EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION
Analyses and tax policies
Analysis and Coordination of tax policies

Brussels, 19 May 2005
Taxud E1 MH/ TN

CCCTB\WP\010\doc\en
Orig. EN

COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

Capital gains and losses

Meeting to be held on Thursday 2 June 2005

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WORKING DOCUMENT

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I. Introduction and purpose of the paper

1. The discussion on assets and tax depreciation was opened at the first meeting of the CCCTB WG on 23 November 2004. The topic was referred to the first subgroup (hereafter the SG1) hosted by Germany. It emerged during the discussions at the CCCTB WG's and the SG1's meetings that taxation of capital gains is very much related to the general tax treatment of assets. Members of the SG1 postponed the discussion on several questions, since they found it necessary to discuss capital gains first. The following issues were postponed by the SG1 in order to discuss them in conjunction with capital gains:

   - Subsequent revaluation of asset (unrealised capital gains / losses)
   - Extraordinary wear and tear and impairment
   - Residual value deduction

2. Given the number of elements which seem to be interrelated for the general treatment of assets and capital gains, particularly the close linkage between the gain/loss and asset itself, Members of the Group should consider whether the topic should be referred to the SG1 for further analysis as suggested by the Commission Services, or whether they wish to discuss the topic in a separate sub-group.

3. The working method employed in this working document is slightly different from those used in previous ones. Capital gains and losses are primarily analysed as a tax issue since IAS are less relevant in this area.

4. The term capital gain/loss is initially used in this paper in the most general sense that it usually has in taxation – i.e. the difference between the price that an asset is sold for, or otherwise disposed of for, and the asset's value relevant for tax purposes. However, there are a number of different methods of calculating the gain or loss and the paper also covers these. For example, the question of unrealised gains and losses which arise when assets are revalued is discussed. The 'asset's value relevant for tax purposes', which is compared with the proceeds, may be calculated in a number of different ways. It may be the original cost of the asset, or the depreciated cost ('tax written down value' or 'tax residual value')[1] of the asset, or if assets have been pooled the depreciated cost of the whole pool of assets eligible for future depreciation may simply be reduced by the proceeds (which in some cases may be limited to the original cost). Finally a combination of taxation via the pool and an individual capital gains tax calculation may be required. Theoretical examples in the Annex demonstrate some of possible different methods.

5. A capital gain or loss that has been received or incurred by the company at the realised disposal of an asset is a realised capital gain or loss. An unrealized capital

[1] The terms 'tax written down value and the 'tax residual value' have broadly the same meaning and represent the original cost less the accumulated deductible tax depreciation.

gain or loss is an increase or decrease in value of the asset which, although it has been recognised in the financial accounts as a result of a revaluation, has not been crystallised by an actual sale or other disposal. Taxation of a realised capital gain represents the right to tax a gain arising from the alienation of a business asset. In most cases a gain or loss is realised at the time the taxpayer ceases to own the asset as a result of the disposal or alienation of an asset.

6. Capital gains and losses can be generally divided into two main groups,

   (i) gains and losses on tangible assets (usually depreciable) but also some intangibles such as patents and

   (ii) gains and losses on financial assets such as shares.

   This working document on capital gains concentrates on capital gains and losses related to the first group, ie assets other than financial assets at this stage. For the purpose of this paper a capital gain/loss is linked to the fixed permanent asset held for the production of income and connected with the business activity of a company. The need for special rules on financial assets will be dealt with at later stage after the general treatment of financial assets has been discussed.

