

Study on the possible adjustments  
for Financial Institutions  
of the general rules of the  
Common Consolidated Corporate Tax Base  
(CCCTB) under Framework contract 2006/CC/087

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## 1 INTRODUCTION

PricewaterhouseCoopers (hereinafter “PwC”, or “we”) are delighted to present this Study at the request of the European Commission on the possible adjustments for Financial Institutions of the general rules of the Common Consolidated Corporate Tax Base (CCCTB) under Framework contract 2006/CC/087.

Financial institutions are very often subject to special tax and also accounting rules in the different EU Member States. This 'special treatment' may be justified due to the nature of this business sector, which presents specific risks and requires a high level of regulation to protect investors and consumers. According to the Commission, in the context of discussions on the CCCTB, there is a general consensus among Member States that financial institutions should be carefully analysed as they may require special treatment i.e. other than that of non-financial institutions.

The objective of this Study is to provide technical assistance, input and recommendations to the Commission Services to assist it in deciding on whether financial institutions should be covered by the CCCTB as any other entity but with specific rules where this is deemed necessary or appropriate, or be subject to special rules.

In particular, this study will:

- (i) Identify the financial institutions or elements thereof which require special rules, and
- (ii) Identify those elements of the CCCTB legislation where special rules for financial institutions may be required and where possible suggest what those special rules should be.

The study looks at each specialist identified financial services area i.e. Banking, Insurance and Investment funds, including pension and venture capital funds, focusing on the rules of a particular Member State where such activity is a major part of that Member State's economy. This study is therefore not an exhaustive EU-wide survey of the tax treatment of the Banking, Insurance and Funds sectors, and it is suggested that this could be done on a sample basis as a follow-up phase of this Study. In particular, this study focuses on the Banking Sector in Spain and Germany, the Insurance Sector in Germany and Switzerland, although not a Member State but a mature FS market and important trading partner, the Investment Fund sector in Luxembourg and the Pension Fund sector in the Netherlands.

As agreed, this phase of the Study does not cover formulary apportionment. Regarding consolidation, the Study analyses whether financial institutions should consolidate with other types of entities or should be excluded from the group because of their special activities. The Commission's document CCCTB/WP/057: "Possible elements of a technical outline" (annotated version) has served as the basis for this Study.

Brussels, January 2008

## 2 EXECUTIVE SUMMARY

### 2.1 Banking Sector

#### 2.1.1 Identification of Financial Institutions or elements thereof which may deserve Special Rules.

On the basis of the pilot reports prepared by our German and Spanish firms, it is recommended that the definition of “financial institutions” which should be the subject of special rules if considered necessary in relation to the CCCTB base as set out in WP 57 should be centred around carrying on financial dealing activity, or possibly simply “financial business”.

in the first instance, this could be by reference to both banks, savings banks, credit co-operatives, building societies, savings or loan institutions which are either regulated by the Member State in question, or by the relevant regulatory body in another Member State under the so-called “passporting” provisions of the relevant regulatory directive or directives, plus service banks, broker dealers acting only for themselves, and hedge funds. This would, however, exclude holding companies or non-financial business subsidiaries in the relevant banking or similar group.

However, our recommendation would be that, even if within a particular banking group, regulated or other financial business entities would compute their CCCTB tax base by reference to the specially varied WP 57 base, all CCCTB Directive annex listed entities (basically companies as per the annexes to the tax Directives) in the relevant bank’s/financial business group in EU Member States (participating in CCCTB) should be eligible to opt into the relevant CCCTB group. This would, however, be conditional on the work on the sharing mechanism concluding that any variation of the sharing mechanism for banks or other financial businesses was not fundamentally different to the general sharing mechanism for non-financial businesses.

In other words, there should not be a CCCTB group for regulated banking or other financial business entities with their CCCTB base computed on the specially varied WP 57 base, and another CCCTB group for “regular” entities, not eligible for the specially varied WP 57 base for banks or other financial businesses. It is recognised that this may afford arbitrage opportunities between the two bases. However, as most of the relevant business has to be carried out in regulated entities, arbitrage possibilities should be largely confined to non-regulated entities engaged in financial business. Consideration may, however, have to be given to introducing eligibility criteria for unregulated entities that should be required to demonstrate that they carry on a financial business as defined.

Where, however, a group undertakes activity spanning two (or more) specialised financial services areas e.g banking and insurance, depending on the outcomes of the sharing mechanism debate, it may be necessary to define two (or more) separate CCCTB groups.

#### 2.1.2 Possible Elements of the CCCTB Base where Special Rules for Financial Institutions may be Required

As an overall observation, we would note that where banks or other similar financial business entities follow fair value accounting with respect to trading books, not only is it normal practice to also follow this basis for tax purposes, but it may actually be impossible to adjust such a trading book (particularly if built up over a long period) for accounts and therefore tax purposes onto a realisation basis

#### **Paragraph 25: Non-deductible expenses**

Insofar as a bank (or other financial business) has 3<sup>rd</sup> country i.e. non-EU branches whose profits are exempted from the CCCTB base (paragraph 122 in particular refers), it is considered that

overall expenses of management e.g. in respect of dealing with the single passporting EU regulator should not be allocated to such branches and disallowed.

### **Paragraph 29: Depreciation of Financial Assets**

Paragraph 29 of WP 57 provides that "... financial assets would not be depreciated unless the taxpayer demonstrates that it has (they have) permanently decreased in value ...". Both our German and Spanish firms confirm that, under their respective tax legislation, generally, including for banks and similar financial institutions, allowance is made for the deduction of temporary decreases in value/impairment of equities and fixed income securities, within certain limits. This is in contrast to the proposed paragraph 29 rule which limits deductions for depreciation of financial assets to cases where the taxpayer demonstrates that such assets have permanently decreased in value.

Moreover, under IFRS, which is the basis of many European banks' accounting in entity as well as consolidated accounts, fair value accounting would ordinarily be followed. Accordingly, the preferred variation of paragraph 29 for banks and similar financial institutions would appear to be to follow the fair value accounting, insofar as applicable.

As financial assets include loans, consideration could alternatively be given to excluding loans from this category for purposes of the CCCTB base for banks and similar financial institutions, whilst incorporating the tax treatment of the impairment of a loan portfolio in the provisions concerning bad debts (see below in comments regarding paragraphs 40-42).

However, as the preference would generally be to follow the accounts, it is suggested that the approach of carving out loans from financial assets and relying solely on redefined provisions regarding bad debt relief be confined to the circumstances where fair value accounting is not followed.

As regards equities or other financial assets than loans, insofar as fair value accounting applies, this should we believe be followed for tax purposes.

We would accordingly recommend a further study of the extent of fair value accounting by banks/similar financial institutions, whether under national GAAP or IFRS.

### **Paragraph 31: recognition of income/expense on an accruals basis**

As our Spanish firm notes, fair value accounting is a fundamental accounting concept underpinning the accounting framework for Spanish banks and similar financial institutions.

Accordingly, we consider that the paragraph 31 reliance on the accruals basis will require modification to fair value for banks and similar financial institutions.

The study recommended under paragraph 29 above should assist in this regard.

### **Paragraphs 40-42: bad debts**

The first condition as regards bad debt relief viz. that the amount corresponding to the receivable was previously included in the tax base will not apply to banking loan write-offs as regards principal as only the interest will have been taken to profit and loss account. Clearly, therefore this requires modification for banks.

Moreover, the second precondition for a deduction to be allowed for a bad debt (paragraph 40, second bullet) that "the taxpayer has taken reasonable steps to pursue the payment ..." should probably not apply in the context of the banking industry, since it can reasonably be presumed that this precondition would always be complied with in an industry whose traditional business consists in the assumption of and management of credit risk.

Furthermore, the provisions of paragraph 41, in requiring consideration of individual debts, would appear inappropriate for the banking industry, where bad debt provisions are determined through complex models that may consider not only individual debtors, but also groups of debtors, and may furthermore take into account multiple factors such as default experiences, changes over business

cycles, losses incurred in homogenous credit risk categories, counterparty quality, form of guarantees provided, amongst other factors. It may, however, be possible to flex the paragraph 41 criteria so as to accept that the methodology used by banks and other credit institutions results in an approach equivalent to that of considering individual debts.

Subject to the above, it is therefore suggested that a separate set of rules for bad debt provisioning be established for the banking industry. We understand, in this regard, that insofar as banks are following IFRS and IAS 39, the criteria required therein are very similar to those set out in paragraph 41, except that debts may not strictly be considered individually.

As regards the precise form of such a separate set of rules, it is recommended that this be the subject of a wider study of Member States' practices in this area.

## **Paragraphs 48 and 49: Foreign Currency**

Paragraph 48 provides "tax base, income and expenses will be measured in Euros or translated in (to) Euros on the last day of the tax year at the average exchange rate issued by the ECB/Central Bank of the State whose currency is being translated."

Given that most, if not all, European banks will be running foreign currency operations/books, including operations/books in functional currencies other than the Euro (rather than simply foreign exchange, spot, forward and hedging transactions either on behalf of customers or "own book" or both), the simple approach advocated in paragraph 48 which may well be appropriate for a regular corporate world, in our view, need considerable development for application to the European banking sector.

It may be that translating currency income/expense quarterly or semi-annually would be an appropriate variation for banks' currency businesses.

It is recommended that this be the subject of a further study of Member States' banks' practice in this area.

Paragraph 49 provides "gains and losses incurred on conversion of foreign currency to Euros would be included in the tax base in the year when they are incurred"

Insofar as "incurred" is a reference to a realisation basis, a fair value or **market to market** approach would appear to require to be substituted for banks.

Again, it is recommended that this be the subject of a further study of Member States' practice as regards banks in this area.

## **Paragraph 50: Matching of gains and losses on transactions including hedging**

Paragraph 50 acknowledges that detailed rules will be required and a description of these will be prepared for a future meeting.

Generally, it is accepted that insofar as hedging is part of a trading book, the accounts fair value treatment should be followed.

Both our German and Spanish firms recommend that, given the high relevance of hedging transactions in the banking industry, for non-trading book hedges a tax neutral treatment is adopted under which cumulative unrealised gains and losses attributable to hedging instruments and hedged items are not recognised until realisation or, alternatively, are accepted as fully matched for tax purposes, where this is the case commercially.

It is suggested that this be the subject of a separate study of Member States' banking practices as regards hedge accounting and taxation.

## **Paragraph 51: Stock Valuation**

As regards securities and similar financial products held by a bank or credit institution as part of their trading book, these would, prima facie, be accounted for at fair value, rather than at the lower of cost and net realisable value, as noted above under paragraph 29. It is suggested that this would require a specific separate provision for banks and similar financial institutions.

### **Paragraph 60: Financial Leases**

Paragraph 60 provides that “depreciation of business assets will be deducted by the economic owner.”

Footnote 26 then states “more detailed rules might be necessary for the application of these principles to certain categories of transactions, e.g. financial leases”.

Insofar as finance leases are a significant part of the business of credit entities and, moreover, at least in Germany, German leasing companies are not necessarily regulated by BAFIN, it appears that further consideration of Member States’ regimes for taxation of finance leases is required to seek to determine a consensus solution. For example, whilst the accounts would ordinarily reflect the economic owner, this will not necessarily always be the case.

### **Paragraph 120: 3rd Country PEs**

We would note that the need to carve out/exempt 3<sup>rd</sup> country PEs from the CCCTB base will be particularly prevalent regarding banks, with single country passporting. This means that it will be particularly important (outside of the CCCTB group) to have clear and uniformly applied criteria for the sourcing of income, to avoid the single entity being subject to tax on more than its actual profits.

### **Paragraph 123 – 125: Portfolio Shareholdings**

Given the importance of equity trading in the banking industry, dividends and gains from shares may form a significant part of the corporate tax base. To the extent that it is envisaged to relieve double taxation on major shareholdings, defined in paragraph 125 as those where the relevant taxpayer has an interest of 10% or more in capital or voting rights and the shareholding has been held for an uninterrupted period of at least 12 months, consideration could be given to the possibility of extending this exemption to portfolio (less than 10%) shareholding dividend income and gains for banks and similar financial institutions.

Alternatively, the equivalent relief of economic double taxation could be achieved via a full credit for any withholding tax.

However, insofar as fair value accounting is followed, it is accepted that this would be difficult to achieve via exemption.

### **Paragraph 130: Interest relief**

The footnote to paragraph 130 refers to “thin capitalisation” provisions. Clearly, it would not be appropriate for the CCCTB base for banks or similar financial institutions to be subject to a “thin capitalisation” regime modelled on the arm’s length rule applicable to regular (non-banking) businesses. Banks’ capitalisation (tier 1/2 equity) is largely driven by the relevant ratios required by the local (or other single passporting) regulator. Broker dealers are evaluated on the basis of the relationship between equity and subordinated debt.

Accordingly, traditional “thin capitalisation” approaches should not apply. Rather we would expect the relevant financial businesses to apply appropriate capitalisation models to the particular line or lines of financial business carried on by them.

### **Other issues: “Synthetics”**

Another major issue requiring addressing but which is not obviously referable to any particular paragraph in WP 57 is the issue of the wide use of “synthetics” in financial businesses. This would include stock lending, repurchase agreements (repos), etc. A key concern here is ensuring that withholding tax credits flow through to the recipient of the “manufactured” dividend paid e.g. by the legal owner to the stock-lender. This is a major area of activity which we recommend be the subject of a separate study.



