Comments by the UNICE Task Force on Tax Depreciation in a CCCTB

- the concepts of pooling and individualized tax depreciation –

Introduction

One of the core issues raised by the European Commission in its Working Paper on Assets and Tax Depreciation (WP 004) is whether assets are to be depreciated on an individual or on a pool basis. The issue has been subject to extensive discussion. The tax depreciation constitutes an essential factor for the calculation of the tax base and thus the effective level of taxation. The UNICE Task Force on CCCTB would like to make some additional remarks on this specific issue.[1]

When the expressions 'pooling' and 'individualized' depreciation are used in this paper, it does not aim at two opposing methods. They are rather used under the notion of a sliding scale between two endpoints where a certain method might feature more or less of the characteristics of either of these extremes.

Simplicity vs. accuracy

The Task Force recognises that the depreciation regime, to the extent possible, should fulfil two main objectives. First of all, it is essential that the system promotes *simplicity* and thereby promotes growth. As has been pointed out by the European Commission, a CCCTB should lead to the simplification of the tax environment in the EU.[2] This would endorse business activity and entrepreneurship in Europe, something that is of utmost importance in the ever more competitive global market. At the same time, however, the depreciation method should provide for a *proper reflection of the economic lifetime of an asset*.

There appears to be a certain tension between these objectives. It seems likely that a pooling method is simpler for both the business community and for the tax authorities. Under this approach it is for example not necessary to keep records of the economic value of each individual asset, something that may be required to be kept for many years under an individualised approach. An individualized depreciation method, on the other hand, seems to give room for a more accurate forecast or assumption with respect to the economic lifetime of different types of assets. It is hard to see a pooling system with only one pool that results in a proper reflection of the economic lifetime of an individual asset, although it likewise must be recognised that it is not possible to achieve a precise forecast of the economic lifetime of an individual asset.

The choice of depreciation method therefore seems to depend considerably on how one regards the respective importance of these two objectives. To the extent they cannot be achieved concurrently, the Task Force would propose a compromise position between the two extremes, but would like to put more weight on simplicity than on (somewhat unrealistic)

[1] The Task Force has given some general remarks on the issue in its commentary on WP004. Available at http://europa.eu.int/comm/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

[2] CCCTB/WP/012, p 5.

accuracy. Since price stability is ensured in the European economy, a minor deferral or acceleration of tax payment should be less of a concern than when the inflation rate is high. This fact, in combination with the arbitrariness of expected economic lifetime, points in the direction of emphasizing simplicity over accuracy.

From a general standpoint, a system that is developed around the principles of pooling might therefore be more appropriate. In this respect we would like to give the following remarks:

1. Simplicity of the tax system is crucial in order to promote business activity and to create a competitive tax system for the European market. A well functioning and competitive business tax regime is essential in order to face the ever fiercer global competition. This must be recognised throughout the process of designing a CCCTB.
2. With respect to administrative costs, simplicity is essential both from the perspective of the business community and the tax authorities. The perceived additional precision offered by a differentiated system based on an individualized scheme must be carefully weighed against the cost of managing such a system and the potential tax arbitrages it may open up. From a business point of view, the administrative burden of a detailed and complex system is obvious and will inevitably take resources away from actual business activity. From the perspective of the tax authorities, the cost of monitoring taxpayers' compliance with the system is equally high.
3. As pointed out by the European Commission, the difference between an individualized depreciation scheme and a pooling approach is not one of objective accuracy versus rough estimates. Both approaches are based on a forecast of the expected economical lifetime *ex ante*. The *ex post* outcome might be very different. No system will thus provide for an 'accurate' result. It shall also be noted that there is an offsetting mechanism inherent in a pooling approach where some assets inevitably will be depreciated quicker and some slower than their 'actual' economical life. Whether a pooling approach provides for sufficient accuracy from an 'overall perspective' therefore largely depends on the depreciation rate chosen.
4. Companies running businesses in countries already using a pooling approach do not generally have any records of the depreciated value of each individual asset. It would therefore be almost impossible for such companies to switch to an individual depreciation scheme. The same is not true in the reverse situation. This would obviously act as a disincentive for businesses predominantly operating in 'pooling countries' to opt for a CCCTB that is founded on an individualized depreciation method.
5. The calculation of capital gains or losses may superficially be more complicated under a pooling approach. Under such a scheme, there is no detailed record of the depreciated value of each asset. However, any eventual loss on a disposal over and above any depreciation allowances claimed is automatically given as part of the pool allowance, spread over a number of years and any gain, either a recovery of allowances given or absolute gain in excess of the acquisition cost is likewise taxed over a number of years by way of reducing the depreciation allowances. If it is desired to tax actual gains, where the disposal proceeds exceed original cost, differently from depreciation allowances, then provided the company is required to keep records of the acquisition price this can be identified and calculated fairly easily. This issue seems to give rise to few problems in countries already using the pooling approach. The same is true regarding the possibility of allowing for roll-over relief under a pooling approach. The issue of roll-over relief is not explicitly addressed in this paper. However, to ensure that the economic capacity and