7. It is well known that the taxation of capital gains varies considerably. In most MS capital gains are added to, and taxed as, ordinary business income, in others they are subject to special taxes levied on each capital gain or on the sum of the capital gains accrued during a year. Some MS do not subject capital gains either to corporate income tax or to any special 'capital gains' tax. Reasons for such different treatment, whether preferential or not, may be traditional and historical. Generally, in common law countries capital gains of companies are taxed differently from other types of business income with separate computational rules and most common law countries prevent the offsetting of capital losses against income.[2]

8. One distinction between ordinary business income and capital gains should be mentioned. Capital gains are generally taxed on a realisation basis whereas the accrual approach is adopted in respect of ordinary business income. In other words, because unrealised gains and losses are not recognised for tax purposes, there is a wider scope in the case of capital gains for the taxpayer to decide whether to defer the recognition of gains, or accelerate the recognition of losses, that may reduce taxes payable on ordinary income. Therefore tax legislators sometimes ring fence capital gains and losses from ordinary business income. The

[2] Some authors see as probable reason for the different treatment of capital gains the fact that the distinction between an income and capital had been developed in England in trust law on the question of entitlement of a life tenant of a landed estate. The income tax in UK naturally adopted the existing distinction and this may have influenced the other income tax systems. The distinction in the UK was clearly established early in the development of its taxation laws, without express reference to trust law, but trust law considerations were important in deciding that bonus shares were not income of the shareholder. However a UK consultation document proposed taxing gains of companies as ordinary business income in August 2002. (John F. Avery et al., International Bureau of Fiscal Documentation Bulletin , June 2003)

effect of this is that capital losses can be offset only against capital gains although provision is made for the carry forward of unused capital losses.[3]

9. Some categories of capital gains are treated preferentially for tax purposes in some tax jurisdictions. Preferences may be given either through lower rates, exemption of the whole or a part of the gain, or averaging and inflation adjustments that are not available for other gains. Although applying a different tax rate on capital gains is out of the scope of competence of the CCCTB WG, and it is not the intention of the Commission Services to enter into a debate on tax rates, Members of the Group may nevertheless wish to discuss whether capital gains received by companies should be subject to any beneficial treatment, e.g. to what extent they are to be taxable, how they are to be taxed and how any relief, such as 'rollover' relief may be provided. Measures of an incentive character may also be discussed together with other incentives, but the general principle for taxation of capital gains needs to be addressed.

►*Do Members of the Group agree with the approach that capital gains on assets will be discussed first and potential specific treatment on financial assets at later stage when a general framework for the treatment of financial assets is discussed?*

►*Do Members of the Group agree that more detailed work should be done by the SG1 given the close links between assets, depreciation and capital gains?*

►*Should capital gains be taxed separately from business income or is it more appropriate and practical to add them to ordinary business income in CCCTB?*

►*Do Members of the Group believe that in CCCTB capital gains should be fully taxed and capital losses fully relievable, or should there be some reduction or deferral mechanism?*

►*Do Members of the Group find it useful to adopt some limitation on the deduction of capital losses (e. g. only against capital gains, perhaps within a certain period)?*

II. Realised capital gains and losses

10. Realised capital gains or losses arise when the respective asset is sold or otherwise disposed. The term disposal should be understood as widely as possible, i.e. any situation in which the ownership of an asset or a part of the asset (partial disposal) changes or an asset ceases to exist should be covered. Besides ordinary sales and various intended realisation events in case of intangible property other than financial assets, involuntary as well as extra contractual disposals such as redemption, expiry, cancellation, surrender, loss, and destruction of an asset should be covered.

11. Members of the SG1 agreed, that an economic owner should be allowed to depreciate the fixed asset in some situations and that the common definition of

[3]Tax Law Design and Drafting, volume 2, International Monetary Fund, 1998, Victor Thuronyi, editor, Chapter 16

economic ownership will be necessary. Therefore the change of ownership of a respective asset for any capital gains taxation has to cover both possibilities, i.e. both the legal and the economic one. If this is not the case then the situation where the economic owner receives tax depreciation, but the legal owner is subject to capital gains tax in the event of a disposal will have to be addressed.

12. When the SG1 discussed subsequent adjustments of tax depreciation plan, several Members believed that modification of the depreciation plan should be allowed if an asset is impaired, or is subject to extraordinary wear and tear and they thought these issues should be discussed in conjunction with the disposal of respective fixed assets. Two situations were identified.

