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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

An overview of the main issues that emerged during the discussion of tax depreciation of assets

Meeting to be held on Thursday 2 June 2005

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WORKING DOCUMENT

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I. Background information and purpose of the document

1. The purpose of this note is to give an overview of the main issues that emerged and remained unresolved during the on going discussion on assets and tax depreciation at the meetings of the Subgroup on assets and tax depreciation (hereafter SG1).

2. The topic of assets and tax depreciation was referred to the first subgroup after the first meeting of CCCTB WG on 23 November 2004. The first meeting of SG1 was organised on 27 and 28 January 2005 and the second one on 6 and 7 April in Berlin by Germany. Austria, Belgium, Cyprus, Czech Republic, Finland, France, Germany, Italy, Latvia, Luxembourg, Malta, Netherlands, Poland, Slovenia, Spain, Sweden and Commission Services attended both meetings chaired by Germany; Denmark participated in the second SG1 meeting. The SG1 discussed tax depreciation of tangible and intangible assets. Commission Services prepared two room documents for each meeting. Two of them summarised written comments received from MS on Working documents 'Assets and tax depreciation' (CCCTB/WP/004) and 'Intangible assets and tax depreciation' (CCCTB/WP/005) and the other two contained the main points for the discussion that emerged from the MS's comments. These documents were circulated to all members of the CCCTB WG.

3. The Chair of SG1 informed the plenary CCCTB WG on the progress on 10 March 2005 and the Group discussed some of the issues that emerged at the first meeting of the SG1 on tax depreciation of assets.

4. The Chair of SG1 prepared the Report on the results of the two meetings of the SG1, which gives an overview of the discussion and views expressed by the members of the subgroup.

5. SG1 has now reviewed all the main issues on tax depreciation of tangible and intangible assets, and it is now necessary for the plenary to discuss some of the issues, especially those where views of members vary and it seems to be rather difficult to find a consensus. Members are also invited to express their views on how the SG1 should proceed, which issues are to be elaborated further and what direction should be taken. It is particularly important to concentrate on the question of whether the interim conclusions on assets and tax depreciation create a sufficiently solid basis for a potential future Commission proposal or whether the SG1 or the Group should go into more detail.

6. The Commission Services have prepared this note in order to highlight the main issues where further work is still required before any proposal could be made. This additional work could be done in the subgroup, either now or at a later stage when more progress has been achieved in other areas. However, if MS think the current output of the subgroup is sufficient, the Commission Services could complete the work without further reference to the subgroup, relying for example on any further discussions in the main Working Group for additional input.

The Commission Services look forward to a discussion on the following issues and invite all Members of the Group to express their views.

II. Key discussion points

Definition of the depreciable asset

7. It is clear that a common definition of depreciable asset will be necessary and several approaches to this have been discussed. For some MS the 'tax balance sheet' seems to be an essential component and the issue of tax depreciation is approached from the perspective of how and whether assets are recorded in this tax balance sheet. The tax balance sheet is a separate balance sheet prepared independently and in addition to company's ordinary accounts. However, this is not the case in all MS where in some cases only a profit and loss account is submitted as part of the annual tax return, sometimes with a reconciliation to the company's financial accounts (and financial balance sheet), but without any 'tax balance sheet' as such. In other words some MS place great emphasis on the 'tax' balance sheet of a company when establishing the taxable base; others concentrate more on the structure of the profit and loss account of the company. The Commission Services believes that at this stage the discussions should be centred more on the possible definition of an asset which should be capitalised rather than expensed, and hence depreciated over a period of time for tax purposes, rather than resulting in an immediate reduction in the tax base.

8. It is however very important to take the note of tax balance sheet concept, because it will have a major impact on the discussion of a number of the structural elements. It will be necessary to discuss what documents would form a company's tax return, and how these should be defined, ie to what extent the balance sheet forms part of the common tax base, but this discussion should be separated from the detailed work on tax depreciation because it is not only a tax depreciation question. As it has not been discussed yet whether a tax balance sheet should be required under CCCTB and it is not common practice in all MS the Commission Services therefore proposes to discuss this procedural question separately and to concentrate on the taxable base itself at this stage.

9. SG1 discussed how the potential definition could be structured. The Commission Services suggested that the primary purpose of the definition should be to identify assets that may not be immediately written off and therefore have to be capitalised. However, whether these assets could be depreciated for tax purposes would depend on further circumstances, for example whether they fulfil further conditions for depreciation such as a business purpose test or whether they should be eligible for any depreciation at all (for example an asset with an indefinite life such as land).

10. As regards a business purpose test most members of SG1 agreed that in order for an asset to be depreciable it has to be linked to the company activity. It was important for some members how the expenditure on potentially disallowed assets is treated at 'shareholder's' level. If for example a company acquires a car which is used by its director for private purposes but the acquisition price of the car is gradually added to director's salary, the company should be allowed to depreciate the car, because it in fact represents part of the director's wage. However, no solution was found for assets that are partially used for business and partially for private activity.

