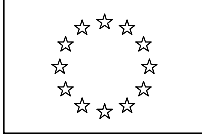

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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

Tax treatment of financial assets

Meeting to be held on Thursday 8 December 2005

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WORKING DOCUMENT

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I. Introduction and purpose of the paper

1. When the structural element of the tax base "assets and tax depreciation" was introduced in the Working Document CCCTB/WP/004, it was suggested to postpone discussions on financial assets to a later stage. Similarly, when the structural element of the tax base "capital gains and losses" was introduced in the Working Document CCCTB/WP/010, it was suggested to deal with capital gains and losses on financial assets at a later stage, after the general treatment of financial assets has been discussed.

2. The participants in the Working Group of the Common Consolidated Corporate Tax Base (hereinafter as "CCCTB WG") have agreed with the approach chosen by the Commission Services. However, they recommended great care when dealing with the tax treatment of financial assets, due to possible tax planning. A typical concern was the fact that capital gains and losses in general could be "crystallised" by taxpayers in the most convenient tax year. Another problem already mentioned by Members of the CCCTB WG may arise if the tax treatment of financial capital gains and losses were to be different compared to "ordinary" capital gains and losses. Both situations, when the taxpayer could potentially avoid or reduce overall taxation could be prevented by the ring-fencing of capital gains and losses from other taxable income or more specifically by the ring-fencing of financial capital gains and losses.

3. The Commission Services have prepared this Working Document to discuss whether any special rules for financial assets, and capital gains and losses incurred in relation to them, will be needed in the CCCTB. This working document primarily suggests and examines possible solutions for the tax treatment of capital gains and losses on financial assets. Members of the CCCTB WG are invited to comment on these issues but may, of course, raise any other issue related to financial assets.

4. As assets and capital gains have been covered in the two Working Documents referred to above, this paper builds heavily on them and should be read in conjunction with them. General elements and principles valid for all types of assets are not repeated in this working document, which concentrates on where and why there may be a need for specific tax treatments for financial assets. The main objective of this paper is to analyse whether gains and losses on financial assets should be calculated differently and be ring fenced from other taxable income and why.

5. The need to foresee a specific tax treatment of financial assets held by financial institutions/entities (such as banks, credit institutions, insurance undertakings, venture capital organisations, mutual funds, unit trusts or similar entities including investment linked insurance funds etc.) compared to the tax treatment of "non-financial" entities will be dealt with at a later stage. The taxation of global trading of financial instruments, as discussed within the OECD, is also outside the scope of this paper.

6. Similarly as in previous working documents on assets and tax depreciation, existing international accounting rules and practices are examined as a possible starting point for tax treatment and it needs to be further examined how relevant they are for CCCTB purposes.

7. In accounting financial assets are included within the definition of "financial instruments" defined by IAS 32 as a category which encompasses "financial assets", "financial liabilities" and "equity" and IAS 39 illustrates the method for recognising and measuring "financial instruments". Several rules contained in these two standards apply to financial instruments in general and do not necessarily serve the purpose of this paper which is focussed on financial assets and in particular capital gains and losses on financial assets.

8. It should be noted that IAS/IFRS[1] may be less relevant in this area because the approach followed by IAS/IFRS for recognition and measurement of financial instruments is particularly innovative compared to more traditional approaches in MS. For example, IAS 39 as revised in December 2003 introduced an option that permitted entities to designate irrevocably on initial recognition any financial asset or financial liability as one to be measured at fair value with gains and losses recognised in profit or loss (the full "Fair Value Option"). However, several stakeholders expressed concerns that an unrestricted fair value option might be used inappropriately, in particular for financial instruments relating to a company's own liabilities. In addition, certain provisions concerning hedge accounting were criticised by some European banks, as they argued that IAS 39 does not allow them to apply hedge accounting to their core deposits on a portfolio basis. Subsequently, some parts of IAS 39 relating to the full fair value option and some aspects of the hedge accounting were "carved out" when IAS 39 was endorsed for use in the EU.[2] On 16 June 2005, the IASB published "Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option"[3] where the application of the revised fair value option is restricted to cases where certain principles must be respected. Work is in progress concerning the amendment to the part of the standard relating to hedge accounting. Annex 1 contains summarised definitions and the basic features of financial instruments as outlined in IAS/IFRS.

