded that mandatory hedge accounting rules based on IFRS with some adjustments for tax accounting are in accordance with sound business practice.

### **7.4.3 Introducing fair value for held for trading financial instruments**

Introducing mandatory hedge accounting rules only works for financial instruments that serve as a hedge. For financial instruments on a stand-alone basis, the introduction of fair value valuation for held for trading instruments could be beneficial. This would better reflect the ability to pay of a company since

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241 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 22.

242 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 22.

243 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 22.

these financial instruments are so easily convertible into cash that they can be regarded as realized. With regard to the financial and economic crisis, this would enhance the function of taxation as an economic stabilizer.<sup>244</sup> In times of economic prosperity when fair value rises, more tax has to be paid, whereas in bad economic conditions less tax has to be paid due to a lower taxable income. This will stimulate aggregate demand in bad times and restrict aggregate demand in good times and therefore act as an economic stabilizer.<sup>245</sup> Introducing fair value would suit in the trend of taxation that is more towards capital growth instead of taxation of realized capital gains. It is stated in literature that a system of taxation on capital growth in general could also be a solution to exit taxes that are threatened by EU law.<sup>246</sup>

The CCCTB proposal prescribes valuation at fair value for financial assets and liabilities held for trading.<sup>247</sup> It makes the distinction between valuation at fair value or cost price therefore on the characteristic if the instrument is held for trading or not. I think this is a good distinctive factor since it reflects the necessity of the financial instrument within the company. If the instrument is held for trading, no problems arise with regard to the liquidity principle when rises in value are taxed. Taxes can be paid out of selling (part of) the financial instrument and therefore converting it into cash. Detailed guidance on the distinction between held for trading and not held for trading financial instruments is available in IAS 39, I would therefore advise using IFRS as a basis for tax accounting in this respect.

#### **7.4.4 Test of fair value against sound business practice**

As discussed above, mandatory valuation of held for trading financial instruments at fair value could be a good alternative to the current practice of valuation at cost price. In this section I will test the fair value approach to the principles of sound business practice, namely reality, prudence and simplicity.<sup>248</sup>

##### ***Principle of reality***

The relevant aspects of the principle of reality for financial instruments are that the method of profit determination holds guarantees against random profit allocations between years and that the profit in a certain year is only influenced by transactions that are wholly or partially related to that year.<sup>249</sup> Consistent valuation of held for trading financial instruments at fair value meets these two criteria. It will also better

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244 Cottarelli, Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy, International Monetary Fund, 2009, point 29.

245 N. Gregory Mankiw, principles of economics, fifth edition, South Western, 2008, p. 797.

246 P.H.J. Essers, De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 27.

247 Article 1, paragraph 1, sub e CCCTB Proposal Directive.

248 These principles have been introduced in section 2.2.2.

249 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 22.

reflect the ability to pay of a company since held for trading financial instruments are so easily convertible into cash that changes in value can be regarded as realized.

### ***Principle of prudence***

For financial instruments, the principle of prudence demands that no profit is recognized unless it is reasonably certain that it will be realized and that the way of profit determination takes the continuity of the company into consideration.<sup>250</sup> The key factor in the requirement that profits can only be recognized if they are realized is the definition of 'realized'. Generally a profit is realized when a good or service is sold.<sup>251</sup> Financial instruments that are readily convertible into cash, entail a right to receive cash. Because they are so close to cash, accrual accounting permits to record changes in value as a profit or loss in the income statement. A gain or loss on a liquid financial instrument can therefore in my opinion be regarded as realized. With regard to the requirement that the continuity of the company needs to be taken into consideration, a distinction has to be made between held for trading and not held for trading financial instruments which will be elaborated on below.

Some argue that valuation at fair value is in conflict with the liquidity principle, which can be regarded as part of the prudence principle. The liquidity principle implies that an entity is only deemed to pay taxes over its profit in so far as the business activities generate resources to pay these taxes.<sup>252</sup> The liquidity principle entails that a taxpayer needs enough liquid assets to pay its taxes. It should be prevented that taxes cannot be paid out of the taxable basis and that external financing is necessary.<sup>253</sup> This principle that is important for taxation is absent in IFRS, since IFRS aims to present a true and fair view on the performance of a company and does not account for tax consequences. Therefore critics argue that IFRS and especially fair value can generally not be used for tax purposes.<sup>254</sup> However, it is also argued that IFRS can be useful for certain areas in tax accounting, especially in areas where tax accounting still has deficiencies as is the case for financial instruments.<sup>255</sup>

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250 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 22.

251 D. Brüll, J.W. Zwemmer, R.P.C. Cornelisse, *Goed Koopmansgebruik*, FED Fiscale Brochures, Deventer: Kluwer 2008, p. 41.