## 2.2 Insurance Sector

It is recommended that the perimeter for accessing any necessarily tailored insurance version of the “regular” CCCTB tax base be based on the regulatory framework. This reflects our understanding that substantially all (apart from captives: see below) of general business and all life insurance business is written through regulated vehicles. Moreover, we would draw a distinction between underwriting and reinsurance of insurance risk, whether life or general, which we consider should be eligible for the specially insurance tailored CCCTB base, and broking, which as an essentially commission based business we believe may not require a specially tailored version of the “regular” CCCTB base.

There are therefore 4 key issues in respect of this perimeter.

First, there is the question of how to deal with the possible dividing line between underwriting of insurance risk and broking, given that many insurance groups are composites, undertaking both activities but through different companies/divisions. It is suggested, insofar as broking is always a fee based business, even where unit linked policies might be involved, that the specialised insurance CCCTB base be reserved for underwriting activity, and not extended to broking. From a regulatory perspective, these should be carried out in separate legal entities.

Secondly, there is the issue of life business mutuals, owned by the policyholders, and the related issue of listed shareholder owned groups who, because of acquisitions or conversion from mutual status, nonetheless have policyholders’ funds as well as shareholder funds. The issue here is that policyholders’ funds would normally not be subject to corporation tax, but rather to income tax or a variant thereof.<sup>1</sup> A possible solution might be for mutuals (not subject to corporation tax) to be excluded from CCCTB and for the mutual business of a shareholder group to also be excluded from CCCTB. The mechanism for dealing with the exclusion of policyholders’ funds must however ensure that there is no double or partial double deduction (or exemption).

Thirdly, there is the question of how to deal with in-house captives. There would appear to be two alternatives. The view could be taken that insofar as these deal only with own risk, being a form of self-insurance, they are not carrying on 3<sup>rd</sup> party insurance business and so should not be accorded the opportunity of accessing any specially tailored insurance CCCTB base. However, many captives carry out 3<sup>rd</sup> party business, and so should prima facie be allowed access to the specialised insurance CCCTB base.

Alternatively, insofar as captives only insure own risk, albeit being adequately capitalised and following traditional insurance principles of provisioning, should they nonetheless be allowed access to any specially tailored CCCTB base? The resolution of this issue should presumably have regard to the desire for avoiding any unnecessary proliferation of special CCCTB bases and limiting any such necessary variations of the “regular” CCCTB base to those who would otherwise be seriously prejudiced. Certainly, extension of any specially tailored insurance base to all captives (and not just those carrying out significant 3<sup>rd</sup> party business) would mean that quite a large proportion of groups who would otherwise only be subject to the “regular” CCCTB base would have 1 or more (captive) companies eligible for the specially tailored insurance company CCCTB base.

On the other hand, denial of access to any such specially tailored base for insurance companies would prima facie put captives carrying out 3<sup>rd</sup> party business at a competitive disadvantage to 3<sup>rd</sup> party insurers.

It is therefore suggested that the perimeter be defined with respect to the regulatory framework in the first instance, but that a further study be undertaken of the extent of use of captives by businesses operating in the EU and of the level of 3<sup>rd</sup> party business written by those captives, to establish the magnitude of the issue.

The last issue is the legal form through which insurance business is undertaken. We understand that in some countries, the legal form may well not necessarily be that of a public or private company listed in the Annexes to the various tax Directives. For example, in Germany the VVaG

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<sup>1</sup> In the UK there are additional complexities that may need to be considered regarding the impact of not including policyholder tax in the corporation tax base.

(mutual). Accordingly, access to any specially tailored CCCTB base may be denied, given the proposal in paragraph 10 of WP 57 for entities eligible for CCCTB to be Annex listed, along the lines of the Parent/Subsidiary and Tax Merger Directives. This may simply be viewed as an ineluctable consequence of the choice of legal form. We do however believe it requires consideration, and so would again recommend a study of the extent to which 3<sup>rd</sup> party insurance business is undertaken via non-corporate vehicles, and the extent to which any such vehicles are liable to corporation tax e.g. mutuals or able to elect into corporate tax e.g. a Dutch CV. A possible solution here might be to refer to the Annex to the Insurance Directive

## 2.2.1 Possible Elements of the CCCTB Base where Special Rules for Insurance Companies may be required

### **Paragraph 21: Annual tax base calculations**

Because of the long-term nature of certain insurance business, underwriting periods may (e.g. Lloyds in the UK) be for more than a year e.g. 3 years, starting with the year in which the business is written. Accordingly, claims in years 2/3 regarding business written in year 1 could be related back i.e. accounted for in the first year in which the business was originated. This would mean that it would not be possible for such underwriting syndicates, insofar as subject to corporation tax, to file CCCTB computations within 9 months of the period end, as the base period would be held open for claims until the second anniversary of the end of that base period.

Accordingly, in accepting that any specially tailored CCCTB base for insurance activity should be with respect to annual periods, consideration should be given either to extending the CCCTB filing period, or to ensuring that the commercial ability to relate claims back into the base period is adequately replicated via appropriate IBNR (claims incurred but not reported) or similar provisions.

### **Paragraph 31: Recognition of income on an accruals basis**

We would recommend further elaboration of the “realisation principle” for purposes of income recognition in the specific context of insurance premiums, as advocated by the CEA.

### **Paragraphs 31- 34: Basis for deductibility of expenses**

WP57 states that “... the expense should be established and the amount be known in order to be accrued. However when an amount arising from a legal obligation or a likely legal obligation relating to activities or transactions carried out in the current or previous tax years ... can be reliably estimated, the expense would be deductible in the current tax year (provided that the eventual settlement of the amount would result in a deductible expense)”. WP57 further clarifies that this approach was partially based on IAS 37, but excludes constructive obligations, i.e. non-legal obligations arising from a pattern of behaviour.

As noted by the CEA, the insurance technical provisions are mandatory not only if legally but also if economically incurred.

Several insurance reserves may be necessary – dependent on the business written by the insurer. Reference is made to Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings that determine the constitution of insurance reserves, as well as to the national accounting regulatory rules that comply with that directive.

As set out in the CEA 7/12/07 paper “CEA position on the CCCTB: possible elements of a technical outline”, provisions for outstanding claims, equalisation provisions, catastrophe provisions, provisions for bonuses and rebates and actuarial reserves are standard industry practice, but may not necessarily satisfy the basic legal or likely legal liability test of paragraph 32. See, for example the incurred but not reported (IBNR) category of provisions for outstanding claims, based normally on statistical experience of prior claims in that category across the sector but tailored with respect to the particular insurer.

The standard for relief of insurers’ provisioning for claims, equalisation and catastrophe provisions, bonuses/premium rebates and actuarial reserves should therefore be the relevant required

provisioning from a regulatory and industry perspective, as reflected in the accounts. It would not however be appropriate in our view simply to look at the regulatory solvency requirements, as these are a minimum standard only. We have with the help of the CEA summarised below the major categories of insurance technical reserves.

#### **Provisions for claims outstanding**

These provisions reflect legal and/or economic third party obligations and are sometimes independent of knowledge on a single case basis (e.g. IBNRs). Their calculation can be done on a single case basis or mathematical/actuarial calculation on a best estimate approach.

#### **Equalisation provisions**

The purpose of these provisions is to equalise fluctuations in loss ratios over time. Premiums levied might on average be sufficient, but experience shows that claims payments in one year can far exceed the premiums earned, e.g. hail and storm. In “good years” a certain amount has to be set aside in order to be able to cover those losses. In this context, the equalisation provisions reflect the specialised need to define when profits have truly been economically realised and accordingly the ability to pay taxes principle.

#### **Catastrophe provisions**

These provisions are necessary in order to comply with business needs. In fact, some risks such as volcanic eruptions, earthquakes, nuclear risks, some pharmaceutical risks and terrorism, would not be insurable if provisioning were not accordingly allowed since there is insufficient experience in the past and so no possibility of calculating premiums properly, nor are these cyclical businesses.

#### **Provisions for bonuses and rebates**

These provisions reflect third party obligations, allowing the compensation of direct claims by one policyholder or claims of the insurance collective. These provisions should be deductible where the amounts are already attributed to a single policyholder or to a specific collective of insureds. Deductibility should be granted even if the amounts which are (already) attributed to policyholders – but not yet distributed – can – in a worst case scenario – (partially) be accessed in order to help redress an insurance company’s operating loss position.

#### **Actuarial reserves**

These provisions comprise the actuarially estimated value of an insurance undertaking’s liabilities including bonuses already declared and after deducting the actuarial value of future premiums.

#### **Paragraph 34: Valuation of reserves**

Insofar as valuation of reserves is concerned, past experience does not appear to be an adequate basis. In the insurance industry where long-term effects play a major role, use of generally accepted mathematical and actuarial methods, which take inflation, trends in demography etc, as well into account, and project future likely outcomes, should be allowed. Moreover, it is worth noting that these methods are applicable in IFRS as well.

#### **Paragraph 39: Long-term contracts**

Long-term insurance business (life, pensions, permanent health insurance) may well constitute a “contract for the performance of (related) services – the term of which exceeds 12 months”. However, for completeness, we note that it is understood that the reference to “related services” is to services related to the “manufacturing, installation or construction” of a physical asset, and so the definition would not encompass long-term insurance contracts.

#### **Paragraphs 40- 42: Deductions for bad debt**

Similar comments apply to those made in respect of the Banking Sector. Bad debt provisioning will generally be done on a business category basis, rather than with respect to individual debts.

Specifically, with regard to mass risks, deductions for bad debts may not be calculated on a single case-by-case basis, but rather on a percentage basis fixed according to past experience, including potential trends. The envisaged “preferable” individual approach should therefore only be applied in cases of material debts outstanding in respect of “one-off” specially tailored or written business (i.e. non-mass business).

#### **Paragraphs 48 and 49: Foreign currency**

The same concerns as for banking entities are in general also applicable to insurance companies.

Paragraph 48 of the WP 57 provides that “Tax base income and expenses would be measured in Euros or translated in(to) Euros on the last day of the tax year at the average exchange rate issued by the ECB / Central Bank of the State whose currency is being translated”. Given the weight of foreign currency transactions in the insurance industry, the rule may need further development for application to the European insurance sector.

It may be that translating currency income / expense quarterly or semi-annually would be an appropriate variation for insurance companies’ currency businesses. We recommend this be the subject of a study of Member States’ insurance companies’ practice in this area.

#### **Paragraph 50: Transactions including hedging**

The same concerns as for banking entities are in general also applicable to insurance companies. Hedge accounting is a very difficult and important topic, although not to the same extent in the insurance sector as it is in the banking sector.

Again, a distinction might be drawn between hedges of insurance and currency / interest rate risk as part of the core insurance business, as compared with “structural” hedges e.g. of long term investments by insurance companies. However, given that, with the exception in particular of unit-linked business, assets held for regulatory, technical reserve, or general business reasons, or simply in excess of all 3 requirements, are not ordinarily segregated, this may be harder to define than from a banking industry perspective.

#### **Paragraph 120: Foreign income and participation exemption**

Similar comments apply to those made with respect to the banking sector. Consideration should be given either to extending the participation exemption or ensuring full credit for withholding tax for portfolio foreign shareholdings held as part of the investment portfolio of insurers and backing their insurance business.

#### **Paragraph 130: Interest relief**

Again, as for banks, we consider that it would be inappropriate to apply “regular” thin capitalisation regimes to regulated insurance companies. Rather, we would expect the relevant insurance businesses to apply appropriate capitalisation models to their particular line or lines of business, having regard to the relevant regulatory framework, regarding solvency and reserve provisioning.

## **2.3 Fund Management Sector**

### **Collective Investment Vehicles**

CIVs are eligible for more favourable tax regimes in order to avoid discrimination between direct and indirect investments: the “neutrality principle”. These favourable tax regimes are always

conditional and only apply if certain criteria are met, such as risk diversification, shareholder requirements and, most importantly, investment activities must be characterised as more or less passive investment activities. Should a CIV be engaged in trading or business activities, then it will normally be taxed as any other company.

In essence, the CCCTB would lead to a common consolidated definition of taxation on investment profits. However, the resulting taxable basis will effectively not be taxed as a result of the common principle that CIVs should not be taxed but instead taxation arises in the hands of its investors. A need for harmonisation of the taxation of CIVs therefore does not appear to arise

As the CCCTB does not deal with the specific problems that CIVs face, there does not appear to be a need for a specifically tailored tax base for CIVs.

## **Pension Funds**

In most Member States PFs are eligible for conditional favourable tax regimes comprising two main conditions:

- Distributions are taxed in the hands of the ultimate beneficiary, usually the (former) employee. As a result, there is normal taxation, albeit that taxation takes place at the end of the chain. If tax would also be due by the PF, then there would be a double economic taxation. This is avoided by exempting the PF and its investments on the one hand and taxing the pension payments in the hands of the (former) employee on the other hand;
- PFs should – as with Investment Funds – limit their activities primarily to investment and other activities supporting the social security function performed by the PF. As soon as they engage in other (competitive) activities the favourable treatment is lost and corporate taxation applies as for regular companies.