9. Compared to previous Working Documents, this paper has a more limited scope and refers to topics which have been already partially touched upon. As further background information Annex 2 contains a table describing some elements of the taxation of financial assets in Member States. Member State experts (hereinafter MS) are kindly requested to comment on the questions asked at the end of the document.

[1] In addition IAS 32 (which deals with disclosure and presentation of financial instruments) and IAS 39 (which deals with recognition and measurement), there are other specific standards dealing with interest in subsidiaries, associates and joint ventures (27, 28 and 31), employee benefit plans (IAS 19) and business combinations (IFRS 3).

[2] See Commission Regulation (EC) 2086/2004 of 19 November 2004 in OJ L363, 9.12.2004, p. 1

[3] Endorsed by Commission Regulation (EC) 1864/2005 of 15 November 2005, in OJ L 299, 16.11.2005, p. 45

II. Definition of financial assets

10. IAS 32 defines the category of "financial instruments" as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity[4]. In any financial instrument there are two parties of a contract: one is the issuer of a financial instrument and the other is the holder. A financial instrument represents a source of financing through liability to third parties or through equity in the books of the issuer and a financial asset in books of the holder.

11. The accounting definition of financial instrument covers also derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps) which transfer between the parties the financial risks inherent in a underlying primary financial instrument (hence the name). In these cases it is not possible to establish at the beginning of the contract whether the instrument will represent an asset or a liability at maturity.

12. As mentioned before IAS deals with financial instruments in general. As this paper aims at focussing mainly on financial assets, the classification contained in the Fourth Council Directive (78/660/EEC) of 25 July 1978 on the annual accounts of certain types of companies[5] may be useful. The Directive classifies financial assets as fixed and current financial assets. Fixed financial assets include shares; loans; participating interests; and investments held as fixed assets. Current financial assets include shares, other investments, and cash at bank and in hand. Whether a financial asset is a fixed asset or a current asset depends upon the purpose for which they are intended[6], and the same asset can be deemed as fixed for one company and current for another. The Directive does not mention financial liabilities or derivatives in this context.

13. If the CCCTB should provide for some specific rules on financial assets and capital gains related to them it will be necessary to define financial assets for the CCCTB purposes. For example, the term financial assets could represent a sub-category of assets with the following characteristics: they are not depreciable (they are not subject to wear and tear) and are intangible. Financial assets could be cash, equity, debt and/or derivatives.

14. Equity represents an ownership right of one company in another company. Equity of the latter company is normally represented by shares or other securities issued to the former company, which is entitled to receive a share of the profit of the latter company and exercise the voting rights.

15. Debt is another method for a company (which is then in a position of a debtor) to finance its business. Debt, or in other words money lent by a creditor, may be represented by bonds, debentures or other securities. The creditor is entitled to receive interest (in addition to the return of the principal) regardless of whether the debtor makes a profit or a loss. The interest can be paid periodically during the duration of

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[4] IAS 32, paragraph 11

[5] OJ L 222, 14.8.1978, p. 11

[6] Art. 15 of the Fourth Accounting Directive.

the debt, or can be 'paid' at the end of the term, for example when debt is issued at a discount and the creditor (the lender of the amount) receives back the full undiscounted amount when the debt instrument matures and is redeemed by the issuing company.

16. It should be noted that a wide range of financial assets may be created by companies and distinguishing between what is debt and what is equity is very important for tax purposes because the tax treatment of interest and dividends is usually different (see also below). The issue is further complicated by the hybrid nature of some instruments.

III. Measurement and recognition of financial assets

17. In accounting a financial asset is recognised initially at the fair value of the consideration given (normally cost). As regards timing, recognition is when the transfer of the asset takes place. The transfer of the asset takes place when the transferor transfers the risk and rewards of ownership to the transferee. If the transferor retains the risk and rewards of ownership the transfer has not occurred. This is the case when there is an agreement to buy the asset back at a fixed price (a so-called "repo" transaction). When there is only an option to buy back the asset at its fair value at the time of repurchase the risk and rewards of ownership are transferred from the very beginning.