252 C. Bruijsten, *De toekomst van het fiscale jaarwinstbegrip*, WFR 2009/823, par. 3.4.3.

253 H.P.W. Snijders, 'Salderen, salderen en nog eens salderen', WFR 2004/6601, par. 3.

254 See for example: W. Bruins Slot, *Wat is er beter dan goed koopmansgebruik?* NTFR 2009/1046, J. Hoogendoorn, *De IAS/IFRS en de fiscale winstbepaling*, WFR 2005/107 and C. Bruijsten, *De toekomst van het fiscale winstbegrip*, WFR 2009/823 and P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 24.

255 C. Bruijsten, *De toekomst van het fiscale jaarwinstbegrip*, WFR 2009/823, par. 3.4.4.

For certain assets like real estate, valuating at fair value can lead to liquidity problems. These assets are generally not held for trading and business continuity could be in danger if the company is forced to sell part of its real estate to pay taxes. However, liquidity problems do not arise if fair value is applied to only certain items of the balance sheet. In case of held for trading financial instruments, the liquidity principle is not an obstruction for taxation at fair value. Taxes can generally be paid out of the financial instrument itself and since the asset is held for trading, business continuity will not be in danger if the company is forced to sell the asset. Although no immediate liquidity problems arise when paying taxes out of held for trading financial instruments, future liquidity problems can arise if loss compensation is limited. This will be discussed below.

An obstacle for introducing fair value for financial instruments in tax accounting could be the limited loss compensation in Dutch tax law. The carry back term is limited to one year and the carry forward term is limited to nine years.<sup>256</sup> In the case losses cannot be offset to profits due to the limitation on loss relief, this is a breach to the concept of total profit. When a financial instrument rises in value in year 1, a positive taxable income is reported. If the company enters into a recession in year 3 with negative income, taxes that are paid in year 1 cannot be received back due to the carry back term of only one year. Although the loss can be offset against future profits for nine years, the limited carry back term can cause liquidity problems for a company that is already in bad conditions. Extending the carry back term would increase the function of taxation as an economic stabilizer and remove a barrier for introducing fair value accounting.<sup>257</sup> Increasing the carry back term will however have negative budgetary consequences, in parliamentary history it is stated that unlimited loss relief is therefore not desirable. A limited loss relief makes a lower tax rate possible which results in a shift of stimulating companies with long term losses to profitable companies. It is stated that this is beneficial for the economy as a whole.<sup>258</sup> I am not convinced however by the argument that a longer carry back term will only stimulate companies with long term losses. Many companies can have temporary downturns, a larger carry back term will prevent them from getting in serious liquidity problems and makes it possible to become profitable again. The current practice of a temporary increased carry back term to three years is in my opinion a good solution.<sup>259</sup> The

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256 Recently the carry back term is temporarily increased to three years carry back and six years carry forward as a measure in the context of the financial and economic crisis, see article 20, paragraph 10, Corporate Income Tax Act.

257 See for example J.A.G. van der Geld, *Hoofdzaken vennootschapsbelasting*, Deventer: Kluwer 2010, p. 10 and R.P.C.W.M. Brandsma, J.A.G. van der Geld en R.J. de Vries, *Fiscaal crisispakket 2009*, WFR 2009/313, par. 3.1.

258 Dutch Parliamentary History, 2005/06, 30 572, nr. 3, p. 22-23.

259 Article 20, paragraph 10, Dutch Corporate Income Tax Act.

liquidity problem for financial instruments held for trading will be solved by a three year carry back since there is generally a short period between the acquirement and sale of these assets.

### ***Principle of simplicity***

The principle of simplicity entails that the way of profit determination is practical and adjusted to the size of the company. Although valuation at cost price or lower market value is usually more easy than valuation at fair value, this is in my view not in accordance with the principle of reality for held for trading financial assets. In this case the principle of reality should be given priority. Even more, valuation at fair value is not so difficult as it may seem since clear market prices are usually available for these financial instruments and extensive guidance is available in IFRS.<sup>260</sup>

Taking the principles of reality, prudence and simplicity into account, it can be concluded that introducing mandatory valuation at fair value of held for trading financial instruments is in accordance with sound business practice.

#### **7.4.5 Connecting commercial and tax accounting**

Sound business practice that is used in tax accounting is an open norm which is developed in case law. A disadvantage of this open norm is that the rules are not set in regulations in tax law which can lead to legal uncertainty. Tax accounting rules have to be deduced from case law which develops gradually. Due to the introduction of horizontal monitoring<sup>261</sup> it is however probable that less case law will become available. Accounting disputes between taxpayers and the tax authority will be settled outside of the court, which will make the content of sound business practice less clear.<sup>262</sup> When there are rulings of the court available, they usually relate to specific cases which makes it difficult to discover a general rule.<sup>263</sup> This is unfavorable in the context of legal certainty and equality. An advantage of the open norm of sound business practice is however that it is dynamic and can be adjusted to developing views in society.<sup>264</sup> In my opinion the dynamics can however also be secured if tax accounting would connect more closely to commercial accounting since the rules in commercial accounting are also continuously changing as a result of developments in society.