Given these considerations, the applicability of the CCCTB does not seem to deal with the problems that PFs face. The use of the CCCTB would lead to a common consolidated definition of taxation of profits of a PF. However, in most Member States the resulting taxable basis will effectively not be taxed as a result of the idea that taxation should not take place at the PF level, but – at the moment pension payments arise in the hands of the (former) employees – at the level of the (former) employees. Except for the few Member States applying the ETT-system, a need for harmonisation of the CIT base for PFs does not appear to arise.

Nonetheless, because of the conditionality of the tax exemptions for PFs, situations may arise in which the PF falls within the scope of the general CIT regime. However, it appears unnecessary to add specific rules to define a CCCTB for such exceptional cases.

## **Venture Capital Institutions**

Most Private Equity Funds in Europe are organised as partnerships. Depending on the regulatory framework in the country of residence, the partnership is taxed accordingly. In most Member States there are no special regulations for Private Equity Funds.

Private Equity Funds or Venture Capital Institutions are normally structured as a master fund with one or more feeders. The investments of the master fund are shareholdings and/or debt investments in listed or non-listed operating companies. In order to structure their investments tax efficiently, the master fund may also set up special purpose vehicles (e.g. holding companies). The financing of the investments are often (highly) geared with debt. Insofar as it pertains to holding and target companies of Private Equity Funds, the tax issues are to a certain extent also common for ordinary companies engaged in trading and/or business activities. These problems consist of tax consolidation issues, absence of cross-border loss compensation, issues regarding the deductibility of interest, etc

In essence, Private Equity Funds face the same problems as CIVs face where they take the form of a Fund vehicle, which they generally do. As Private Equity Funds are not normally subject to corporate tax, designing a specially tailored CCCTB tax base for Private Equity Funds does not appear appropriate.

### 3 COUNTRY REPORT: BANKING SECTOR - SPAIN

#### 3.1 Overview of the Spanish tax system for determining the Corporate Tax base in the banking industry

- The Spanish system for determining the Corporate Tax base starts from individual statutory accounts prepared in accordance with the appropriate national accounting principles. The Corporate Tax Law provides the adjustments to be made to the profit or loss so determined for establishing the Corporate Tax base. In the absence of a specific provision included in the Corporate Tax Law and related tax legislation, the accounting treatment for a transaction or an item is valid for Corporate Tax purposes.
- Spanish Credit entities have always adopted specific accounting principles dictated by the Bank of Spain. In 2005 a new set of accounting principles was adopted through Circular 4/2004 of the Bank of Spain. Circular 4/2004 is adapted to IFRS, is applicable to both individual and consolidated statutory accounts and consists of an exhaustive set of IFRS principles specifically adapted to the activity of credit institutions.
- For the purposes of applying Circular 4/2004, Credit Institutions include in Spain: Banks, Savings Banks and the Spanish Federation of Savings Banks, Credit Cooperatives, the Official Credit Institute, Financial Establishments of Credit, and Electronic Money Companies. Circular 2/2004 is applicable as well to the branches of foreign Credit Institutions that operate in Spain. However branches in Spain of Credit Institutions headquartered in a Member State of the European Economic Area may use all or any of the measurement bases used by their headquarters in place of those established by Circular 4/2004 and do not have to file separate public accounts.
- Where a Credit Institution is the parent of a group, consolidated accounts are prepared by applying the principles of Circular 4/2004 and converting to these principles the individual accounts of all the group members, irrespective of their business activities. The individual accounts of the consolidated companies may have been prepared by following different accounting principles. In this respect, Spain does have a General Accounting Plan which is applicable to companies for which no specific Industry Accounting Plan is applicable and Industry Accounting Plans or adaptations. Therefore the individual companies of a financial services group led by a Credit Institution would normally be prepared under a minimum of three different accounting principles (Circular 4/2004, General Accounting Plan and Insurance Industry Accounting Plan) although it is usual as well that banking groups own building and real estate companies to whom specific Industry Accounting Plans are as well applicable. It should be observed however that a new General Accounting Plan has been approved in year 2007, entering into force on January 1<sup>st</sup> 2008, which is mainly based on IFRS. Similarly, a draft Insurance Industry Accounting Plan is being discussed currently which as well is inspired by IFRS. It is expected that all Industry Accounting Plans will converge shortly with the new General Accounting Plan and therefore with IFRS. Please note that the referred new plans do not fully match with IFRS.
- Corporate Tax consolidation is available by way of election for Spanish companies included in a tax group. For these purposes, the tax consolidation perimeter is smaller than the accounting one (since for tax purposes a minimum participation of 75% in the share capital is required), it does not include foreign dominated entities and excludes, among others, companies taxed at a rate different to the parent's one. A branch in Spain of a foreign entity can be the parent of a Spanish tax group. For tax purposes the parent company of the tax group has to prepare consolidated financial statements for the specific tax consolidation perimeter.
- Finally it should be observed that the autonomous regions of the Basque Country and Navarra have competencies in the scope of Corporate Tax, which do not fully match with the Corporate Tax rules applicable in the rest of the State. No reference is made in this

study to these specific rules, although they affect a number of credit institutions based in these regions under specific rules and circumstances.

### 3.2 Specific corporate tax rules applicable to credit entities in Spain

- Spain does not tax credit entities under a separate system but provides specific tax treatments for certain aspects. The following paragraphs make reference to the aspects of the Corporate Tax legislation where a special rule has been expressly provided for credit entities.
- Financial entities in general are expressly excluded from the scope of application of the local thin capitalisation rules. This exclusion is additional to the general one applicable where the lender is resident in a Member State.
- Credit entities do not follow the general Corporate Tax rules for bad debt but specific provisions which are tailored to the specialities of bad debt losses of these entities. Further reference is made to these specific provisions in section 3 below.
- Savings Banks are allowed to deduct from the Corporate Tax base the contributions they make under their special regulations for financing their charity and social works statutory activity, subject to certain limits and conditions. Charity and social work maintenance costs, and positive and negative income derived from the transfer of investments allocated to this activity are not included in the taxable base.
- Credit Cooperatives apply a special tax regime and, among others, they are allowed to deduct from the Corporate Tax base the contributions they make under their special regulations to special funds of education and promotion, with certain limits and conditions. As well, credit cooperatives split their Corporate Tax base into two (cooperative and non cooperative tax base), applying a reduced tax rate of 25% to the first instead of the general 30% rate.
- The Bank of Spain is declared exempt from Corporate Tax.

### 3.3 Elements of the CCCTB legislation where special rules may be required

- This section comments on the elements of the CCCTB where special rules may be required from the Spanish perspective in the view not only of the specific tax rules applicable to Credit Institutions described in section 2 above, but as well in the view of the specialities of their business activity and on how these specialities are treated under the Spanish Corporate tax rules of general application.
- Comments are made by following the reading of the EU Working Document dated November 27<sup>th</sup> 2007 and making references to the specific paragraphs as numbered in this document.

#### **Paragraph 29: Depreciation of financial assets**

- Although no specific tax rules are provided for credit institutions, Spanish tax legislation allows the deduction of temporary decreases in value (impairment) of equities and fixed income securities, within certain limits, as opposed to the rule proposed in paragraph 29 which seems to limit the deduction of the depreciation of financial assets to the cases the taxpayer demonstrates that such assets have permanently decreased in value. Given the relevance of financial assets in the banking industry, this limitation may have a significant impact from the Spanish perspective.
- Under Spanish tax law, the limits and conditions for the deduction of the depreciation of financial assets represented by securities are, broadly (i) recognition of the impairment in the profit and loss account; (ii) a quantitative limit of the negative variation in net book value for equities not admitted to listing in a regulated market or issued by group, multi-group or associated companies; (iii) a quantitative limit of the net (positive and negative) variation of the value of the portfolio in the case of fixed income securities admitted to listing in regulated

markets, (iv) no deduction for impairment of fixed income securities which are not admitted to listing in a regulated markets; (v) no deduction for impairment of equities issued by residents in tax haven jurisdictions unless they are consolidated for accounting purposes with the taxpayer; and (vi) no deduction for impairment of fixed income securities issued by residents in tax haven jurisdictions.

- Since the concept of financial assets includes loans, consideration may be given to the possibility of excluding them from this category for tax purposes, incorporating the tax treatment of the impairment of a loan portfolio to the provisions concerning to bad debt (see below). This is the approach taken in Spain.
- Express reference might be made to the tax treatment of derivative instruments, for which no express tax reference is made in the Spanish tax legislation. The absence of tax reference implies in Spain the deduction / taxation of the losses or profits on derivative instruments to the extent they are registered in the profit and loss account.

### **Paragraph 31: Recognition of income and expenses on an accruals basis**

- Given the relevance in the Spanish banking industry of fair value accounting, an express distinction between this concept and the accruals basis may be needed for tax purposes.
- Under the Spanish tax system, revenues are taxable only to the extent that they have to be registered in the profit and loss account according to the accounting principles applicable. Hence, financial instruments measured at fair value are recognised as taxable revenues only to the extent the variation of fair value is recognised in the profit and loss account, but not to the extent they are recognised in equity accounts. The taxation occurs when the changes in the fair value are transferred from equity accounts to the profit and loss account at the time they are effectively realised (as for instance financial instruments available for sale), or when they are registered immediately into the profit and loss account, even before realisation (as for instance financial instruments held for trading).
- The same treatment as above is granted to losses derived from the negative variation of the fair value of financial instruments: they are not tax deductible while they are recognised in equity accounts but only when they are recognised in the profit and loss account, directly or as a transfer from equity accounts, and in this case subject to the specific tax limitations for the deduction applicable to unrealised losses of financial instruments (see comments to paragraph 29 above).
- It should be observed that under the special accounting rules for credit entities, “equity” has two main components: “own funds” (represented by the traditional components such as share capital, reserves, retained earnings ...) and “valuation adjustments”. Accounts corresponding to the last component of equity are the ones used for registering the aforementioned variations in fair value recognised in equity.

### **Paragraphs 40 to 42: Deductions for bad debt**

- The paragraphs do not contemplate the special rules that may be required for financial institutions as regards the deduction of bad debt losses (note 22).
- The first issue to consider as regards bad debt treatment is that the first condition established in paragraph 40 for the allowance of a deduction of bad debt (i.e., that the amount corresponding to the receivable was previously included in the tax base) is not met in most of the cases in the banking industry, where bad debt losses arise as a consequence of the default in the repayment of financial assets (significantly loans granted to customers, but as well debt securities carried at amortised cost for accounting purposes) the initial recognition of which does not imply an accounting or taxable revenue. The first condition of paragraph 40 is only met for the interest element of the receivable and never for the principal amounts lent or invested in. If this condition was applicable to the credit institutions it would lead to the disallowance of an extremely significant part of the expenses recorded in their profit and loss account. Therefore the need for special rules for credit institutions seems very clear.



- The second condition established in paragraph 40 for the allowance of bad debt (i.e. reasonability of the steps in pursuing the payment) should be probably eliminated in the context of the banking industry, since a presumption of compliance with it should always apply in an industry the traditional business of which consists in the assumption and management of credit risk.
- As well, the approach adopted in paragraphs 40 to 41 expressly requires the consideration of individual debts, while in the banking industry individual debts are mostly long term and are repaid in instalments, which means that a single loan transaction can be disaggregated in as many debts as payments of interest and repayments of principal are foreseen in the loan contract. It should be observed as well that the bad debt provisions in the banking industry are determined through complex models that may consider not only individual debtors but as well groups of debtors, and that take into account multiple factors such as default experiences, their changes over business cycles, losses incurred in homogeneous credit risk category, counterparty quality, guarantees provided and their recoverable amount, among others.
- The above considerations lead us to suggest establishing a completely separate set of rules for bad debt allowances for the banking industry. This suggested approach has been adopted in Spain, where through the application of complex tax rules, there has been established a principle of primary admission for tax purposes of the minimum bad debt provisions resulting from the application of the accounting rules on the subject, combined with a set of limitations to the deductibility applicable to different categories of debts such as for instance (in specific circumstances) those (i) owed by public law bodies, certain political and professional bodies and organisations, or related parties; (ii) guaranteed by special preferential rights or goods; (iii) generic provisions based on estimations, in the part corresponding to certain low-risk debts and to an excess over specific percentages.
- In an EU context, the coexistence of different national GAAP for individual company accounts may make it very difficult to adopt the Spanish approach outlined in the above paragraph, since there would not be a common starting point for making tax adjustments.
- A first alternative approach may be admitting IFRS consolidated accounts for determining the tax deductible bad debt provisions. However this approach may have two obstacles: (i) unlike in Spain, not all EU financial services groups have the obligation to file IFRS consolidated accounts and therefore many groups should have to make a conversion to IFRS for tax purposes, which is a very complex exercise in the specific area of the impairment of financial assets; (ii) IAS 39, governing the rules for measurement of the impairment of financial instruments, does not provide an objective rule for such measurement in the cases of loans, carried at amortized cost. The measure of the impairment requires an entity to make judgements on the existence of objective evidence of impairment for individual or grouped assets and on the estimated recoverable cash flows, that have to be valued subsequently by discounting them at effective interest rates; judgements and estimation models may differ from one banking entity to the other, resulting in different measures of the impairment for identical or very similar financial assets. Notwithstanding the former, the alternative of relying on IFRS-like accounts cannot be discarded in the view of the complexity of this area in the case of the banking industry.
- A second alternative approach may be establishing fixed rates for the deduction for bad debts. While this alternative appears to be initially rejected in WP 57 (paragraph 41), it may be another realistic solution in view, again, of the complexity of this area in the banking industry. A combination of rates applicable to different financial assets by considering not only their specific risk profiles but as well the economic cycles seems a realistic alternative.