13. The first one is when an asset is used and subject to wear and tear more intensively than normally and the taxpayer is able to substantiate this. As mentioned above some Members of the SG1 believe that a special depreciation plan should be available in such situation. However, such a specific rule may not be necessary if the applicable depreciation scheme is reasonably flexible. If the rules for tax depreciation leave some space for options to the company, e. g. whether or not the tax depreciation is claimed, the need for special rules for extraordinary wear and tear does not seem to be so necessary.

14. The second situation is when the asset is partially or completely destroyed or lost (e. g. through fire, flooding or theft) and it is necessary to spend considerable resources on its repair or replacement. When an asset is completely destroyed or lost it has to be eliminated from the balance sheet in accounting[4]. IAS also provides companies with very detailed rules on how to estimate the recoverable amount of the asset in case an asset is impaired during its useful life. Companies assess at each reporting date whether there is any indication that an asset may be impaired. Intangible assets with indefinite lives and goodwill are tested irrespective of whether there is any indication that an asset may be impaired[5]. This approach closely follows one of the essential purposes of the accounting according to which the balance sheet may never be overstated. As mentioned in previous Commission Services' working documents the goal of corporate taxation is different – to ensure that the declared taxable income is not understated, therefore detailed rules on the annual revaluation of assets in addition to rules for depreciation seem to be redundant in tax area. In taxation the relevant question in case of destruction or loss of an asset (complete or partial) is whether the company is allowed to deduct the loss on the asset in question and what evidence it is required to obtain in order to make it tax deductible (e. g. police protocol in case of theft).

►*Do Members of the Group agree that the definition of disposal should cover as wide as possible range of situations when the ownership or other rights enabling the taxpayer to use the asset change?*

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[4] IAS 16 Para 55
[5] IAS 36

►*Members of the Group are invited to comment on what solution they would find appropriate for the CCCTB in case of extraordinary wear and tear and impairment of assets.*

III. Unrealised capital gains

15. Most MS observe the realisation principle and only tax capital gains when an alienation of a capital asset takes place. However, there are some exceptions when companies are required to revalue fixed assets although they do not dispose them and the capital gain arising from revaluation is subject to corporate income tax or a special tax. Some MS permit unrealised permanent losses in the value of assets to be recognised for tax purposes as well.

16. In accounting companies are often obliged to register the revaluation of assets in certain situations. Furthermore, such revaluations may affect the accounting profits. Whether or not these unrealised capital gains or losses should be taxed or relieved should be discussed by Members of the Group and possible common approaches, with or without exceptions, should be evaluated.

17. It seems to be appropriate and justified to only tax capital gains, and relieve capital losses, when they are actually incurred – i.e. only realised gains and losses are taxable or relievable. This question has already been raised at the SG1's meetings, specifically in relation to depreciation rather than gains or losses, and Members generally agreed that any revaluation of a depreciable asset (e. g. due to the change of its fair value) should not in principle influence the tax base or the tax residual value of an asset. Members of the Group may however wish to discuss whether there should be any exceptions to this. In the financial accounts of companies various approaches to subsequent revaluations of assets can be identified in accordance with their respective national accounting standards. In many cases the actual decision whether and how the revaluation is made may depend on the judgement of companies (particularly when IAS/IFRS are applied). Regardless of the accounting treatment a common taxation approach will be necessary for the CCCTB.

18. An underlying principle to be followed is that any gain or loss should be reflected in the tax base only once. In other words if the revaluation of an asset is tax relevant at the time of revaluation, the re-valued residual value has to be recognised at the moment of actual realisation and vice versa. It has to be ensured that not more than 100% of the acquisition cost of an asset is expensed, if any increase in value due to a revaluation has not been taxed. If a revaluation lowers/increases the accounting profit and thus the tax base, the depreciable amount that is deductible over the whole useful life or more precisely tax residual value of the asset at the time when the asset is disposed has to be reduced/increased by the same amount.