Economic ownership

11. The SG1 in principle agreed that the common definition of economic ownership will be necessary as there was a consensus that in certain cases (for example some leasing) the economic owner should depreciate the asset, instead of the legal owner. Members have not however discussed the potential definition itself. Members of the Group are invited to express their views on how much detail the subgroup should go in its findings ie should it aim for concrete proposals, or is it sufficient to identify that a definition is needed, and leave it to the Commission Services to create the definition?

Standardisation of the useful life

12. Although the 'pooling' and the 'individual asset' approaches are sometimes presented as complete opposites the estimated useful life of assets is standardised to varying degrees in the vast majority of tax depreciation systems. This is regardless of whether the pooling or the individual approach is applied. Assets are typically divided into several groups and each group is allocated a fixed standardised useful life over which assets falling into this group are depreciated.

13. If there is more than one group then demarcation criteria have to be created. It is generally agreed that movable and immovable assets should be differentiated and the differentiation between movable and immovable assets is relatively easy. Opinions on the further categorisation within plant, machinery and equipment however differ. It is clear that the more depreciation groups that are created, the greater the apparent level of potential accuracy in the initial calculation of the 'estimated' or 'expected' useful life of an asset. At one extreme all assets could be estimated to have the same useful life – ie pooled in a single pool, at the other extreme each individual asset could be assigned an 'estimated' useful life. Whether the additional complexity and potential disputes between tax authorities and tax payers arising in such an extreme individual approach produce a 'better' result is open to debate. 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.

14. On this issue the Commission Services has pointed out several times that:
    (i) Unless every individual asset is assigned a unique useful life then the level of complexity used to allocate assets to the groups of specified useful lives, and the 'closeness' to economic reality of the subsequent depreciation <u>does not depend on whether a pooling approach or an individual depreciation approach is applied.</u> The results depend on the accuracy of the estimates and on how many depreciation groups (pools) are created. Some confusion may have arisen because in practice systems with pooling tend to have fewer depreciation groups (pools) than systems with individual depreciation. However, this should not be understood as the defining difference between the pooling and the individual systems. For example, it would be perfectly possible to have a pooling system with, say five different pools (based on estimated useful lives) or an individual system which although it

depreciated each asset individually actually only had four different estimated useful lives ie four groups of asset life.

(ii) The fact that detailed categorisation of assets works smoothly and to the common satisfaction of the tax administration and taxpayers within the national tax system is not a sufficient proof that it would work in the CCCTB in the same way. The CCCTB will be administered by up to 25 different tax administrations and if MS want to have many different depreciation groups it will have to be ensured that each asset falls within the same group in all of the participating MS. Most of the SG1's members favoured 'the proper reflection of economic reality' in taxation; and linked this to an individual asset approach. However, how a relatively complex system could be uniformly applied across up to 25 different tax jurisdictions was not discussed in detail. In particular, whether MS should apply a system of 'mutual recognition' or attempt to agree a single common allocation has still to be addressed.

15. Considering the above, together with the fact that several MS have systematically applied depreciation of plant machinery and equipment in one or very few depreciation groups (pools) for many years and appear to be satisfied with it, the Commission Services continue to prefer the solution with as few depreciation groups within plant machinery and equipment as possible. In practice this favours a pool system rather than an individual system. It should also be mentioned that the CCCTB should lead to the general simplification of the tax environment in the EU, therefore if the choice is between a well functioning system and a well functioning <u>and simple system</u> preference should be clearly given to the latter.

16. If the Group is convinced that further differentiation of plant machinery and equipment according to their estimated useful life is necessary for tax depreciation purposes, the Commission Services believe either the CCCTB WG or SG1 should develop the work in more detail, rather than leaving it to the Commission Services. This would have to include how many depreciation groups should be created, how assets should be allocated to each of them, what standardised fixed useful lives should be set for each group and particularly what mechanisms need to be introduced in order to effectively ensure that the allocation of assets into these groups is done in a common and uniform way in all participating MS.

17. The argument that depreciation of plant machinery and equipment in a single group (pool) favours companies with large assets is particularly important and must be addressed. One approach would be to create a special pool (or pools) for assets above a certain acquisition cost, or with an exceptionally long estimated useful life.

<u>Individual versus pooling method of tax depreciation</u>

18. Whereas the Commission Services recognise that the majority of participants preferred the 'individual asset' approach to the 'pooling' approach they are concerned that some of the potential disadvantages which were mentioned during the meetings should be more fully explained and taken into consideration. The individual approach is presented by many members of SG1 as being more accurate, and therefore more objective, since the 'specific useful life' is reflected. However, as it has been already explained above these 'individual' useful lives are estimates and

the comparison should be between a method which makes one (or perhaps a limited number) of estimates and a method which may require many more detailed estimates.

19. The Commission Services is of the opinion that it would be incorrect to present the differences between the two methods as one of objective accuracy versus rough estimates; and that all advantages and disadvantages of both have to be assessed in the context of the CCCTB which will be a rather different tax environment to that in national tax systems. In the individual asset approach it is not simply a matter of making use of computerised accounting systems to make a large number of depreciation calculations – the individual asset approach seems to imply that for every single asset purchased by a company there is a potential dispute between tax payer and tax authority over the precise estimated life of that particular asset in that particular company, and the precise month in the year that the asset qualified, or ceased to qualify for depreciation. The cost of making and checking these individual decisions must be weighed against the potential loss of tax revenues which might result from a more 'broad brush' approach where assets are simply pooled and depreciated at an overall accepted 'average' rate. The more the individual approach makes use of 'groups' to simplify the process – for example creating lists of assets with a five year life, an eight year life etc – the more the individual approach resembles the pool approach in its level of accuracy.