## **Paragraphs 48 and 49: Foreign currency**

- Paragraph 48 of WP 57 establishes that *“Tax base, income and expenses would be measured in EUR or translated in EUR on the last day of the tax year at the average exchange rate issued by ECB / central bank of the State whose currency is being translated.”* Given the weight of foreign currency transaction in the banking industry, where foreign currency can be a banking business in itself, the former rule may need further development.

- Hence, Spanish credit entities follow the former rule in the case of monetary assets and liabilities, but not for income and expenses nor for non monetary assets. Spanish credit entities apply the following rules for both accounting and tax purposes:
  - a) Monetary assets and liabilities. They shall be translated at the closing rate, defined as the average spot exchange rate at the reporting date.
  - b) Non-monetary items measured at historical cost. They shall be translated at the exchange rate at the date of acquisition.
  - c) Non-monetary items measured at fair value. They shall be translated at the exchange rate on the date when the fair value was determined.
  - d) Income and expenses shall be translated at the exchange rate at the transaction date. An average exchange rate may be used for all the transactions carried out in a particular period, unless there have been significant exchange rate fluctuations. Depreciation and amortisation shall be translated at the exchange rate applied to the related asset.
- Paragraph 49 establishes that gains and losses incurred on conversion of foreign currency to EUR would be included in the tax base in the tax year when they are incurred. To the extent that incurring the gain or loss meant realizing it, this would be against the general principle established in the Spanish accounting rules for banking institutions (described above), which are applicable for tax purposes. Given the importance of foreign currency gains and losses in the banking business, it would be more accurate allowing the deduction / taxation on an accruals basis, i.e. as they are shown in the accounts under the principles summaries in the preceding paragraph.

**Paragraph 50: Transactions including hedging**

- WP 57 recognises that detailed rules would be required for the matching of gains and losses in transactions including hedging.
- Hedge accounting is a complex area in the banking industry. Because no specific tax rules exist in Spain on the subject, the accounting principles lead on occasions to mismatches in the taxation / deduction of the two components of the transaction (hedging instrument and hedged item). This is the case where, under fair value hedges, a cumulative unrealised profit is recognised for the hedging instrument in the profit and loss account (which is taxable) and a correlative cumulative unrealised loss is recognised for the hedged item, which may not be tax deductible as per the application of a specific limitation established by the tax rule (see comments to paragraph 29 above). On the contrary, in the case of cash flow hedges, cumulative profits or losses are not recorded in the profit and loss account but in equity accounts until they are realized, the tax consequence being the neutrality of the accounting treatment.
- Given the relevance of transactions including hedging for the banking industry, it may be suggested, from a Spanish perspective, to establish a tax neutral treatment under which cumulative unrealised gains or losses attributable to hedge instruments and to hedged items are not recognised until realisation or, alternatively, are fully matched, for tax purposes, irrespective of the tax rules that would have been applicable for the treatment of the hedged item in the absence of a hedge.

**Paragraph 51: Stock valuation**

- Principles of stock valuation are pending to lay down. In this respect, although the Spanish tax law does not provide for specific rules on the subject for financial institutions, it should be observed that to the extent that equities trading is a traditional business of the banking industry, a symmetric treatment may be desirable for gains and losses of trading or available for sale stock portfolios, either realized or unrealized.

## Paragraphs 56 to 77: Depreciation

### Financial leases

- Paragraph 60 establishes that the depreciation for business assets would be deducted by the economic owner, i.e. the person who has substantially all the benefits and risks attaching to an asset, regardless of whether that person is the legal owner. A tax payer who has the right to possess, use and dispose of an asset and bears the risk of its loss of destruction would in any event be considered the economic owner.
- Footnote 26 to such paragraph states that more detailed rules might be necessary for the application of these principles to certain categories of transactions, e.g. financial leases. As financial leases are a significant part of the business of credit entities, this statement is particularly true.
- Under Spanish tax rules, transactions qualified as financial leases under local GAAP applicable to credit entities (which are based on IAS 17, *leases*), are qualified as well as leases. This may be an appropriate way to define the concept of economic ownership. However, in addition, the tax law provides a rule under which, irrespective of the accounting qualification of the lease, it will always be treated as a financial lease; this is the case where there is a purchase option and its price of exercise is below the net book value of the leased asset on the exercise date, calculating the net book value by applying the maximum allowable depreciation rate during the term of the lease. This tax rule does not strictly follow IAS 17.

### Assets depreciated on an individual basis

- Under Spanish tax law, buildings used for administrative or commercial purposes can be depreciated at a 4% rate if the building acquired is more than ten years old, against the rate proposed in paragraph 66 (2.5% depreciation rate). Because of the significant number of banking offices owned by Spanish retail banks, this difference can be significant in terms of cash flows.
- Under Spanish tax law software can be depreciated at a 33% rate on a straight line basis (possibly at a 10% rate under legislation applicable as from 2008, subject to interpretative guidelines to be provided by the tax authorities). The respective depreciation periods are normally shorter than those proposed in paragraph 68, for which the intangible assets enjoy legal protection or of 15 years. Because of the importance of information technology investments in the banking industry, the proposed depreciation rates may significantly impact the banking industry in terms of cash flows.
- Under Spanish tax law, cash dispensers can be depreciated at a 25% rate on a straight line basis. Under the depreciation rules proposed in paragraph 72, cash dispensers would be depreciated on a pooled basis by using the reducing balance method at a 20% rate per annum, which would extend considerably the full depreciation period.

## Paragraphs 123 to 125: Portfolio shareholdings

- Given the importance of equity trading in the banking industry, dividends and gains from stocks may form a relevant part of the corporate tax base. To the extent that it is envisaged to relieve from economic double taxation major shareholdings, defined in paragraph 125 as those where the recipient taxpayer has an interest of at least 10% of either capital or voting rights and the shareholding is held for an uninterrupted period of at least 12 months, consideration may be given to the possibility to extend the exemption to portfolio dividend income and gains. Currently Spain grants a credit of 50% for Spanish sourced dividends (100% credit for interest of at least 5% held during more than one year) and an exemption or a credit for the underlying tax for non Spanish sourced dividends for holdings of at least 5% held during more than one year. All these credits and exemptions are subject to strict anti-avoidance rules.

## 4 COUNTRY REPORT: BANKING SECTOR - GERMANY

### 4.1 Overview of the German tax system for determining the Corporate Tax base in the banking industry

- The German system for determining the Corporate Tax base starts from individual statutory accounts prepared in accordance with the appropriate national accounting principles (Commercial Code). The Corporate Tax Law provides the adjustments to be made to the profit or loss so determined for establishing the Corporate Tax base. In the absence of a specific provision included in the Corporate Tax Law and related tax legislation, the accounting treatment for a transaction or an item is valid for Corporate Tax purposes. German tax law stipulates balancing and evaluation rules that differ from the regulations of the Commercial Code. The principal diverging regulations concern the tax acceptance of accruals (e.g., for contingent losses) and the evaluation of assets (including the tax acceptance of certain depreciation) or the evaluation of liabilities and accruals (e.g., discounting of long-term liabilities or accruals, accruals for pensions, etc.).

Moreover, the Commercial Code consists of special evaluation regulations for credit institutions. Two of these regulations in particular must not be transferred into tax law so that the taxable income is to be increased:

One specific regulation allows risk provisioning in the form of a lower evaluation of certain assets if necessary as a security against the specific risks of banking business.

Another provision provides the opportunity for credit institutions to build a position on the liability side as security against the general risks of the banking business, called "fund for general banking risks".

- German Credit entities have always adopted specific accounting principles. Accounting requirements for banks are set out in the legal text of the Commercial Code, the Accounting Ordinance for Banks and the banking committee pronouncements of the German Institute of Certified Public Accountants (IDW). Special additional requirements apply to banks with listed securities (equity or debt securities).
- If the bank is incorporated as a legal entity it has to prepare an annual financial statement, regardless of its capital structure or size. Branches have to prepare a statement of assets and liabilities.
- A bank that is the parent of subsidiaries has to prepare consolidated financial statements. Special exemptions exist for parents that are themselves subsidiaries of ultimate parents domiciled in the European Economic Area (EEA).
- Corporate Tax consolidation is available by way of election for German companies included in a tax group. For these purposes, the tax consolidation is dependant on a profit and loss absorption agreement (profit pooling agreement) under German Corporate Law, which has to fulfil some additional requirements for tax purposes (e.g. minimum duration). It does not include foreign dominated entities. A branch in Germany of a foreign entity can not be the parent of a German tax group. For tax purposes the parent company of the tax group has to prepare consolidated financial statements for the specific tax consolidation perimeter.

### 4.2 Specific corporate tax rules applicable to credit entities in Germany

- Germany does not tax credit entities under a separate system but provides specific tax treatments for certain aspects. The following paragraphs make reference to the aspects of the Corporate Tax legislation where a special rule has been expressly provided for credit entities.
- Corporate Tax Exemption: several corporations are tax exempted, for example the German Federal Bank (Deutsche Bundesbank), the Reconstruction Loan Corporation (KfW) and certain other banks with a public mission.

- According to the Corporate Tax Act the tax deductibility of interest from shareholder debt financing is limited (thin capitalization rules). If there is an excessive shareholder debt financing the exceeding part of the interest thereon will be reclassified as a hidden profit distribution. Basically, this regulation applies to all industries.

Exemption: The consequences of the German thin capitalization rules do not apply provided that finance is taken up by credit institutions to fund transactions within the meaning of relevant section of the Banking Act, i.e., banking business. This exemption is not applicable to transactions of the debtor with related parties that are not credit institutions themselves. Moreover, with reference to holding companies special regulations for the calculation of the safe haven (within the allowed debt equity ratio) apply. An exemption is also made when the company is able to prove that it would have been able to obtain the funding under the same circumstances from a third party on the same conditions.

Interest capping rule: Within the scope of the Business Tax Reform 2008 (Unternehmensteuerreform 2008) the thin cap rule will be displaced by the interest capping rule, i.e. that interest only at the amount of 30% of EBITDA is deductible for tax purposes. This regulation applies to all industries. The thin cap rule will continue to exist but with an inferior meaning.

However, concerning shareholder debt financing the above described exemption for banks will still exist, i.e. the interest reclassification under the specific requirements for banks as a hidden profit distribution does not apply.

- Credit entities do not follow the general Corporate Tax rules for bad debt but specific provisions which are tailored to the specialities of bad debt losses of these entities. Further reference is made to these specific provisions in section 3 below.
- Tax Treatment of Income from Participating Interest and Capital Gains

Income from participating interest (e.g. dividends) and capital gains which are received by corporations are tax exempt for German corporate income tax purposes. However, 5% will be classified as non-deductible business expense and, hence, only 95% of this kind of income will be free of tax. Refinancing costs which occur to finance the investment are fully deductible for tax purposes.

On the contrary, depreciation and capital losses are not deductible for tax purposes.

With regard to credit entities the tax exemption concerning income from shares in other corporations can be limited. Provided that the shares are allocated to the credit institution's trading book within the meaning of the relevant section of the Banking Act, neither the tax exemption for dividends and capital gains, nor the provisions regarding non-deductible business expense apply. In this case and also regarding depreciation and capital losses we would recommend discussing the several guidelines given by the German fiscal authorities more generally.

- Realised Losses from Derivatives: On the level of a corporation realised losses from derivatives can only be offset against gains from derivatives except for losses in conjunction with hedging activities.

By contrast, banks are allowed to offset losses from derivatives against every kind of income.

- Building and loan associations are allowed to provide an additional reserve for Corporate Tax purposes subject to certain limits and conditions.
- Trade Tax Issue: In addition to the Corporate Income Tax, in Germany, a trade tax is charged. In calculating the trade tax income several add backs and deductions based on the Corporate Tax base have to be made, e. g. 50% of interest on long term debts.

Within the scope of the Business Tax Reform 2008 (Unternehmensteuerreform 2008) the add back of interest will be reduced to 25% but contrary to the actual regulation all kind of interest are subject to add back for trade tax purposes.

Generally for credit institutions, the add back of remuneration paid for debt is excluded (the banking privilege due to the special business of banks). Only under certain conditions (certain fixed assets exceeding the equity) is part of the interest added back.

### 4.3 Elements of the CCCTB legislation where special rules may be required

#### Paragraph 29: Depreciation of financial assets

- Although no specific tax rules are provided for credit institutions, German tax legislation allows the deduction of temporary decreases in value (impairment) of equities and fixed income securities, within certain limits, as opposed to the rule proposed in paragraph 29 which seems to limit the deduction of the depreciation of financial assets to the cases where the taxpayer demonstrates that such assets have permanently decreased in value.

Given the relevance of financial assets in the banking industry, this limitation may have a significant impact from the German perspective. According to the German Commercial Code, the historical cost represents the upper evaluation limit of assets. This principle is valid for banks, as well.

- Unlike the balance sheet of corporations in industry, the substantial portion of banks' assets consists of receivables and securities. Thus, for purposes of valuation one differentiates between three categories of securities
  - Securities treated as fixed assets;
  - Trading securities;
  - Securities of the liquidity reserve.