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260 See for example the opinion of Kampschöer in *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 45.

261 Horizontal monitoring refers to the practice in which taxpayers and tax authority engage in an open relationship based on mutual trust.

262 R. Russo, *De betekenis van het eenvoudselement in goed koopmansgebruik*, WFR 2011/616, par. 5.

263 C. Bruijsten, *De toekomst van het fiscale jaarwinstbegrip*, WFR 2009/823, par. 3.1.1.

264 J. Doornbal, "Goed koopmansgebruik als open norm", *NDFR-B* 2008/33, par. 1

A more close connection between commercial and tax accounting could possibly solve the problem of legal certainty and equality. In commercial accounting detailed guidelines are available on the accounting treatment of assets and liabilities. The great benefit of a close connection is that little adjustments have to be made to transform the commercial annual account in the tax annual account, which will reduce the administrative burden for companies. However, the commercial account is intended to give a true and fair view on the performance of a company and is not written for tax purposes. It does not take liquidity issues into account that are important in taxation since taxes have to be paid on the basis of the income that is reported. This does however not mean that commercial accounting and especially IFRS cannot be used for tax purposes. As is argued by Kampschöer, the liquidity problems of using IFRS can be neutralized by using liquidity reserves for unrealized gains for tax purposes.<sup>265</sup> In that case there is the advantage of one single accounting base for commercial and tax accounting and the prudence principle of taxation can be incorporated by means of the liquidity reserve. I do not agree with Kampschöer that IFRS can be comprehensively used for tax purposes and that any problems can simply be neutralized by using a liquidity reserve. Specific tax issues are not answered by IFRS and need additional guidance in tax accounting rules. The optional system of hedge accounting in IFRS is for example not suitable for tax purposes. Also the issues that are mentioned in section 4.4.3 are not answered by IFRS because they relate so much to taxation. For example the question if hedge accounting needs to be applied in case the hedge instrument is exempt for corporate income tax and the hedged position is not is not clarified in IFRS. Another issue is if hedge accounting needs to be applied when the hedge instrument is part of foreign permanent establishment and the hedged position is not.<sup>266</sup> These differences in taxability are not recognized in commercial accounting, specific tax accounting rules are therefore needed to achieve a fair taxation.

I am in favor of using IFRS as much as possible for tax purposes, but make adjustments if this leads to undesirable tax effects. An example is the optional use of hedge accounting in IFRS that should be made obligatory for tax purposes in case of a hedge. Convergence can also be beneficial with regard to valuation matters. In commercial accounting there is an incentive to overstate value so a better performance can be reported. In tax accounting it is usually beneficial to understate value so lower taxes have to be paid. Connecting these accounting systems could provide for a balanced valuation since the upward and

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<sup>265</sup> See the arguments of G.W.J.M. Kampschöer in P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 45.

<sup>266</sup> These examples are explained in section 4.4.3.

downward incentives compensate each other. A formal dependency as applied in for example Austria could be beneficial in this regard.<sup>267</sup>

Based on the arguments stated above it can be concluded that convergence of commercial and tax accounting can be beneficial and this is also confirmed by the State Secretary.<sup>268</sup> To resolve the issue of legal certainty I am in favor of codification of tax accounting rules in for example a council of tax accounting as is proposed by Essers.<sup>269</sup> This will give more clarity and legal certainty than the case law of sound business practice. When it is based as much as possible on commercial accounting rules, only limited adjustments have to be made for tax purposes.

#### **7.4.5 Proposed tax accounting system for financial instruments**

Taking into account the accounting systems of the different EUCOTAX countries, the proposed CCCTB directive and the principles of sound business practice I would suggest a tax accounting system that consists of three parts: (1) financial assets and liabilities not held for trading, (2) financial assets and liabilities held for trading and (3) financial instruments that serve as a hedge.

##### ***Financial assets and liabilities not held for trading***

For financial assets and liabilities not held for trading I would recommend continuing the Dutch current sound business practice of valuation at (amortized) cost price. Valuation of these instruments at fair value would lead to a liquidity problem since these instruments are not easily convertible into cash. This approach is also in accordance with the current practice in most EUCOTAX countries and the proposed CCCTB directive.

##### ***Financial assets and liabilities held for trading***

In the case financial assets and liabilities are held for trading, I would recommend changing the current Dutch sound business practice of valuation at (amortized) cost price. Since these instruments are so easily convertible into cash, I would recommend valuation at fair value. Changes in value can be regarded as realized because of the high liquidity. This will better reflect the ability to pay of a company and is in accordance with the principles of reality, prudence and simplicity. The fair value valuation is in

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267 See section 6.3 for a comparison of the relation between commercial and tax accounts within the EUCOTAX countries.