19. In current tax systems a disposal is often deemed to arise at the moment when an asset leaves the tax system (e.g. change of residence status). This form of exit taxation is a consequence of the principle of territoriality generally applied in

taxation area. The need for such a rule may occur also in the CCCTB in relation to third countries not participating in the project. In other words the disposal would not be deemed when an asset moves within CCCTB countries, but only if it leaves the CCCTB jurisdictions. Members of the Group should however make sure that the selected solution is compatible with the EC Treaty, especially if not all MS participate in the project. Members of the Group may find it useful to postpone discussion of this issue until the general issue of third countries and waters edge rules etc are discussed.

►*Members of the Group are invited to comment in detail on whether unrealised gains / losses should or should not affect the tax base and why.*

►*Do Members of the Group agree that 'exit rules' should be discussed in conjunction with other 'third countries issues'?*

IV. Calculation of a capital gain or loss

20. A capital gain/loss is represented by the net proceeds from the disposal of the respective asset. Techniques of calculation may however vary. The method of calculation itself depends very much on what method is used for tax depreciation, particularly whether individual or pooling system is applied.

21. In accounting gains or losses arising from the retirement or disposal of an item of property, plant and equipment or an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the income statement[6].

22. In taxation the situation is often more complicated and there are a number of possible variations (as mentioned in paragraph 4). In a system where tax depreciation is calculated on an individual asset basis, or on a pool basis, the sale proceeds can be compared to the tax residual value of the asset and any difference is taxed or relieved as a gain or loss. In an individual asset system the tax residual value is always available, in a pooling system the tax residual value of the asset would have to be specifically calculated, if the asset is disposed of. In a system where tax depreciation is calculated on a pool basis the sales proceeds can be deducted from the pool. This effectively spreads the taxation of any gain, or the relief for any loss, over a number of years as the depreciation available in future years via the pool is reduced. A possible variation of this approach would restrict the sales proceeds deducted from the pool to the original cost of the asset and provide for an additional calculation of the capital gain for immediate taxation by comparing the total proceeds with the original cost of the asset. Other additional factors such as subsequent expenditure of an investment character on an asset also need to be taken into account.

23. It was discussed at the SG1's meetings whether the depreciable amount should be determined after deducting the residual value of the asset that the enterprise expects to obtain for an asset at the end of its useful life as it is required in

[6] IAS 16 Para 56

accounting[7]. It is particularly relevant when at the moment of acquisition the taxpayer knows that the asset is going to be disposed of before the end of the depreciable period of such asset. This rule is very important if the capital gain at the disposal is not taxable or is exempt because the full cost of the asset is tax depreciable, the proceeds are not, and the company has effectively gained additional tax deductions. If the capital gain is taxed when the asset is sold restricting the tax deprecation to take into account the expected residual value is not as important as the advantage to the company is restricted to timing, rather than absolute tax deductions.

24. Proceeds or consideration received for the disposed asset should be the price received including the market value of any in kind consideration. If the disposal of assets occurs between two related companies rules for the calculation of the proper market price are necessary. The arm's length principle seems to be the most appropriate one for such situations. In the CCCTB such treatment would only be applicable for related companies where one is resident in an EU MS and another one outside the EU. Members of the Group may prefer to discuss the whole issue of relations between companies covered by the CCCTB and companies resident in third countries all together at a later stage rather than in conjunction with each individual structural element.

25. In case of loss or destruction of an asset the taxpayer often receives compensation from an insurance company. In such situations the consideration received should be linked to the insurance proceeds or compensation received in relation to the destroyed or lost asset. If the compensation received is higher than the tax residual value of the destroyed or lost asset the difference may represent a capital gain. It may be rolled over into the new asset acquired for the compensation (see below). If the compensation is lower than the tax residual value of an asset the company incurs a loss. Some MS however limit deductibility of tax residual value of destroyed or lost asset by the amount of received compensation from the insurance company.