The first category will be valued as fixed assets (i.e. extraordinary write-downs may be taken on the securities if a lower value is ascribed to them on the close of the fiscal year). Such write-downs shall be taken on a prospective permanent reduction in value. Securities of the trading portfolio and the liquidity reserve are valued in line with the regulations for current assets. They are valued at the lower of cost and net realisable value. Write-down to net realisable is automatic, even for temporary diminutions in value. Write-ups in later years are permissible, but no more than to original cost. For tax purposes, securities treated as fixed assets are more restrictive, for trading securities and securities of the liquidity reserve the final depreciation might differ (commercial code: relevant valuation day = business year end; tax: relevant valuation day = the day when the balance sheet is drawn up.)

According to the Commercial Code, assets shall be valued at no higher than the cost of acquisition less depreciation. However this general rule does not apply for banks in the case of receivables, which can be included at nominal value, if the difference between the nominal value and the payment value consists of interest or an interest like - payment. Furthermore in accordance with the option to set up a provision for general banking risks, financial institutions may under the Commercial Code form a special item "fund for general banking risks" as security against general bank risks, which is shown with liabilities on the balance sheet. Please note that these positions are not allowed for tax purposes.

- Since the concept of financial assets includes loans, consideration may be given to the possibility to exclude them from this category for tax purposes, incorporating the tax treatment of the impairment of a loan portfolio to the provisions concerning bad debts (see below). This is the approach taken in Germany though special rules apply regarding the exemption from income (dividend / capital gain from equities) received.
- Express reference might be made to the tax treatment of derivative instruments, for which no express tax reference is made in the German tax legislation. The absence of tax reference generally implies the deduction / taxation of the losses or profits on derivative instruments to the extent they are registered in the profit and loss account in Germany.

- Under the commercial code a derivative which is still pending follows the general rule for pending transactions:
  - Unrealized gains are not be shown in the balance sheet
  - Unrealized losses have to be shown. They might either fall under a) provisions for contingencies or b) provision for contingent losses
    - If they are qualified as provision for contingent losses, they are not tax deductible
  - Realized losses from Derivatives

At the level of a corporation, realised losses from derivatives can only be offset against gains from derivatives except for losses in conjunction with hedging activities.

By contrast, banks are allowed to offset losses from derivatives against every kind of income (see 2.)

- Securities lending / repurchase agreements (repos): In German accounting and taxation practice, different outcomes apply, depending on the nature of the contract. E.g. "Non-Genuine Pensions Transactions" might lead to a provision for contingent losses, which is not tax deductible.

#### **Paragraphs 40 to 42: Deductions for bad debt**

- These paragraphs do not contemplate the special rules that may be required for financial institutions as regards the deduction of bad debt losses.
- The first issue to consider as regards bad debt treatment is that the first condition established in paragraph 40 for the allowance of a deduction of bad debt (i.e., that the amount corresponding to the receivable was previously included in the tax base) is not met in most of the cases in the banking industry, where bad debt losses arise as a consequence of the default in the repayment of financial assets (significantly loans granted to customers, but as well debt securities carried at amortised cost for accounting purposes) the initial recognition of which does not imply an accounting or taxable revenue. The first condition of paragraph 40 is only met for the interest element of the receivable and never for the principal amounts lent or invested in. If this condition was applicable to credit institutions it would lead to the disallowance of an extremely significant part of the expenses recorded in their profit and loss account. Therefore the need for special rules for credit institutions seems very clear.
- The second condition established in paragraph 40 for the allowance of bad debt (i.e. reasonability of the steps in pursuing the payment) should probably be eliminated in the context of the banking industry, since a presumption of compliance with it should always apply in an industry the traditional business of which consists in the assumption and management of credit risk.
- In addition, the approach adopted in paragraphs 40 to 41 expressly requires the consideration of individual debts, while in the banking industry individual debts are mostly long term and are repaid in instalments, what means that a single loan transaction can be disaggregated in as many debts as payments of interest and repayments of principal which are foreseen in the loan contract. It should be observed as well that the bad debt provisions in the banking industry are determined through complex models that may consider, not only individual debtors but also groups of debtors, and that take into account multiple factors such as default experiences, their changes over business cycles, losses incurred in homogeneous credit risk category, counterparty quality, guarantees provided and their recoverable amounts, among others.
- The above considerations lead us to suggest establishing a completely separat set of rules for bad debt allowances for the banking industry.

Basically, the evaluation of debts for tax purposes in Germany is based on the Commercial Code, e. g. provision for specific doubtful accounts. In addition, certain general provisions for

doubtful accounts can be set up. It is a rather complex system and one has to distinguish between:

- A general provision for doubtful accounts;
- A provision for specific doubtful accounts (including lump sum provisions on foreign accounts)

For example, the German tax authorities apply standard percentage rates for bad debt provisions which are derived from classifications of rating agencies (e. g. "S&P", "Euromoney). According to the tax authorities, a country claim volume will be defined as follows:

Sum of Claims

Minus: Claims from Commercial Business

Legally Binding Credit Approvals

Claims which are already adjusted

Claims which are valuable and legally enforceable

- In an EU context, the coexistence of different national GAAP for individual company accounts may make it very difficult to adopt the German approach outlined in the above paragraph, since there would not be a common starting point for making tax adjustments.

#### **Paragraphs 48 and 49: Foreign currency**

- Paragraph 48 of the WP 57 establishes that *"Tax base, income and expenses would be measured in EUR or translated in EUR on the last day of the tax year at the average exchange rate issued by ECB / central bank of the State whose currency is being translated."* Given the weight of foreign currency transaction in the banking industry, where foreign currency can be a banking business in itself, the former rule may need further development.

Under the Commercial Code German credit entities have to distinguish between different kinds of hedging methods, which have an impact on open and closed currency positions. There are no specific taxation rules re the conversion of currencies. In this context a complex discussion re valuation units should be addressed (see below).

#### **Paragraph 50: Transactions including hedging**

- WP 57 recognises that detailed rules would be required for the matching of gains and losses in transactions including hedging.
- Hedge accounting is a complex area in the banking industry. From 2007 on it is clarified under German Tax law that the hedging (creating valuation units to match transactions) is now binding, if it is used under the Commercial Code. In practice, the use of different applicable methods (Micro-, Macro- and Portfolio hedges) of creating valuation units differs between the industry and the banking area.
- Given the relevance of transactions including hedging for the banking industry, it may be suggested, from a German perspective, to establish a tax neutral treatment under which cumulative unrealised gains or losses attributable to hedge instruments and to hedged items are not recognised until realisation or, alternatively, are fully matched, for tax purposes, irrespective of the tax rules that would have been applicable for the treatment of the hedged item in the absence of a hedge.

#### **Paragraph 51: Stock valuation**

Principles of stock valuation are pending to lay down. In this respect, it is important to mention that the German tax law provides specific rules on the subject for financial institutions. Provided that the shares are allocated to the credit institution's trading book within the meaning of the relevant section of the Banking Act, neither the tax exemption for dividends and capital gains,



nor the provisions regarding non-deductible business expense apply. In this case also depreciation and capital losses are deductible for tax purposes.

Generally due to the traditional business of the banking industry, a symmetric treatment may be desirable for gains and losses of trading or available for sale stock portfolios, either realized or unrealized.

## **Paragraphs 56 to 77: Depreciation**

### Financial leases

- Paragraph 60 establishes that the depreciation for business assets would be deducted by the economic owner, i.e. the person who has substantially all the benefits and risks attaching to an asset, regardless of whether that person is the legal owner. A tax payer who has the right to possess, use and dispose of an asset and bears the risk of its loss or destruction would in any event be considered the economic owner.
- Footnote 26 states that more detailed rules might be necessary for the application of these principles to certain categories of transactions, e.g. financial leases. As financial leases are a significant part of the business of credit entities, this statement is particularly true.
- The German Commercial Code generally follows the tax rules (due to the absence of own specific criteria) re the economic ownership to qualify transactions as financial leases which are also applicable to credit entities. Therefore from a German perspective the concept of economic ownership may be an appropriate way to define. However, in addition, the tax practice provides a rule where the economic ownership for example shifts towards the lessee, if a purchase option exists and its price of exercise is below the net book value of the leased asset on the exercise date, calculating the net book value by applying the straight-line method of depreciation rate during the term of the lease. This tax rule does not strictly follow IAS 17. We would recommend discussing the guidance given by the German fiscal authorities in a more general focus, because German Leasing companies are not obliged to be regulated under the German regulatory authorities (BAFIN) and therefore a broader discussion should take place.

### Assets depreciated on an individual basis

- Under German tax law the depreciation for moveable property from 2008 onwards is limited under the declining balance depreciation-method and the twofold and maximum 20% of the straight line method. The common tangible assets in the banking industries (e.g. cash dispensers etc.) have a straight line rate of 20%.
- General remark: We would recommend discussing the specific depreciation rules in a more general focus; because it is not limited to the banking industry (Software and Buildings would of course have a significant impact on the banking industry as well).

## **Paragraphs 123 to 125: Portfolio shareholdings**

- Given the importance of equity trading in the banking industry, dividends and gains from shares may form a relevant part of the corporate tax base.

To the extent that it is envisaged to relieve from economic double taxation major shareholdings, defined in paragraph 125 as those where the recipient taxpayer has an interest of at least 10% of either capital or voting rights and the shareholding is held for an uninterrupted period of at least 12 months, consideration may be given to the possibility to extend the exemption to portfolio dividend income and gains. Currently Germany does not distinguish between portfolio or major shareholdings and / or domestic or foreign dividend income and / or holding periods.

Income from participating interests (e.g. dividends) and capital gains which are received by corporations are tax exempt for German corporate income tax purposes. However, 5% will be classified as non-deductible business expense and, hence, only 95% of this kind of income will be free of tax. Refinancing costs to finance the investment are fully deductible for tax purposes.

On the contrary, depreciations and capital losses are not deductible for tax purposes.

On the other hand, no tax credit for foreign withholding taxes on dividend source income is granted in case a tax exempted portfolio dividend is received.

With regard to credit entities, the tax exemption concerning income from shares in other corporations can be limited. Provided that the shares are allocated to the credit institution's trading book within the meaning of the relevant section of the Banking Act, neither the tax exemption for dividends and capital gains, nor the provisions regarding non-deductible business expense apply. In this case also depreciation and capital losses are deductible for tax purposes.

## 5 COUNTRY REPORT: INSURANCE SECTOR - GERMANY

### 5.1 Possible Elements of the CCCTB where Special Rules for Financial Institutions may be required

#### Paragraph 9:

Differences in provisions for own account may cause a difficult transition to the tax base according to CCCTB (for example loss reserve, provision for premium refunds).

Smaller insurance companies are not subject to IAS/IFRS accounting standards until now. Thus, no expert opinion exists. As CCCTB is deemed to correspond to IAS/IFRS, such expert opinion has to be obtained.

The idea that CCCTB has to follow IAS/IFRS is too demanding. This may cause differences in tax calculations.

In Germany, the tax balance sheet has to be prepared based on the principles of the Commercial Code. CCCTB would impair this principle.

The system will become inevitably more complicated as three standards should be considered when preparing the respective tax calculations. These will also deviate depending on the respective insurance techniques applied. It is unlikely that national authorities throughout the EU will interpret particular parts of the CCCTB in the same way.

#### Paragraph 10:

Up to now, a foreign insurance company has only to prepare a local GAAP tax balance sheet. Probably IFRS/IAS will become necessary. A US insurance company that prepares its balance sheet according to US-GAAP would have to consider a further standard although US-GAAP and IAS/IFRS standards will be accepted mutually in the near future.

#### Paragraph 11:

This will lead to high administrative expense. The requirement to opt for a certain period will become a problem if the option would make no sense anymore under changing economic conditions. Special cases have to be considered.

#### Paragraph 13-18:

The relation between DBA (double tax treaty) and CCCTB needs clarification. All legal forms of an insurance company to which the CCCTB shall apply have to be put on a list. If not, VVaG (mutual insurance company) and AG (public limited company) will be treated in different ways.

Partnerships and corporations will be taxed differently which has to be taken into consideration.

The same applies to trusts and investment funds. The latter have great impact on life and health insurance companies.

#### Paragraph 43 and 44:

An important question will be, how risk financing will be evaluated, especially what impact CCCTB will have on Financial Reinsurance Contracts and Alternative Risk Transfer. Discussions in Germany about the tax treatment of those are continuing.

**Paragraph 79:**

Impact on Foreign Transactions Tax Act. Insurance companies will be affected especially in case of foreign investments (investment company, funds). This will also apply to Captives.

Single insurance companies of a group will probably be treated in a different way. National CFC regulations have to be adjusted to EC law.

**Paragraph 80:**

This interferes in the current discussion about OECD draft part IV. As a first step, there will have to be consideration by the CCCTB countries of the approach to the outcome of the OECD discussions.

There will also be an impact on the right of supervision, as in Europe different forms of the right of supervision apply.

**Paragraph 81:**

A standardized regulation how to consider funds and partnerships is essential. Local authorities in Europe assess differently the transparency (for example: participation of a Belgian SA in a partnership in Germany is treated as not being transparent by Belgian law but as transparent by German law). A standardized regulation has to be invented.

**Paragraph 84:**

A standardized regulation regarding losses must be invented. Especially, it has to be decided if member states are allowed to pass rules regarding minimum taxation or in case of changes in contributions (for example sec. 8c Corporate Tax Act in the latest version).