18. For the purpose of measuring a financial asset after initial recognition (subsequent measurement), the IAS 39 classifies financial assets in four categories: "at fair value through profit and loss"; "held to maturity"; "loans and receivables"; "available for sale"[7]. The categories apply to measurement and profit and loss recognition, but the other categorisations are possible when presenting information on the face of the financial statements[8].

19. Subsequent measurements of financial assets must be done at fair value for assets recognised as "at fair value through profit and loss" or as "available for sale" and at amortised cost for assets recognised as "held to maturity" or as "loans and receivables". "Fair value" is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. If there is an active market, the fair value of an asset is the quoted price, but if there is not an active market a valuation technique must be used to determine the fair value. "Amortised cost" of a financial asset is calculated allocating the interest income over the relevant period applying the effective interest rate.[9]

20. As it is known, IAS/IFRS have a strong preference for the fair value method. The IAS 39 assumes that the fair value can be calculated for almost all financial assets. If this is not possible (for example for investments in equity instruments without a

[7] IAS 39 paragraph 9
[8] IAS 39 paragraph 45
[9] IAS 39 paragraph 46

quoted price in an active market and for which other methods of valuation are not possible or not appropriate) the financial assets are valued at cost.

21. When financial assets are revalued after the initial recognition gains and losses due to a change in the fair value are treated as follows for accounting purposes:

- if a financial asset is classified as "at fair value through profit or loss" gains and losses are recognised in profit or loss;
- if a financial asset is classified as "available for sale" gains and losses are recognised in equity (in a special fair value reserve) until the asset is sold. However impairment and foreign exchange rate changes are recognised in profit or loss;
- for assets valued at amortised cost gains or losses are only recognised when the asset is derecognised or impaired, and through amortisation.
- financial assets that are designated as hedged items are valued separately.

22. For financial assets which are not subject to periodic revaluation to fair value IAS 39 contains rules concerning impairment and uncollectibility. The impairment is recognised in the profit or loss account. IAS 39 permits recognising impairment if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset. Subsequent reversal of the impairment must also be recognised in the profit or loss account (without exceeding the amortised cost) except for assets carried at cost or equity recognised as "available for sale", for which the impairment loss cannot be reversed. In this regard, IAS deviate from the Fourth Accounting Directive, Article 35, paragraph 1.(c)(dd) and the IAS treatment takes precedence over that in the Directive.

23. As described above it is important for accounting to reflect the actual value of a financial asset and its changes over time and the IAS rules provide for this. Such practice is in line with one of principle purposes of accounting (to ensure that assets and income are not overstated, nor liabilities and expenses understated). It has to be closely examined to what extent and for what types of financial assets this should be relevant in taxation and reflected in the CCCTB.

IV. Tax treatment

24. In taxation financial assets are normally measured at cost on initial recognition in a similar way as depreciable assets. Further discussion may be needed on which types of costs should or should not be included in the acquisition costs of financial assets. For example, whether or not certain commission costs should be included.

25. In many existing tax systems the taxable income is also potentially affected by subsequent revaluations of financial assets in accounting as a result of dependency between taxation and accounting. However, most MS adjust these effects and exclude (some or all) revaluation effects from the taxable income. For the CCCTB it will not be possible to maintain such close links between the financial and taxation accounts and the major question is whether, and in which cases, the change of value of a financial asset should affect a taxable base.

26. Revaluation of financial assets for tax purposes when their value drops with an effect on taxable income is currently accepted by some MS who follow the prudence principle in taxation. Such practice may give rise to unrealised losses in taxation. Members of the Group may wish to consider how relevant this principle should be in relation to financial assets for the CCCTB, and whether it should be extended to unrealised profits in relation to liquid financial assets.

27. When a financial asset is disposed of the difference between proceeds from the disposal and the financial asset's tax value, which may be either acquisition value or a value after subsequent revaluation, represents a gain or loss. Some MS tax/relieve this gain/loss and some have special exemption rules (for more details see the section on the participation exemption). The general justification for not taxing such a gain is the elimination of double economic taxation and a general trend of increased application of such a relief can be recognised among MS. If such gains on financial assets are excluded from taxable income, the losses are not normally relievable. If the CCCTB adopted a solution whereby capital gains and losses on financial assets were not in principle included in taxable income it may be most practical not to re-value financial assets after the initial recognition for the CCCTB purposes. How such an exemption would fit with a policy of taxing gains on the disposal of tangible assets needs to be examined in more detail. MS who currently exempt gains on certain financial assets, but tax gains on tangible assets may wish to comment on how they deal with the potential tax planning strategies which this approach may encourage.

28. In principle, a financial asset could give rise to profit (or loss) to its holder (a) during the possession period (e.g. in the form of interests or dividends); (b) at the time of its disposal (in its broad meaning[10]); and (c) at the closing-date of the taxable year if the financial asset is revalued/devalued.

29. The first kind of revenue (interest and dividends) is not dealt with in this paper. However, it should be noted that dividend distribution and capital gains/losses on the sale of shares are two inter-related issues, as the value of shares changes depending on whether such shares have recently or will soon pay dividends. When the distribution of dividends is exempt but capital losses are deductible, tax planning is possible. Similar issues arise with debt and interest. To counter this, several MS have put in place different anti-avoidance measures such as disallowing deductibility of capital losses on the sale of shares, when the dividends of such shares are tax exempt, or re-qualifying the accruing discount of a bond as interest. This is an important issue and although anti-avoidance in general is to be discussed at a later stage, these specific aspects could be considered now.

30. As regards the remaining two kinds of revenues (which we refer to as "realised capital gains and losses" and "unrealised capital gains and losses", although some clarifications and distinctions may be needed for financial assets held as part of trading portfolio), the following analysis builds upon the work carried out by the

[10] The OECD Model Tax Convention on income and capital uses the expression "alienation" to cover capital gains resulting from sale, exchange, expropriation, transfer to a company in exchange of shares, the sale of a right, the gift and even the passing of property on death (OECD Model, condensed version July 2005, commentary on Article 13, paragraph 5)

CCCTB WG and by the sub-group in charge of assets and tax depreciation (hereinafter "SG1"). In particular, it takes into account the results of the discussion on the tax treatment of "ordinary" capital gains and losses" (ie capital gains and losses arising from assets other than financial assets).

31. During these earlier discussions it was generally agreed that realised capital gains and losses should be treated as part of the ordinary business income of companies. As a consequence, realised gains should be fully taxable and losses fully relievable. However, unrealised capital gains should not be taken into account for CCCTB purposes. Discussions did not achieve a common view on the tax treatment of unrealised capital losses, as some Members supported a symmetrical treatment of gains and losses whereas others prefer asymmetrical treatment for unrealised losses; in application of the more general principle of prudence.

32. The question is now whether the tax treatment of financial capital gains and losses should be different from the tax treatment of "ordinary" capital gains and losses and, if this is the case, what the most suitable tax system for financial capital gain (both realised and unrealised) is.

a. Ordinary income vs. separate taxation

33. On the basis of the general principles already agreed on capital gains and losses, it seems preferable to tax financial capital gains and losses together with the ordinary income of a company without distinguishing between fixed and current financial assets.

34. If capital gains and losses are not regarded as different, ie 'ring fenced', from "ordinary" income the owner of financial assets has a certain leeway in determining when realising them. This allows for, for example, the realisation of capital gains in a tax period where the company has other losses available. To avoid such tax-planning, some MS ring-fence transactions that give rise to capital gains and losses and allow, for example, deduction of capital losses only against capital gains of the same nature in future financial years. This prohibits the setting-off of "ordinary" income against capital losses and vice versa as already mentioned in the Working Document CCCTB\WP\010 and discussed by SG1.

35. It is a question whether ring-fencing of capital gains and losses from other income is also relevant for financial assets and if so whether it should be done in general or whether there is a need to ring-fence capital gains and losses related to financial assets separately.