26. When only a part of an asset is disposed of the rule for apportionment of the tax residual value of the original asset attributable in case of partial disposal to the disposed part is necessary. Pro rata basis by reference to relative market values of the part sold and part retained at the time of the disposal seems to be the most appropriate rule. It may be however difficult to find a market value of the transferable part of an asset in some cases. The allocation of the residual value on a pro rata basis using features other than market value such as the size may be useful especially in case of some types of assets (e. g. immovable property). Similar rules should apply where two or more assets are disposed for one indivisible consideration (e. g. another asset).

27. If a number of assets of the same type are held by the taxpayer and these fungible assets were acquired for different costs and not all these assets are disposed of at the same time some method for identifying or allocating which of the assets is

[7] IAS 16 Para 46

being sold will be required. This issue is particularly relevant in cases of assets other then depreciable assets (e.g. shares), however for the sake of completeness it is mentioned now. In most cases of tangible assets it is possible to identify the particular asset disposed of and its actual tax residual value where necessary. As this is most relevant for financial assets Members may wish to postpone discussing an appropriate allocation method until financial assets and capital gains arising from the disposal of financial assets are discussed and to establish a consistent methodology for all types of assets.

V. Timing and roll over treatment

28. As already mentioned above gains and losses arising in relation to assets are usually taxed not as they accrue, but rather in the tax year in which the taxpayer realises the gain or loss.

29. In some situations in which a taxpayer has realised a gain or a loss on disposal of an asset the recognition of the gain is deferred until a later stage. The taxation of a gain or deduction of a loss may be rolled over. The taxpayer is deemed to have disposed of the relevant property for a consideration equal to its cost and to have acquired a replacement asset for a consideration equal to the original cost. It is presumed that the gain the taxpayer may have incurred on the sale of the old asset is used for the acquisition of the new one.

30. Most MS currently provide taxpayers with some form of roll over relief, some of them however limit it to cases where a new replacement asset of the same type is actually acquired within a designated period.

31. Various techniques of providing roll over relief are employed. The type of method and mechanics for calculating depreciation may influence the method of providing the roll over relief. The general intention of such reliefs is to defer the taxation of the gain because the proceeds (parts of which represent the gain) are to be used by the company to acquire new or replacement assets. Depending on the method of providing tax depreciation and of computing the gain the mechanics of providing the relief may vary from adjusting the pool value, adjusting the cost of the newly purchased asset, the creation of tax deductible reserves or a combination of these methods. Additional qualifying conditions relating to timing and/or the type of replacement asset may also be imposed.

32. In addition to providing relief via roll-over mechanisms some MS (e.g. Denmark, Spain, Ireland and UK) make, or have made, allowances for inflation when computing capital gains. Broadly speaking these seek to exclude from taxation that element of the gain which has arisen purely because of inflation and their importance increases or decreases depending on inflationary trends. The precise mechanics, and the applicable inflation indices, may vary and their application, for example the treatment of losses, may be quite complex. Finally, relief may also be provided by reducing the proportion of any gain which should be taxed depending on how long an asset has been owned.

►*Do Members of the Group think that CCCTB should provide taxpayers with reliefs such as roll over relief, or some form of allowances for inflation or for assets held over a certain period of time before being disposed of? If so, what form would they prefer? Would Members of the Group like to impose special conditions on such reliefs? Members of the Group are invited to comment with detailed comments as appropriate.*

33. ►*Members of the Group are invited to comment on any other issue they find relevant in connection to capital gains.*

Annex

EXAMPLE 1

*A fixed depreciable asset '**A**' was acquired in the tax year '**Y**' for EUR **2,000**. 'A' is depreciated under declining balance method **20%** a year, full depreciation charge is claimed in the year of acquisition, no depreciation charge is claimed in the year of disposal. 'A' was sold in year Y+3 for EUR **2,050**.*