**Paragraph 85:**

It has to be discussed, which Member State will get the taxes. Something like a European interstate financial adjustment should be established.

The income will be assessed according to the stand-alone method and recorded and taxed in the Member States (see paragraph 137).

**Paragraph 87:**

The relation between double tax treaties and CCCTB needs clarification. Which double tax treaty has to be applied if the mother company does not belong to the EU (see example 1)?

**Paragraph 89:**

For instance, an EU insurance company in Member State 1 owns 80% of a subsidiary in Member State 2. Another EU insurance company in Member State 2 owns the remaining 20%. According to the wording of section 89, the participation would be 100 % assessed to the consolidated entity of the EU insurance company in Member State 1. Does this imply that the minority shareholder receives all income tax-free? Several regulations have to be considered, e.g. transfer pricing regulations, loss utilization etc.

**Paragraph 104:**

The comments by the Member States make sense: if an existing CCCTB group were taken over by another CCCTB group, the loss-carry-forwards of the sold CCCTB group could get lost and therefore not be utilized by the purchasing CCCTB group.

**Paragraph 106-109:**

This is a complex regulation which would be rather difficult to apply. Non-transparent companies of one group would become transparent if they were sold. Hidden reserves which have been revealed in the departing company would have to be attributed pro rata to the new shareholder (analogous to the treatment of a German partnership which is supposed to draw up a supplementary tax balance sheet). If not, the minority shareholder would have to pay taxes on hidden reserves although he has not sold his shares.

If the departing company is resident in another Member State than the selling company, hidden reserves have to be revealed as different accounting standards shall apply for the determination of the tax base.

**Paragraph 111-115:**

Impacts may occur in the areas of reinsurance and asset management. A more detailed estimation seems to be difficult as these sections mainly deal with the trading of products.

**Paragraph 117-129:**

The question how to avoid double taxation in case of foreign income and income from participations mainly affects insurance companies.

As life and health insurance companies in Germany have to pay taxes on income from participations in corporations (sec. 8b para. 8 Corporation Tax Act) it seems to be appropriate to change national law in order to treat property insurance companies and life and health insurance companies the same way in the future. There will be an impact on the tax deductibility of the reserves created for the transfer of contributions, as regulations for this are applied by a highly sophisticated calculation.

The question how to credit foreign taxes in case of life and health insurance companies at home is essential. A major question will be, whether they are to be credited completely, although 90% of the reserves for the transfer of contributions have been transferred and are thus tax-free.

The impact of these regulations on various assets should be checked in more detail.

The implementation of national CFC regulations in connection with CCCTB seems to be rather comprehensive and not really practicable.

It should be discussed how income of an outside minority shareholder will be taxed (same income source but possibly different tax consequences).

Special rules have to be applied to insurance companies - similar to those in the Foreign Transactions Tax Act (CFC rules) have to be passed. If not, the CCCTB may not be applied on income to be used for capital investment.

**Paragraph 130-134:**

This section corresponds to the ongoing discussion in Germany regarding sec. 8b para. 5 of the Corporation Tax Act.

## 6 COUNTRY REPORT: INSURANCE SECTOR - SWITZERLAND

### 6.1 Overview of the Swiss tax system for determining the Corporate Tax base in the insurance industry

- Switzerland consists of 26 Cantons, each having separate income tax legislations. However, based on Federal legislation, the tax laws of the Cantons are to a large extent harmonized. In addition, there is a corporate income tax on the Federal level.
- Since Switzerland consists of 26 Cantons with individual governments and the right to tax individuals and companies, the country might be a good example on how to co-ordinate / harmonize different tax laws and different authorities to levy taxes, even if Switzerland is not part of the EU.
- The Swiss system for determining the Corporate Tax base starts from individual statutory accounts prepared in accordance with the appropriate Swiss statutory accounting principles. The Corporate Tax Law provides the adjustments to be made to the profit or loss so determined for establishing the Corporate Tax base. In the absence of a specific provision included in the Corporate Tax Law and related tax legislation, the accounting treatment for a transaction or an item is valid for Corporate Tax purposes.
- Swiss insurance entities follow Swiss statutory accounting principles. There are some specific additional requirements relating to circumstances of the insurance environment. Even if the Swiss stock exchange requires consolidated accounts under IFRS or US-GAAP, the Swiss tax system follows the statutory accounts.
- There is no Corporate Tax consolidation available in Switzerland. There were serious considerations whether Switzerland should implement such a system about 10 years ago. However, due to the resistance of the Cantons, the project was abandoned at a very early stage. The resistance of the Cantons mainly reflected the difficulties on how to allocate the profits between the Cantons.
- On the other hand, Switzerland has already had to deal with inter-cantonal tax allocation issues for more than a century. Generally speaking there is an indirect allocation of profits between the Cantons (head office and branches) based on the branch accounts (e.g. for banks) or, more often seen in practice, based on a formula approach.

### 6.2 Accounting principles in Switzerland, which form – indirectly – the basis for corporate income taxes

- The accounting rules for both bookkeeping purposes and the annual financial statements are based on the principle that the books shall accurately reflect the economic situation of the company (Art. 959 Swiss Code of Obligations, "CO"). This principle is realized by other principles which are derived from the CO. The main two principles, which are also applicable for insurance companies are explained in more detail:
- Principle of Realization: The principle of realization provides that gains and losses may not be reported until they are realized. Upon realization, they are included in the income statement. The realization event occurs generally upon the creation of a legal claim. This means that neither the signing of a contract nor the payment of a debt can be considered the realization event. If no payments are made until the due date or the closing of a position (e.g., for options, forwards etc.) other than down-payments like commissions, the maturity date or the date of exercise, respectively, is considered to be the realization event. Additional mid-term net compensation payments in connection with swap contracts are considered to be partial realizations of a contract. On the other side, pure collateral payments are to be booked as debits or credits and have no influence on the timing of realization. The principle of realization is overruled by the principle of imparity and the possibility to value securities at market value pursuant to Art. 667 CO.

- Principle of Imparity / Lower of Cost or Market Rule: The principle of imparity forbids unrealized gains from being taken into account, but requires unrealized losses to be shown in the balance sheet by the creation of reserves and provisions for risks and pending losses. The lower of cost or market rule provides that an asset may generally not be valued higher than its purchase price or the lower market value on the date of the balance sheet. The principle of imparity is overruled by Art. 667 CO which permits quoted securities to be valued at market value.

### 6.3 Specific corporate tax rules applicable to insurance entities in Switzerland

- Switzerland does not tax insurance entities under a separate system but provides specific tax treatments for certain aspects.
- Insurance entities are in general expressly excluded from the scope of application of the local thin capitalisation rules. This exclusion is additional to the general exclusion applicable where the lender is resident in a Member State.
- Insurance entities do not follow the general Corporate Tax rules for bad debt but specific provisions which are tailored to the specialities of bad debt losses of these entities.
- If a Swiss insurance entity has a head office and branches in different Cantons, the inter-cantonal tax allocation is in general based on gross insurance premium income. Thus, there is no fiction of independent insurance companies, but the inter-cantonal insurance entity is regarded as a whole, and the cantonal shares are allocated indirectly by means of their share in the gross insurance premium income.
- On dividend income from subsidiaries (as well as on qualifying capital gains upon a sale), a Swiss entity is entitled to apply a participation relief, which is to a certain extent comparable to the participation exemption in some of the EU member states. As in many member states, some of the costs relating to the investment have to be deducted from gross participation income (e.g. administrative costs, financing costs). With respect to insurance companies it is difficult to define the financing costs implicitly to be calculated on the provisions, e.g. the technical provisions. Therefore a practice of a lump sum deduction of 25% from gross participation income is common, at least in the non-life area.
- Swiss tax practice is rather generous regarding provisions of an insurance entity by applying the imparity principle (see above). It is in general acceptable to consider unrealised currency gains by a provision, if certain assets are entered into the balance sheet on a mark-to-market basis.

### 6.4 Elements of the CCCTB legislation where special rules may be required

- This section comments on the elements of the CCCTB where special rules may be required from the Swiss perspective. We are aware of the fact that this might be rather hypothetical, since Switzerland is not part of the EU and it is not expected that this will change within the next decades.
- Comments are made by following the reading of the EU Working Document dated November 20<sup>th</sup> 2007 and making reference to the specific paragraphs as numbered in this document.

#### Paragraph 9:

- Experience in Switzerland, in particular regarding the tax allocation between head-office and branches, both in an inter-cantonal and in an inter-national context, showed the difficulties of an overall approach (as opposed to the fiction of independent entities), if there is not one single set of accounting standards on which the tax figures and in particular the tax allocation between the involved jurisdictions can be calculated. Therefore we suggest a strong initial discussion,

whether the consolidation project in practice requires a unified accounting approach, such as IFRS. The harmonisation of different local GAAPs seems to be too complicated.

**Paragraph 21:**

- We do not see a specific need for a general requirement of a 12 month accounting period at any rate. There are some circumstance, based on which a shorter or longer period might be required. The basis should in our view be the actual business year.

**Paragraph 25:**

- A distinction between trading income and non-trading income regarding expenses would cause major problems in continental Europe. It is not clear whether the term “expenses relating to assets treated as non-business” refers to such a distinction.
- We do not think it as appropriate to have a general 50% limitation on entertainment and representation costs. Any eventual limitation should be applied by analysing the individual case based on sound business reasoning.
- Since in Switzerland taxes are tax-deductible expenses, the clause that taxes are not tax-deductible, would give raise to an adjustment of Swiss tax law, if the EU rules applied accordingly. This is, however, a Swiss-internal topic.

**Paragraph 31: Recognition of income and expenses on an accruals basis**

- Under the Swiss tax system, revenues are taxable only to the extent that they are booked as income (taxes follow the accounts, as mentioned in the introduction). The most important accounting rules of the realisation principle as well as the imparity provide for some flexibility regarding the valuation of assets, which is on the other hand limited by regulatory requirements in the financial services industry. It should in our view be made clear, what standards have to be applied, in order not to discriminate against banks and insurance companies, both of which have a tight regulatory framework.

**Paragraph 33:**

- The Swiss pension fund system comprises not only provisions by the employer, but pension funds established as separate entities (usually foundations). Thus, any generic rules should reflect the different pension fund systems, which exist throughout Europe.

**Paragraph 37:**

- According to Swiss insurance rules, costs relating to the conclusion of an insurance contract can in general not be allocated over the life-time of an insurance contract. Thus, the rules should consider different systems and provide for an equal tax treatment.

**Paragraphs 40 to 42: Deductions for bad debt**

*Remark: The same concerns as for banking entities are in general also applicable to insurance companies.*

**Paragraphs 48 and 49: Foreign currency**

*Remark: The same concerns as for banking entities are in general also applicable to insurance companies.*



- Paragraph 48 of the Working Document establishes that “*Tax base, income and expenses would be measured in EUR or translated in EUR on the last day of the tax year at the average exchange rate issued by ECB / central bank of the State whose currency is being translated.*” Given the weight of foreign currency transaction in the insurance industry, this rule may need further development.
- In the case of unrealised currency gains it should be possible to opt for the set-up of a provision, in order not to be taxed on profits, which have not been realised. WP 57 should be more specific in this context.

## **Paragraph 50: Transactions including hedging**

*Remark: The same concerns as for banking entities are in general also applicable to insurance companies. Hedge accounting is a very difficult and important topic, although not exactly to the same extent in the insurance sector as in the Banking Sector.*

## **Paragraph 51: Stock valuation:**

- The valuation of stock is very vague. Indeed, the valuation of insurance entities is different from the valuation of entities in the non-financial markets sector. For insurance entities, the balance sheet, including the net asset value, is much more important than in typical growth industries. This significant business difference should be properly reflected in the valuation guidelines.

## **Paragraphs 56 to 77: Depreciation**

*Remark: The same concerns as for banking entities are in general also applicable to insurance companies.*

- The Swiss tax practice provides for safe haven rules regarding depreciation rates (reflecting the average lifespan of an asset). However, the company is entitled to use a different rate, e.g. if there is an additional loss in the market value of the asset. The most important thing is the continuity of the methods to be applied. Therefore we suggest implementing safe haven depreciation rates for various categories of assets as well as stating the general principles, such as continuity.

## **Paragraph 78:**

- Regarding the qualification as related parties, it would probably not be correct just to rely on the voting rights of 20%. It could in practice also be possible to be a related party by other means such as profit sharing or other arrangements.

## **Paragraph 84:**

- The period of the tax loss carry forward does in our view not necessarily have to be the same in every country.

## **Paragraph 120:**

- It is our understanding that this paragraph introduces common CFC rules. The question is whether this is really necessary in order to achieve the goal of taxation on a consolidated basis.

## **Paragraphs 123 to 125: Portfolio shareholdings**

*Remark: The same concerns as for banking entities are in general also applicable to insurance companies.*

## 7 COUNTRY REPORT: INVESTMENT MANAGEMENT – LUXEMBOURG

### 7.1 Overview of the Luxembourg tax system for determining the Corporate Tax base for Collective Investment Vehicles (CIVs)

- As outlined in a recent OECD document<sup>2</sup> most financial systems nowadays rely heavily on financial intermediaries: *“Small investors deal with their local financial institutions, which may purchase and hold investments on their behalf. Those who invest through intermediaries gain the benefits of economies of scale even if they have invested relatively little. In addition, clients of financial institutions benefit from the market experience and insights of professional money managers. Moreover, a small investor who buys interests in a CIV can instantly achieve the benefits of diversification that otherwise would require much greater investment”*.