efficiency of a business is maintained, a roll-over relief is preferred.[3]

Despite the above, the need for capital gains taxation when businesses assets are disposed of needs to be analysed. There seem to be few, if any, justifications for treating one type of business income different from any other kind of business income.

6. The complexity of an individualized approach appears increasingly difficult when adopted within the context of a CCCTB (compared to when used within a domestic context of one single country). The more depreciation groups that are created (or in the extreme case, a single depreciation assessment for each individual asset) the more room there is for countries to apply the depreciation regime differently with respect to individual assets. That is, it becomes more difficult to ensure that each individual asset is depreciated in an equal way by all Member States. This suggests that the number of pools should be kept as few as possible.
7. There is no direct link between the choice of depreciation method and the size of the tax base (and thus the tax revenues). This depends on the depreciation rates rather than the method used for depreciation.

Intermediate solutions

Even though the pooling concept is preferred for reasons of simplicity, the Task Force recognises that such an approach, at least in its purest form, might not provide for an acceptable level of 'economic reality'. We agree with the European Commission that a "good balance between reflecting as closely as possible economic reality in the tax base and creating a system which can work effectively and efficiently across the EU has to be found".[4] In order to ensure such a balance, some sort of intermediate system is conceivable. Such a scheme could be based on the concept of pooling but allow for a more individualized depreciation method with respect to a limited number of assets, such as immovable property and intangibles.

As an intermediate system would feature more than one group of assets, it is (unfortunately) necessary to establish demarcation criteria. From a general perspective, an imaginable approach could be to seek suitable criteria based on the distinction between assets typically characterized by large volumes and relative low values (such as inventories), and assets generally characterized by low volumes and high values (such as buildings). The rationale behind such an approach would be that assets of the latter group are not excessively burdensome to document (records are often already kept for non-tax reasons) but at the same time, due to their relatively higher values, essential to depreciate at a 'correct' economic rate. Therefore, a more individualized depreciation scheme is conceivable for these assets. With respect to the former group, the circumstance is the reverse. Thus, here pooling appears more appropriate.

It appears as if there is general consensus among Member States that a distinction between movable and immovable property is suitable. Considering the characteristics of the latter category, a demarcation between these asset types might be possible. Even though it is relatively easy to differentiate between these categories it must, however, be noted that it is

[3] Additional arguments have been raised by the Task Force in its commentary on WP010, which are available at http://europa.eu.int/comm/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

[4] CCCTB/WP/012, p. 4.

often intricate to decide whether an asset shall be regarded as a movable asset or constitute part of an immovable asset.

From the perspective of simplicity, it is preferable that immovable property is depreciated together in one single pool. Considering the value and volume of such assets (again speaking in general terms), an individual depreciation approach is, however, conceivable. This could potentially be based on an *in casu* estimation of the economic life of each asset (perhaps directed by some guidelines) or on a list defining different types of buildings etc. Both these alternatives do, however, have the apparent downside of requiring considerable elements of assessment.

With respect to other (movable) assets, at least four approaches can be outlined.

1. *All assets other than immovable property are depreciated in* *<u>one single pool</u>*. This approach promotes simplicity and efficiency as it is based on a relatively straightforward demarcation criteria (i.e. the one between movable and immovable assets). Since the depreciation is done within one single pool, this approach inherently gives a less accurate reflection of the economic life of each *individual* asset. From an overall perspective, however, it does not necessarily provide for an unacceptable result. As pointed out above, some assets will have a longer economic lifetime and some a shorter economic lifetime than the one reflected in the pool's depreciation rate. This will obviously work as an offsetting mechanism.