268 Dutch Parliamentary History, 2005/06, 30 107, nr.9.

269 P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005*, *Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 51.

accordance with the CCCTB proposal, but will require a change for most EUCOTAX countries compared to the current accounting rules.

### ***Financial instruments that serve as a hedge***

For financial instruments that serve as a hedge, the Netherlands together with Germany have a leading role in the EUCOTAX countries. When there is a hedging relationship, applying hedge accounting is obligatory for tax purposes, irrespective if hedge accounting is applied in the commercial accounts. Many other countries simply follow the commercial financial statement. This can however lead to the reporting of losses that will never be incurred if the risk is effectively hedged, but no hedge accounting is applied. In national tax accounting and in the CCCTB, some questions with regard to hedge accounting need still to be answered. I would recommend to use the hedge accounting rules of IFRS as much as possible, but make adjustments to make them suitable for tax purposes. Hedge accounting should for example be made obligatory instead of optional in case of a hedge, this will prevent reporting losses that will actually never be incurred.

### ***Concluding remarks***

In general I am in favor of a more close connection between commercial and tax accounting. Although IFRS is not suitable to be used comprehensively for tax purposes, it can prove to serve as guidance, especially in the case of financial instruments. Adjustments and additions can be made to make the commercial accounting rules appropriate for tax accounting. As proposed by Essers, I would recommend codification of tax accounting rules in for example a council of tax accounting.<sup>270</sup> This will give more legal certainty and equality than the gradually developing rules of sound business practice in case law. Especially in the context of the implementation of horizontal monitoring, which makes it probable that less case law will become available, codification of sound business practice would be helpful.

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270 P.H.J. Essers, *De toekomst van Goed Koopmansgebruik na de invoering van International Financial Reporting Standards in 2005, Geschriften van de Vereniging voor Belastingwetenschap*, Deventer: Kluwer 2005, p. 51.

## 8. Conclusion

This thesis was written in the context of the EUCOTAX Wintercourse 2011 with the main theme 'financial and economic crisis and the role of taxation'. It can be concluded that financial instruments played an important role in the causes of the crisis, this thesis focused on the commercial and tax accounting treatment of these instruments. The accounting systems of different EUCOTAX countries have been compared and evaluated. Based on the previous chapters, an answer can be formulated to the following research question:

*What are the Dutch commercial and fiscal accounting rules on financial instruments and should these be reviewed in the context of the financial and economic crisis?*

In the Netherlands, the commercial and fiscal accounting rules are independent. Although they are both based on business economics, they have their own set of rules based on the different purpose of both systems. Commercial accounting is focused on providing financial information that is relevant for a wide range of users. Its rules are laid down in the Dutch Civil Code and guidelines of the Council of Annual Reporting. Tax accounting aims to determine the amount of tax an entity has to pay. Its rules are developed gradually in case law regarding the concept of sound business practice.

Financial instruments are usually recorded at cost price or lower market value for tax purposes in the EUCOTAX countries. There is no evidence that tax accounting rules on these instruments contributed to the financial and economic crisis. However, the current accounting rules in most EUCOTAX countries can lead to an outcome that is not in accordance with the ability to pay of a company, especially in the case of hedging. Therefore, I would suggest an alternative tax accounting systems for financial instruments that is more closely related to IFRS. In this three different types of financial instruments can be recognized. Financial instruments not held for trading should be valued at cost price. Financial instruments held for trading should be valued at fair value. For financial instruments that serve as a hedge, IFRS should be applied with amendments that make it suitable for tax purposes. Hedge accounting should for example be made obligatory in case of a hedging relationship instead of optional. This system is in accordance with the principles of sound business practice, namely reality, prudence and simplicity. It can be applied both in the proposed CCCTB directive and in national tax accounting

In general I am in favor of a more close connection between commercial and tax accounting. The gradually developing rules in case law of sound business practice do not always provide clear guidance for taxpayers, which creates legal uncertainty. Although IFRS cannot be used comprehensively for tax purposes because of the different purpose of commercial and tax accounting, it can prove to serve as useful guidance. As proposed in literature, a council of tax accounting could establish clear tax accounting rules based on IFRS. This will increase legal certainty and equality for taxpayers, especially in the context of the implementation of horizontal monitoring.

## **List of abbreviations**

CCCTB	Common Consolidated Corporate Tax Base
CFC	Controlled Foreign Company
CITA	Corporate Income Tax Act
EC	European Commission
EEA	European Economic Area
EII	Exempt Investment Institution
EU	European Union
FII	Fiscal Investment Institution
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
RJ	Directives of the Dutch Council of Annual Reporting ( <i>Richtlijnen voor de Jaarverslaggeving</i> )

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