Straight line and declining balance methods

20. Some members of SG1 expressed concern that under the declining balance method assets are not fully depreciated by the end of their estimated useful lives. The Commission Services would like to highlight that in fact the major part of the asset is depreciated within a comparatively short time under the declining balance method (for example at a rate of 25%, 76% of the asset is depreciated within 4 years, and 90% within 8 years). More importantly, if an asset is still owned by a company, and still in use (and therefore still of value to the company) at the end of the estimated useful life fixed for tax purposes it seems reasonable that it should not be fully depreciated. If the asset is no longer in use and is scrapped there would still be scope for the final depreciation to be allowed in the year of 'sale' if that were desired.

21. For those members who stress the need to reflect properly 'economic reality' in taxation the continued use of an asset long after its originally estimated useful life has expired could create problems and, logically, pressure for the tables of estimated useful lives to be revised. Examples from practice show that it is relatively common for an asset to be still in use after the end of the depreciation period. In this context it should be pointed out that the determination of estimated useful lives of assets does not always reflect only the economic reality as it is often the result of negotiation with various interest groups.

Sale of assets

22. Tax solutions for capital gains and losses are going to be subject of the discussion as a separate topic. Nevertheless the Commission Services would like to emphasise that taxpayers can be required to calculate capital gains or losses either as the difference between the selling price and the tax residual value of the sold asset or between selling price and original cost regardless of whether the pooling or individual system of depreciation is applied.

23. For example, when an asset is depreciated under the pooling method and sold providing the year of purchase is known (accounting rules will generally require such records to be maintained), and the rate of depreciation is known (which it will be) it is straightforward to calculate the tax written down value of the asset. The difference between the individual basis and the pool basis is that the calculation of the tax written down value is calculated for every asset, every year, based on the initial agreement of the estimated useful life of each individual asset, under the individual approach. Under the pool approach individual calculations would only be required for an asset which is subsequently sold, and then only required once. Some systems do not calculate the capital gain or loss as they require taxpayers to deduct the selling price of an asset at the disposal from the pool. However this does not mean that the calculation of the tax residual value of individual asset is not possible if pooling is applied. It should be noted that where options (to claim or not the depreciation, or to switch methods as is the case in Sweden) are available such calculations could be complicated but this is not a consequence of the pooling system, but rather a consequence of the existence of options.

Options in the CCCTB

24. Views on whether there should be certain options in the CCCTB (eg. tax depreciation optional or compulsory) vary considerably among MS. Those who favour compulsory solutions link this to the objectivity of the tax base. The Commission Services have however already expressed doubts about whether this is necessarily correct. Options for alternative treatment do not necessarily run counter to an objective tax base. As already mentioned in previous Commission working documents reducing the number of options for alternative treatment should not be presented as a goal of the CCCTB provided that all members accept the options for alternative treatment.

25. In this context it is important to note that one member of SG1 emphasised that since not claiming depreciation only resulted in a higher taxable base then he thought companies should have this option. Although this issue is part of the wider one concerning options, and also interacts with loss reliefs, in the interest of balance it should be highlighted.

SUMMARY AND PRELIMINARY CONCLUSIONS

Although the issues identified are complex and interlinked the Commission Services' preliminary conclusions are as follows:

- Some specific areas would benefit from further work in the subgroup – for example the definition of economic ownership.
- The concept of the 'Tax' Balance Sheet needs to be considered in more detail, but as this impacts on more than assets this should be discussed separately.
- The 'Pooling' and 'individual asset' approaches have some similarities. In particular 'pools' are very similar to defined 'groups' of assets of specified useful lives into which individual assets are allocated. As such the individual approach does not necessarily reflect 'economic reality' more accurately.
- Whether pooling or the individual approach is eventually proposed for the CCCTB agreement will be have to be reached over how many 'pools' or 'groups' there should be. For example, should there be one life for all assets (one pool/group), or five possible lengths of useful life (five pools/groups – 3 years, 5 years, 7 years, 10 years, 15 years)? The subgroup, taking into account current practice, could usefully review the possible numbers of pools/groups there should be in the CCCTB.
- Concerns over how to calculate capital gains and losses under pooling seem to be a major part of the pooling/individual comparison. However, it is possible to tax capital gains if assets are pooled for depreciation purposes so perhaps this has been given too much emphasis. A separate working document has been prepared on capital gains and losses for further discussions.
- Concerns that under the reducing balance method assets can remain in use after their estimated useful life has expired, and continue to be depreciated, should not be a reason for rejecting this method. It can also be argued that an asset still in use has a value, and therefore the reducing balance method is actually more appropriate.
- Removing options is not a goal in itself for the CCCTB. Providing MS offer the same options there is no reason why they should all be removed.