Most OECD countries have followed this trend and concluded that where no specific provisions are otherwise made, tax discrimination will arise for small investors investing directly into or through an investment fund. The above OECD document adds that: *“Most countries have dealt with the domestic tax issues arising from groups of small investors who pool their funds in CIVs. In many cases, this is reflected in legislation that sets out specific tax treatment that may have significant conditions. The primary result is that most countries now have a tax system that provides for neutrality between direct investments and investments through a CIV, at least when the investors, the CIV, and the investments are all located in the same country.”*

- While CIVs are sometimes taxed under the general Corporate Income Tax (“CIT”) regime of an EU Member State, they are usually outside the scope of this general regime in order to fulfil the “neutrality principle” between direct investments and investments through a CIV.
- With about 10,000 funds and assets under management of about Euro 2 trillion, Luxembourg is the second most important investment fund domicile in the world (after the US). The Luxembourg fund centre is the prime location for the pan-European and global distribution of investment funds. At the same time, Luxembourg has developed a strong track record in alternative investment products and bespoke investment structures such as hedge funds, private equity vehicles, real estate funds and pension pooling.

### 7.2 Different types of CIVs

- CIVs may have different legal forms such as funds, trusts or companies. Some of these do not have legal personality whereas others do. The entities that have legal personality are sometimes considered and indeed taxed as transparent entities. In order to illustrate the variety in types of CIVs, a review has been undertaken of the most common Luxembourg types of investment funds. The enclosed overview in Appendices A and B set out in broad terms the most common Luxembourg types of investments funds, including the main legal and tax characteristics.
- The overview of the most common Luxembourg investment fund types demonstrates that CIVs can have different kinds of legal forms and that each legal form and/or purpose of a specific investment fund may lead to very different tax consequences. In general, from the relevant literature, the following five generic corporate tax models can be derived:<sup>3</sup>

<sup>2</sup> OECD Document on the First meeting of the Informal Consultative Group on the Taxation of Collective Investment Vehicles, London 9-10-11 May 2007, *Issues presented by CIVS and other intermediated financial structures*.

<sup>3</sup> L.J. Ed and P.J.M. Bongaarts, *General Report on Financial Institutions*, IFA 1997.

1. Not subject to tax: this can be because the fund is not a taxable person and therefore not subject to tax. Alternatively, the fund is not taxed because it is exempt;
  2. Subject to tax but wholly exempt: the fund can be subject to tax but it can be subjectively exempt from tax if it fulfils certain conditions, e.g. on the basis of its activity or for certain classes of investor or income;
  3. Subject to tax but not an object of tax: this could involve an unusually low tax base but most commonly involves a reduction in the tax base for distributions paid to investors. The result may be that the fund pays little or no tax, although it is subject to tax;
  4. Subject to tax and an object of tax with a low or zero per cent tariff: this involves the entity being subject to tax but a special rate;
  5. Fully subject to tax and the object of tax with integration at the investor level: the entity can be fully and normally taxed but the investor gets some form of integrated approach to avoid double taxation.
- As can be derived from the above, special tax regimes apply to CIVs provided that certain conditions are met. A common feature is that they have a favourable position as compared to 'normal companies' given that they limit themselves to investment activities. If, and insofar as investment funds are engaged in business activities, they may lose their special tax status and as a result become taxable as ordinary companies which are engaged in trade and/or business activities in the local country.
  - As mentioned before, the reason for the favourable regimes is that these special tax regimes are designed to take away differences in tax treatment of direct investments by investors and indirect investments through CIVs. However, if CIVs would compete with ordinary companies through the engagement of business activities, there is no longer a need to provide them with a favourable treatment. As a result, they will be taxed as any other person or company.

### 7.3 Current tax position of CIVs and problems they face

- There are three angles to look at the tax position of CIVs, namely at fund level, at investment level and at investor level.

- Fund level

Generally, CIVs are typically single entities established in a particular country which do not operate through subsidiaries or branches in other MS. This certainly applies to the more traditional CIVs investing in portfolio equities or bonds. Real estate CIVs may structure their investments through special purpose vehicles or may operate through taxable branches in other countries. Also for example, private equity CIVs and, to a lesser extent, hedge funds, may structure their investments through special purpose vehicles. However, these special purpose vehicles are normally not considered themselves to be a CIV, but taxed as ordinary companies engaged in trade and/or business activities.

Hence, at fund level, it can be argued that the tax issues are mainly national MS issues, such as meeting the conditions to remain eligible for a specific fund regime. There have been several harmonisation initiatives. However, they have merely been restricted to legal<sup>4</sup> and accounting<sup>5</sup> issues and have not included tax issues. For example, CIVs can use a single European passport for their European distribution activities.

However, the consolidation process of funds which has taken place in the European fund market in recent years has highlighted the need to facilitate tax-free cross border fund mergers. As it is now more feasible than ever before to market UCITS<sup>6</sup> on a cross-border basis, attention is being focused on the ability of the industry to move to an EU market

<sup>4</sup> UCITS Directive of 20 December 1985 and the ICBE Directive of 19 March 2007.

<sup>5</sup> Reporting Standards, such as IFRS.

<sup>6</sup> Undertakings for Collective Investment in Transferable Securities.

where more funds are sold on a cross-border basis. There is a broad consensus that the European UCITS market is very fragmented. The average fund size is around one fifth of that found in the US market and consequently a significant rationalisation of these funds would be required in order to move towards the economies of scale reached in the US market-place. According to the joint report by the European Fund and Asset Management Association (EFAMA) and PricewaterhouseCoopers (PwC) entitled: "Tax Discrimination against foreign funds. Light at the end of the tunnel", one impact of the current fragmented market-place is that production costs are higher than necessary.<sup>7</sup> Also, in other areas of the fund industry, such as real estate funds, there is a tendency towards consolidation across Europe.

- Investment and investor level

As mentioned before, most EU Member States now have a tax system that provides for neutrality between direct investments and investments through a CIV (at least when the investors, the CIV, and the investments are all located in the same country). However, there are multiple complex tax issues in case investors, the CIV and the investments are not located in one and the same country. These complex tax issues are the subject of the already quoted OECD report on the Taxation of Collective Investment Vehicles and also the EFAMA and PwC report, which distinguishes between two forms of tax discrimination:

- Tax relief only available to investors in domestic funds and not to the same investors in foreign-based CIVs.<sup>8</sup>
- Tax rules which are applied only to foreign based CIVs and not to domestic CIVs which have some adverse tax effect on investors in foreign CIVs.

Such tax discrimination will, in almost every case, be illegal under the provisions of the EC Treaty as it contravenes the EU's Fundamental Freedoms, in particular the free movement of capital and the freedom to provide services within the EU.

Increasingly, EU financial services groups or businesses have brought cases of alleged Treaty infringement before the European Court of Justice ("ECJ"). The ECJ has invariably ruled that tax discrimination of the kinds outlined above cannot be justified under the Treaty and is illegal. Due to the evolving ECJ case law and also authoritative reports such as that of EFAMA and PwC, Member States have recognised that action was needed to eliminate the widespread discrimination against foreign funds or tax relief only available to domestic funds.

The success in eliminating some of the most serious tax discriminations in the (then) EU-15 in recent years means that greater emphasis should be placed on other significant types of discrimination and tax inefficiencies that still remain, and which also tend to adversely affect the attractiveness of foreign CIVs.

A potential source of such discrimination concerns the tax credit systems in some MS that allow withholding taxes and domestic tax credits to flow through to domestic investors, but only where that investor is investing capital via a domestic CIV.

Further problems arise when investing cross-border in Real Estate, as CIVs are confronted with different tax regimes in the various Member States regarding rental income and capital gains of its immovable properties. The reason for this is that based upon international tax principles income derived from immovable properties is always allocated to the source State.

Also, it should be noted that CIVs based in different countries suffer varying rates of withholding tax determined solely by their country of residence. Such discrepancies can no longer be seen as compatible with the EC Treaty. Recent ECJ case law has established the principle that if a Member State has a domestic system for the avoidance of double taxation on corporate dividends, and hence no withholding tax on domestic dividends, then

<sup>7</sup> EFAMA and PwC, Tax Discrimination against foreign funds. Light at the end of the tunnel. London 2006.

<sup>8</sup> The EFAMA and PwC report refers to UCITS, but for purposes of this report reference is made to CIVs.

the advantage of this must be extended to other EU investors. This extension would encompass many CIVs.

Many CIVs do not qualify for relief under double taxation treaties. By contrast, investors in such funds would usually qualify for a reduced rate of withholding tax if they invested directly in the underlying investments that the CIV holds. This is a complex issue as Member States retain the right to negotiate bilateral double taxation treaties. However, there also is ECJ case law in this area and, if it can be shown that EU Member States have negotiated a treaty that is incompatible with their obligations under the EU Treaty, then the legality of that agreement or provision may be challenged.

In this respect, it is key to note that the relevant EU Directives also do not provide tax relief for CIVs, mainly because it is required that the company relying on the Directive is subject to tax without the possibility of option or of being exempt.<sup>9</sup> In fact these EU Directives are based on the notion that the persons relying thereon are regular companies. Also, CIVs are usually not subject to tax or have the possibility or option of being exempt. No relief is, therefore, provided for portfolio dividends which a CIV typically holds. Further, both the Interest and Royalty Directive and the Merger Directive state that companies may only rely thereon if they are subject to tax without the possibility of option or of being exempt. Thus, these Directives do not provide any relief to CIVs.

Finally, some countries also subject foreign based CIVs to a requirement that they must comply with certain aspects of local law or the investor will suffer some form of tax penalty. There is, however, a body of ECJ case law that suggests that overly burdensome administrative requirements may be judged incompatible with the EC Treaty on the basis that they have the effect of restricting the development of the Single Market.

## 7.4 Conclusions and recommendations

- The general line of reasoning is that CIVs are eligible to favourable tax regimes in order to avoid discrimination between direct and indirect investments. These favourable tax regimes are always conditional and only apply if certain criteria are met, such as risk diversification, shareholder requirements and, most importantly, investment activities must be characterised as more or less passive investment activities. Should a CIV be engaged in trading or business activities, then it will normally be taxed as any other company.
- Given these considerations, the CCCTB does not seem to deal with the problems that CIVs face nor does it offer a solution for these problems.
- In essence, the CCCTB would lead to a common consolidated definition of taxation on investment profits. However, the resulting taxable basis will effectively not be taxed as a result of the common idea that CIVs should not be taxed but instead taxation arises in the hands of its investors. A need for harmonisation of the taxation of CIVs does not appear to arise.
- There are additional obstacles as described for instance in the report of EFAMA and PwC on tax discrimination against foreign funds. In this respect, the following may be considered by the European Commission:
  - Introducing a Fund Merger Directive. It is almost certain that countries which permit domestic CIVs fund mergers to occur on a tax-free basis, but do not extend this to mergers with foreign CIVs, are likely to be judged ultimately in the Courts to have regimes that are incompatible with the EC Treaty. However, the most rapid way of ensuring progress for countries which do not permit tax-free fund mergers to occur would probably be to adopt a Fund Merger Directive that mandates Member States to allow such mergers to occur according to a clear regulatory framework and in a tax-free manner;

<sup>9</sup> E.g. section 2 of the Parent Subsidiary Directive.

- Harmonization of the tax credit systems in all EU MS allowing withholding taxes and EU tax credits to flow through to EU-based investors investing capital via EU based CIVs;
- Harmonization of rates of EU withholding taxes suffered by EU based CIVs through e.g. the introduction of a model tax treaty that would grant reduced withholding tax benefits to EU based CIVs, where it can be shown that the underlying investors of the vehicle reside in a EU Member States;
- Initiating an infringement procedure pursuant to Article 226 EC against the Member States treating domestic and foreign CIVs differently;
- Abolition of onerous administrative requirements for foreign EU based CIVs.
- With respect to Real Estate investments we suggest to investigate the possibilities to formulate homogenous rules.
- Further investigation of the above potential solutions is recommended, but is acknowledged to be outside the scope of the present CCCTB for Financial Services study.

## 8 COUNTRY REPORT: PENSION FUND MANAGEMENT - NETHERLANDS

### 8.1 Overview of the Dutch tax system for determining the Corporate Tax base for Pension Funds.

- Pension Funds (“PFs”) cover a social function by providing social protection to (former) employees against the financial consequences of old-age, death, disability and /or sickness. This social function is based on the thought of unity and collectivity. In principle, PFs are established by an employer to facilitate and organize the investment of employees’ retirement funds contributed by the employer and employees and to pool the risks of death, disability and longevity.
- The PF is a common asset pool meant to generate stable growth over the long term and to provide pensions for employees at retirement, disability and/or sickness and for their surviving relatives.
- In the context of an ageing population the social protection provided by private PFs is one of the most important vehicles to secure future welfare. It is generally found worthwhile to stimulate pension savings by providing fiscal facilities for the accumulation of capital to cover future pension payments. As a consequence PFs are usually outside the scope of the general regime of the CIT.