36. In several MS, gains earned through participations in investment funds or investment companies receive a separate tax treatment. This can be connected to the taxation of individuals and therefore, as the CCCTB work is only concerned with the corporate tax base, discussions may be difficult. However, the underlying tax treatment of such funds and companies is not considered in this paper, nor is the potential treatment of corporate investments in these funds or investment companies.

b. Realised financial capital gains/losses

37. The tax treatment of realised financial capital gains and losses varies considerably among MS, where one can find (except for the participation exemption, which is discussed later), full or partial taxation (the gain is considered as part of the ordinary income) and separate taxation (the gain is considered as a separate item of income).

38. The calculation of a capital gain/loss follows *mutatis mutandis* the methods already discussed in a previous paper and will not be elaborated further. However, some specificity should be mentioned. For interest-bearing transferable financial assets, the interest is often accrued in each tax (financial) year although it has not been paid (or become payable) yet. Such accrued interest is usually taken into account when calculating a capital gain or loss. If interest has not been paid or is even not payable yet it is relatively certain that it will be paid in future (ie the amount and date are known) and therefore it may be deemed for tax purposes at earlier stage. For shares and other equity related financial assets whether profit has been distributed or not influences their actual value. However there is no certainty whether a company will make a profit or loss in the respective and following tax years.

39. If the financial assets grant a preferential subscription right to the holder in case of issuing new assets, and the holder makes use of such a right, the newly issued assets will be subscribed at a lower value than the market value, and this value should be the initial value for computing future capital gains or losses.

c. Unrealised capital gains/losses

40. Unrealised capital gains or losses occur when the value of a financial asset varies, but the asset remains in the hands of the holder**.** There are various methods among the MS for calculating the market value of financial assets. For assets exchanged in stock markets, it can be the price of the day at the end of the financial year, or an average of the last month, or the last three months, etc. Some MS also apply the equity method to qualifying participations. The equity method consists of valuing the participation at a corresponding pro-rata to the value of the whole equity of the participated company. However, technical details and even the criteria for defining a "qualifying" participation vary considerably.

41. Due to the volatility of certain financial assets, it could be inappropriate to tax unrealised capital gains, because the higher value (gain) recognised at the closing date of the financial year can change quickly and become a loss. Companies would be requested to pay taxes on a gain which not only has not been realised, but that in addition has become in the meantime a loss. On the other hand, financial assets are normally very liquid compared to non financial assets and this could justify a different treatment.

42. It should also be noted that as regards the limited taxation of unrealised gains and losses on some financial assets as mentioned above some MS further distinguish between 'fixed' assets and 'current' assets. Financial current assets could be considered as assets which are held for sale in the ordinary course of the business and treated as "inventory; however, the "lower of cost and net realisable value" (which applies to

inventory) does not apply to financial instruments in accordance with IAS 2. As a consequence, some MS allow the valuation of some financial current assets at fair value at the closing date of each financial year and the increase or a decrease in the value of financial current assets is recognised in profit and loss and forms part of the taxable base. This does not apply to financial assets recognised in the balance sheet as fixed assets.

V. Participation exemption

43. The expression "participation exemption" is used in this paper with the meaning of tax free sale of "qualified" financial assets (mainly shares and other participation in companies) under certain circumstances. Participation exemption is a tool to avoid or reduce economical double taxation, as the "underlying" company (the company the shares of which have been sold) has already been taxed on its profit.

44. Participation exemption is more and more used by MS, although conditions and requirements vary significantly with regard to:

- The amount of exemption;
- The conditions to be fulfilled by the participations to qualify for the exemption, such as requirements of the holding company, requirements of the participated company and requirements of the participations themselves (duration of possession, minimum threshold, etc.);
- The applicability of anti-avoidance rules and systemic provisions concerning the non deductibility of capital losses, the non deductibility of related expenses (such as fees, legal costs, due diligence costs and interest on loans used to purchase exempt participations), special rules for intra group transactions and special rules for transactions with low-tax jurisdictions.

45. Participation exemption is relevant for CCCTB in two cases: when it concerns the sale of a participation in a company which is not covered by CCCTB, and when it concerns the sale of a participation in a company which is covered by CCCTB provided that the threshold for participation exemption is lower than the threshold for consolidation. On the contrary, if the former threshold is the same or higher, the company the participation of which has been sold will be included in the consolidation and all intra-group transactions will disappear (depending on the formula chosen for consolidation).