Year	***Depreciation charge***	***Tax residual value***
Y	**400**	**1,600**
Y+1	1600*20% = **320**	**1,280**
Y+2	1280*20% = **256**	**1,024**
Y+3	**A realised capital gain of (2,050 - 1,024) = <u>1,026</u> was incurred in the year Y+3.**	

EXAMPLE 2

*A taxpayer has a fixed depreciable asset '**A**' (see Example 1) and another fixed depreciable asset '**B**' acquired in year **Y** for EUR **1,500**.*

<u>Situation a):</u>

*As described above in the Example 1, the A is sold in year Y+3 for EUR 2,050. (**a gain when comparing proceeds with both the acquisition cost and the tax residual value**)*

<u>Situation b):</u>

*The A is sold in year Y+3 for EUR 1,000**. (a loss**)*

<u>Situation c):</u>

*The A is sold in year Y+3 for EUR 1,100. (**a gain when comparing proceeds with the tax residual value**)*

Calculations for situations a), b), and c) are shown for:

1) The pooling system with the selling price reducing the pool.

2) The pooling system with the tax residual value reducing the pool.

3) The system of individual depreciation of assets.

1) POOLING SYSTEM WITH THE SELLING PRICE REDUCING THE POOL

Year	***Depreciable amount in the pool***	***Depreciation charge at 20% of the pool***	***Capital gain/loss***
Y	2,000 + 1,500 =**3,500**	700	-
Y+1	3,500 - 700 =**2,800**	560	-
Y+2	2,800 – 560 =**2,240**	448	-
a) Y+3	2,240 - 448 = **1,792 – 2,050 = -258** Asset A sold for 2,050	0	The pool is **negative**. In such situation the negative amount of **258** would be usually taxed (e.g. added to ordinary taxable income).
b) Y+3	2,240 - 448= **1,792 – 1,000 = 792** Asset A sold for 1,000	158	1,000 – 1,024 (tax residual value of Asset A) = the **capital loss of 24** remains in the pool for future relief.
c) Y+3	2,240 - 448 = **1,792 – 1,100 = 692** Asset A sold for 1,100	138	1,100-1,024 = **76** – the capital gain is effectively removed from the pool immediately **reducing the future relief**.

2) POOLING SYSTEM WITH THE TAX RESIDUAL VALUE REDUCING THE POOL

Nb. This method gives the same result as the calculation for individual depreciation of assets under 3).

Year	***Depreciable amount in the pool***	***Depreciation charge of 20% of the pool***	***Capital gain/loss***
Y	2000 + 1500 = **3500**	700	-
Y+1	3500 - 700 = **2800**	560	-
Y+2	2800 – 560 = **2240**	448	
a) Y+3	2240 - 448 = **1792 – 1024 (tax residual value of the A) = 768** Asset A sold for 2,050	154	2,050 – 1,024 = capital gain of **1,026**
b) Y+3	**2240 - 448 = 1792 – 1024 (tax residual value of the A) = 768** Asset A sold for 1,000	154	1,000–1,024 = capital loss of **24**
c) Y+3	**2240 - 448 = 1792 – 1024 (tax residual value of the A) = 768** Asset A sold for 1,100	154	1,100-1,024 = capital gain of **76**

The tax residual value of Asset A (1,024) is calculated same way as in the Example 1. **The tax residual value is only calculated for asset being disposed of.**

3) DEPRECIATION OF ASSETS ON INDIVIDUAL BASIS (shown only for Asset A)

Year	***Depreciable amount***	***Depreciation charge 20%***	***Capital gain/loss***
Y	2,000	400	-
Y+1	**1,600**	320	-
Y+2	**1,280**	256	-
a) Y+3	**1024 (tax residual value of the A)** Asset A sold for 2,050	0	2,050-1,024 = capital gain of **1,026**
b) Y+3	**1,024** Asset A sold for 1,000	0	1,000–1,024 = capital loss of **24**
c) Y+3	**1,024** Asset A sold for 1,100	0	1,100-1,024 = capital gain of **76**