### 8.2 Different types of PFs

- PFs may have different legal forms such as foundations, trusts or companies. Some of these do not have legal personality whereas others do.
- As part of the agreed scope of work, a review has been undertaken of the Dutch tax provisions for PFs. The Dutch pension system is known for its soundness to face the imminent consequences of an ageing population. The amounts available at Dutch PFs to pay out pensions in the future even total to 125% of the Dutch GDP (2006).<sup>10</sup>
- In the Netherlands three kinds of PFs exist, i.e.:
  - PFs managing single-employer plans.
  - PFs managing multi-employer plans.
  - PFs managing occupational pension plans.
- In addition special funds for early retirement provisions are known. There are plans to introduce the possibility to create (pan-European) Institutions for Occupational Retirement Provision (IORPs or ‘Algemene Pensioen Instellingen’) as meant by the IORP Directive.<sup>11</sup> For the existing kinds of Dutch PFs it is almost impossible to operate as a pan-European PF. It is intended that the Dutch IORP may have any legal form as long as the IORP has legal personality.
- The Dutch Corporate Income Tax Act contains a conditional exemption for PFs. In the tax law there are no constraints regarding the legal form of the PFs in order to qualify for this exemption, although from a regulatory point of view a PF needs to have legal personality. For the applicability of the exemption the legal form, the nationality and the character of the PF are not relevant. PFs (of any kind or nationality and in any form) should be able to apply for the full exemption as long as the conditions with respect to the pension plan and the distribution of eventual profits made are met, i.e. (article 5.1.b of the Dutch CIT Act):

<sup>10</sup> Statistical Bulletin of the Dutch Central Bank, December 2007.

<sup>11</sup> IORP Directive of 9 October 2005

- The purpose of the PF should be the provision of old-age and disability pensions for employees and former employees and surviving relatives' pensions for their spouses and children. It should be the sole or main purpose of the PF to undertake those so-called core activities.
- The (early-retirement) pensions provided by the PF should be wholly or mainly based upon a pension scheme as meant in the Dutch Public Laws on the regulation of the provision of pension plans or the Dutch Income Tax Law or upon a comparable foreign pension scheme (article 5.3 of the Dutch CIT Act).
- The investments and other activities should wholly or mainly relate to the core business and activities of the PF.
- The profits and benefits of the PF have to be distributed to the insured persons or exempted PFs or have to be used for general social purposes except for a distribution of not more than 5% of the equity of the fund.
- The full exemption is based upon the idea that PFs are non-profit organisations solely aiming for the fulfilment of a socially desirable purpose. Accordingly, the benefits derived from the investments from PFs have to be distributed to the participants by lowering premiums or by enhancing their pension rights.
- If the PF meets the aforementioned requirements, the PF is fully exempted from CIT. Nonetheless, if the PF has other commercial activities not directly supporting its core activities and these other commercial activities comprise more than 10% of its total activities, the exemption is not applicable and CIT will be levied as for any other company.
- Also in various other MS (especially domestic) PFs meeting certain requirements can benefit from a special CIT regime, such as a full exemption from CIT or a reduced tax rate. This was noted in a recent study performed by the EFRP and PricewaterhouseCoopers into the taxation of domestic versus outbound dividends and interest payments to PFs in 18 Member States.<sup>12</sup>

### 8.3 Current tax position of PFs and problems they face

- As with Collective Investment Vehicles "CIVs"), here, there are in principle also three angles that require analysis. Firstly, from a former employee ('investor') level. Secondly, from a PF level and thirdly from an investment level.

#### Employee level

- As mentioned before, the function of a PF just consists of the management of the pension scheme of its participants and of the investment portfolio covering the pension rights of its participants. For the participants the tax position of the pension scheme is relevant with respect to three different issues, i.e.:
  - the fiscal treatment of premiums paid;
  - the fiscal treatment of the returns made by investing the accumulated capital; and
  - the fiscal treatment of pension payments received.
- As a result, the tax system for pension schemes is a three factor system with premiums taxed/exempt, investment returns taxed/exempt and pension payments taxed/exempt. The Dutch system is therefore in principle an EET-system.<sup>13</sup> Other MS may have an EET-system, TEE-system or an ETT-system. However, most other MS also apply the EET-system.

<sup>12</sup> 2005 EFRP and PwC report, *Discriminatory treatment of EU Pension Funds making cross-border portfolio investments in bonds and shares within the European Union*. Prepared by J. Maassen / F.A. Engelen

<sup>13</sup> The abbreviation of the EET-system can be explained as follows. The first "E" stands for Exempt premiums, the second "E" stands for Exempt returns and the "T" stands for Taxed payments.



- The fiscal treatment of premiums paid and pensions received concerns the levying of income tax and is out of the scope of this study. The same applies if the investment returns of the PF are taxed at the level of the participant. Nonetheless, sometimes the eventual taxation of investment returns takes place at the level of the PF. In that case the fiscal treatment of the investment returns falls within the scope of this study, although it is an issue at the PF-level.

Pension fund level

- Generally, PFs are typically single entities established in a particular country which do not operate through subsidiaries or branches in other Member States. However, certain investments may be structured through special purpose vehicles or CIVs which are normally not considered themselves to be a PF. As a consequence those CIVs are in principle taxed as ordinary companies engaged in trade and/or business activities. However, the CIVs will normally be subject to special tax regimes as outlined in the previous section.
- Further, at PF level the same reasoning as mentioned for Investment Funds applies: there are mainly national issues, such as meeting the conditions to remain eligible for the specific PF regime. Most PFs operate in only one Member State and the domestic legislation usually takes care of their needs sufficiently.
- However, the introduction of the aforementioned IORP Directive is supposed to bring multi-national companies one step closer to establishing pan-European pension provisions. The IORP Directive introduces the single passport principle for pan-European PFs, amongst others by introducing minimum prudential standards for cross-border pension funds. This development highlights the need to facilitate tax-free cross border PF mergers. Diverging conditions (or the impossibility) to get an exemption for CIT by PFs in different Member States can frustrate the intended opening of the single European market for PFs and will actually lead to diverging CIT bases for PFs in different Member States.

Investment level

- As mentioned above, in many Member States (especially domestic) pension funds meeting certain requirements can benefit from a special corporate income tax regime, such as full exemption from corporate income tax or a reduced tax rate. This preferential tax treatment often also applies to withholding taxes on distributions of dividends and interest payments to PFs by a domestic corporation or debtor as well. As outlined in the above mentioned study of the EFRP and PricewaterhouseCoopers: *“The tax treatment of domestic pension funds may result in an exemption at source, a refund of withholding tax levied, or a credit of withholding tax levied against corporate income tax due. However, the preferential treatment of pension funds with respect to withholding taxes on dividends and interest payments does not apply to foreign pension funds.”*
- The study concludes: *“The differential treatment of (outbound) dividends and interest paid to foreign pension funds as compared to (domestic) dividends and interest payments to local pension funds constitutes unjustified discrimination. As a result, the tax withheld at source on dividends and interest payments to foreign pension funds infringes the EC Treaty. We recommend the European Commission to start an infringement procedure pursuant to Article 226 EC against the Member States treating domestic and foreign pension funds differently.”*
- Following the recommendation made, in May 2007 the European Commission sent a Formal Notice to 9 Member States asking them for further clarification and information regarding the discriminatory treatment of dividends and interest paid between domestic and foreign PFs<sup>14</sup>. The discriminatory treatment of withholding taxes results in actually diverging CIT bases between Member States.
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<sup>14</sup>

Press Release IP/07/616 of the European Commission, 7 May 2007.

## 8.4 Conclusions and recommendations

- In most Member States PFs are eligible to conditional favourable tax regimes comprising two main conditions:
  - The first condition is that the distributions are taxed in the hands of the ultimate beneficiary, usually the (former) employee. As a result, there is normal taxation, albeit that taxation takes place at the end of the chain. If tax would also be due by the PF, then there would be a double economic taxation. This is avoided by exempting the Fund and its investments on the one hand and taxing the pension payments in the hands of the (former) employee on the other hand.
  - The second condition is that PFs should – same as Investment Funds – limit their activities primarily to investment – and other – activities supporting the social security function performed by the PF. As soon as they engage in other (competitive) activities the favourable treatment is lost and corporate taxation arises as at regular companies (corporates).
- *Prima facie*, given these considerations, the applicability of the CCCTB does not seem to deal with the problems that PFs face.
- In essence, the use of the CCCTB would lead to a common consolidated definition of taxation of profits of a PF. However, in most Member States the resulting taxable basis will effectively not be taxed as a result of the idea that taxation should not take place at the PF level, but – at the moment pension payments arise in the hands of the (former) employees – at the level of the (former) employees. Except for the few Member States applying the ETT-system, a need for harmonisation of the CIT base for PFs does not appear to arise.
- Nonetheless, because of the conditionality of the tax exemptions for PFs, situations may arise in which the PF falls within the scope of the general CIT regime. However, it may be deemed unnecessary to add specific rules to define a CCCTB for such exceptional cases.
- As soon as the IORP is introduced in The Netherlands, situations may arise in which the financial statements of the IORP have to be consolidated with the financial statements of an entity falling within the scope of the general CIT regime.<sup>15</sup> In that case distortions may be created if the CCCTB is not applied to the IORP resulting in the possibility to manipulate the tax position of the group. So, despite the requirements of IAS 27, for tax purposes it may be considered necessary to exclude IORPs (and other PFs) from the group because of their special activities and tax position. Otherwise a further study on the adjustments needed to the general rules of the CCCTB should be considered by the European Commission.
- There are additional obstacles as described above. In this respect, the following may be considered by the European Commission:
  - For (further) facilitation of cross-border (mergers of) PFs domestic conditions to be exempted from CIT by PFs should be harmonised;
  - The continuation of initiating infringement procedures pursuant to Article 226 EC against the Member States treating domestic and foreign pension funds differently as mentioned above;
  - The possible consequences of eventual infringement procedures with regard to the tax exemptions for specifically PFs may need further investigation. If the tax exemptions for PFs will be deemed incompatible with the rules on state aid in the EC Treaty, a totally new situation arises.
  - Again, it is accepted that these issues are strictly outside the scope of this Study but they have been included for completeness.

<sup>15</sup>

See IAS 27, Consolidated and separate financial statements.

## 9 GENERAL COMMENTS ON THE TAXATION OF PRIVATE EQUITY FUNDS

### 9.1 Introduction

- In July 2007, the OECD<sup>16</sup> published a report regarding the implications of investment vehicles and in October 2007 the RSM Erasmus University<sup>17</sup> (by order of the Dutch Ministry of Finance) has published a report with the outcome of its research relating to private equity funds and hedge funds.

Based upon these reports, private equity is a generic term used to define investors who provide risk bearing equity to non-listed companies in order to acquire control over these companies. In exchange for its capital, private equity funds get an interest in the company, either by means of equity such as ordinary shares, cumulative preference shares or by means of debt such as issuing a mezzanine-loan (subordinated loan which will be converted into equity if the loan is not redeemed before a certain date) to the company. The intention of private equity funds is not to maintain long-term control of the companies. Instead, private equity funds tend to be actively involved in the acquired companies, by actively participating in the (management of the) business. However, within a relatively short period of time, when the companies are (more) profitable, the private equity funds will dispose the investment. For example, investments of private equity funds are often deployed for the financing of the development of non-listed companies, management buy-out, management buy-in, divisional buy-out, privatization of public companies, restructuring and/or used as venture capital.

- Venture Capital Institutions (“VCI”) typically invest in start-up businesses. For the purpose of this study we refer to the description for Private Equity Funds, as Venture Capital Funds often take the form of Private Equity Funds.

### 9.2 Different types of Private Equity Funds

- As mentioned in the abovementioned OECD report most Private Equity Funds are organised as partnerships. Depending on the regulatory framework in the country of residence the partnership is taxed accordingly. In addition, in most countries there are no special regulations for Private Equity Funds.

### 9.3 Current tax position of Private Equity Funds and problems they face

- Private Equity Funds or VCIs are normally structured as a master fund with one or more feeders. The investments of the master fund are shareholdings and/or debt investments in listed or non-listed operating companies. In order to structure their investments tax efficiently, the master fund may also set up special purpose vehicles (e.g. holding companies). The financing of the investments are often (highly) geared with debt.
- In essence, Private Equity Funds face the same problems as CIVs face, in case they take the form of a Fund vehicle. We refer to our comments relating to CIVs above.
- Insofar as it pertains to holding and target companies of Private Equity Funds, the tax issues are to a certain extent also common for ordinary companies engaged in trading

<sup>16</sup> OECD report, *The implications of alternative investment vehicles for corporate governance: a synthesis of research about private equity firms and “activist hedge funds”*. July 2007.

<sup>17</sup> A. de Jong, P.J.G Roosenboom, M.J.C.M. Verbeek and P. Verwijmeren. *Hedgefondsen en Private equity in Nederland*. October 2007 RSM Erasmus University.

and/or business activities. These problems consist of tax consolidation issues, absence of cross-border loss compensation, issues regarding the deductibility of interest etc.

#### 9.4 Conclusions and recommendations

- As mentioned above, as Private Equity Funds generally take the form of Fund vehicles we refer to our earlier recommendations for CIVs. Insofar as Private Equity Funds are not normally subject to corporate tax, designing a specially tailored CCCTB tax base for Private Equity Funds does not appear appropriate.
- With respect to Private Equity Funds' holding and target companies we refer to our recommendations for ordinary taxable entities.

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**10 APPENDICES**