46. To give a brief description of the various systems, it should be mentioned that the most common requirements of the holding company are: being resident of the country that grants the exemption; having a defined legal form; and being subject to corporation tax. The most common requirements of the participated company are, again: having a defined legal form; being subject to corporation tax; not being resident in a low-tax jurisdiction[11] (for a certain period before the disposal, for

[11] Definition of a low tax jurisdiction varies among Member States. It happens often that Member States issue a "black" list of countries taking into account the level of taxation, the existence of special regimes, the possibility of exchanging information, etc. However it is often possible to obtain a ruling

example three years); and carrying out trading activities[12] (for a certain period before the disposal, for example three years).

47. As regards the requirements that participations must meet, it is very often required that they be shares (including own shares) or other financial instruments which represent an ownership interest (equity[13]) in a company; be kept for a certain period (12/18 months) and be recognised as fixed assets in the first balance sheet during the possession period. The participation must also represent a minimum specified share of the equity in the participated company (typically, 10%).

48. As regards anti-avoidance provisions, capital losses, either solely recognised or actually realized, are generally non deductible if relating to financial assets that would be exempt. In addition, expenses which are connected with the disposal of exempt participations are, in general, non deductible (for example consultant fees, legal advice, due diligence costs, etc.). On the other hand, general costs (which are not directly connected to exempt income) are in principle deductible, unless a given country disallows in full or in part general costs which generate both taxable and exempt income.

49. Among non deductible expenses interest should be mentioned because some MS have anti-avoidance legislation which presumes that interest is paid to borrow money used to purchase financial assets benefiting of exemption. Therefore, interest is often not deductible according to specific ratios (such as taxable income/exempt income ratio[14].

Members of the Group are invited to consider the following questions:

1. *Do members of the group agree to limit the current discussion to capital gains and losses on financial assets and the participation exemption? If not which other issues should be discussed together?*

2. *Do members of the group think that capital gains and losses on financial assets should have a different tax treatment compared to capital gains and losses on other assets? Do they consider as relevant, for tax purposes, the distinction between fixed and current financial assets?*

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from tax authorities in case where – notwithstanding the residency in a low-tax jurisdiction, the benefits of the exemption are granted. Some countries have sophisticated anti-abuse rules to avoid the use of conduit companies (treaty shopping).

[12] Several anti-avoidance rules exclude for example the application of the participation exemption regime for companies the core business of which is finance or the main component of its value is immovable property. However, often the trading activity is presumed when the company is quoted in stock markets, or if the sale of the shares is regulated by public authorities such as "public purchase offer" or the like.

[13] Among the various financial instruments, it is not always easy to distinguish between equity and debt instruments, due to the existence of hybrid financial instruments such as convertible bonds which have the feature both of equity and debt. IAS 32 contains useful guidance on this aspect. In general, equity entitles its holder to participation in the results (profit/loss) of the participated company, but does not oblige the issuer to deliver cash or another financial instrument to the holder.

[14] This ratio is different from the equity/debt ratio used for thin capitalisation purpose.

3. *Do members of the group have a preference for the most suitable tax treatment of financial capital gains and losses? For example, full or partial taxation following the same rules of ordinary income or separate taxation?*

4. *Do members of the group consider for example that financial capital gains and losses should be ring-fenced from "ordinary" trading income? Or would it be sufficient to envisage specific anti-avoidance provisions to prevent undesirable tax planning?*

5. *Do members of the group have a preference on the most suitable method of computation for financial capital gains and losses? What should be included/excluded when computing the acquisition value and the alienation value?*

6. *Do members of the group agree that unrealised financial capital gains should not be taken into account for tax purposes? Do they envisage a symmetrical treatment of unrealised financial capital losses? Do they agree on a different treatment for fixed and current financial assets? Should this symmetry, or asymmetry, be the same as that applied in respect of tangible depreciable assets?*

7. *Do members of the group consider that participation exemption rules should be introduced in the CCCTB? If yes, what should be the conditions for benefiting from participation exemption?*