   Under this approach, the chosen rate of depreciation is very important. A period between 3-5 years might be appropriate. It could also be accompanied by a rule allowing for a direct deduction of assets of a lower value (e.g. below € 2000).

2. *Assets other than immovable property are divided into a limited number of pools (preferably three or less) and the demarcation criteria are based on the* *<u>acquisition cost of the asset</u>*. Since the acquisition cost is relatively easy to establish, this approach gives rise to rather limited demarcation problems. It also allows for more than one depreciation rate. This method does, however, have at least two notable drawbacks. First, even though many high value assets (such as ships, vehicles and heavy machinery) have a rather long economic lifetime, there is no clear relation between the acquisition cost and the lifetime. Second, it is often difficult to establish what should constitute an asset. For example, are the hardware and the software of a computer one or two assets and shall the acquisition cost be calculated together or separate?

3. *Assets other than immovable property are divided into a limited number of pools (preferably three or less) and the demarcation criteria are based on the* *<u>type of asset</u>*. Under this approach, there would be a standard depreciation rate of perhaps 3-5 years. All assets that are not specifically attributed another depreciation scheme would fall within this general pool. Certain types of assets, such as ships, aircrafts, machinery and motor vehicles, would be depreciated within one or a few special pools with different depreciation rates. To ensure sufficient simplicity, it is essential that the number of special pools are kept to a minimum and that the demarcation is based on clearly definable asset types (such as aircrafts, ships etc.). The hardship of achieving this is obviously the most significant downside with this approach.

4. *Assets other than immovable property are divided into a limited number of pools (preferably three or less) and the demarcation criteria are based on the* *<u>expected</u>*

economic lifetime. Also this approach allows for more than one depreciation rate. This does come at the expense of a more intricate demarcation criterion but this has been found to be workable in practice in at least one member state. Even if the number of pools is kept to a minimum, the method would require an assessment of the lifetime expectancy of each asset type in order to attribute them to the appropriate pool. That is, some mechanism to asses the expected economic life of each asset type would be required. Provided the categories are drawn widely (e.g. economic life less than 25 years and economic life greater than 25 years) this should not present insurmountable difficulties. As a consequence, some of the simplicity with the pooling is lost, but such an approach may offer a reasonable compromise.

In addition, it must be recognised that there are assets that only have a marginal value and/or a very short economical lifetime (such as computers, mobile phones etc.). Under a simple and cost effective system, such assets should be expensed. It should also be recognized that under modern environmental consideration land, previously considered as never loosing its value, in fact not only loses its value, but eventually becomes a liability (for example when a chemical plant is built and operated on it and there are environmental spills. Finally, the unique characteristics of intangibles (such as patents, trademarks and goodwill), might call for a differentiated treatment in relation to other movable assets. The Task Force has presented its view on the treatment of intangibles in its commentary on the Commission Working Paper 005.[5]

Conclusion and final remarks

For reasons of simplicity the Task Force prefers an approach based on the notion of pooling but recognises the importance of ensuring an acceptable reflection of an assets economic lifetime. It might therefore be appropriate to establish some sort of intermediate scheme which is based on the concept of pooling with one or a limited number of pools and which allows for a more individualized scheme with respect to a limited number of assets. As a point of departure, this could be based on distinction between assets that typically represents large quantities and relatively low values and assets characterized by low quantities and high values. Considering the characteristics of immovable property, a separate depreciation scheme could be used for this asset group. This is also supported by the fact that there seem to be a consensus between the Member States to make such a distinction. Other (movable) assets should preferably be depreciated under one or a very limited number of pools. Demarcation of such pools by reference to estimated economic life would be possible provided the categorisation uses broad estimates, e.g. economic life less than 25 years or greater than 25 years. In any case, straightforward demarcation criteria should be sought. In summary, simplicity is preferred over accuracy.

On behalf of the UNICE Task Force on CCCTB

Krister Andersson
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[5] Available at http://europa.eu.int/comm/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm