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PROFITS FOR TAX PURPOSES

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P R O F I T S F O R T A X P U R P O S E S

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Preliminary remarks

A new law on annual accounts of July 17, 1975, published in the official Gazette (Moniteur Belge) of September 4, 1975, will come into effect on January 1, 1976. As it is only a "cadre-loi" (outline law), several important sections of it require further implementation.

At the time this report was written it was not yet clear what the fiscal consequences would be. It has been reported that the tax authorities will not be entitled to reject the balance sheets which are in conformity with the new law. The new law, however, does not contain any fiscal provisions.

BELGIUMA. GENERAL CONCEPT - Introductory remarks

Profits from a business enterprise are in principle, profits arising from all activities carried out in or through the establishments of the enterprise, whether within Belgium or abroad, including any increases in the value of assets, used for the business activities and any decrease of liabilities. Certain items such as charges and expenses, exempt income and losses may be deducted.

In practice, the taxable income of the enterprise represents the difference between the opening balance sheet and the final balance sheet, subject to certain statutory adjustments. The balance sheets are those approved by the general meeting of shareholders. On the one hand, the enterprise is bound by the approved balance sheets but on the other hand the tax authorities may substitute reasonable estimates of taxable income if the balance sheets appear to be incorrect. The corrections to be made for tax purposes may relate to permissible instalments of depreciation, disallowed expenses, exempt income, reserves, carry forward of losses etc.

Depending upon the taxpayer, income from business enterprise will be subject to either individual income tax, corporate income tax, or non-resident income tax. Subject to certain exceptions, the rules concerning the nature and the determination of taxable income are the same for individual income tax and the corporate income tax. Taxable income will also be determined for purposes of non-resident income tax in a similar manner though this is limited to Belgian source income. The many treaties for the avoidance of double taxation, however, may affect the determination of taxable income.

Foreign source business profits taxed abroad are subject to a reduced rate: 25% of the corporate tax rates or 50% of the normal individual tax rates, unless exempt by treaty.

B. Depreciation of business assets1. Introduction

Depreciation of business assets may be deducted from gross income as business

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expenses if such depreciation is necessary and corresponds to a real decrease in value during the relevant taxable period. Whether a depreciation is necessary and corresponds to a real decrease in value, is a matter of fact and not law. The burden of proof is on the taxpayer. The Administration, faced with considerable problems of valuation has accepted a system of fixed annual rates to be agreed between the tax inspector and the taxpayer. If necessary such rates may be modified. In general, land may not be depreciated since it does not decrease in value.

2. Depreciable assets

All tangible and intangible assets used in the conduct of business activities are depreciable. Tangible assets include plant and machinery, furniture, cars and other vehicles etc. and business premises. Dwelling houses are depreciable if they form part of the assets of the enterprise. Examples of intangible assets are clientele, goodwill, patents, trade-marks, concessions and licenses, formation expenses, costs involved in the issue of bonds and shares, sums paid by a company for outside professional expertise, sums paid for the purchase of an insurance portfolio, consideration paid for the taking over of a tenancy agreement etc. No depreciation is allowed for assets in which the company only acquires the right of enjoyment (use) and not the right of property.

Since only assets which are used for the conduct of the business enterprise qualify as depreciable assets, raw materials, manufactured products and merchandise, investment portfolios and debt-claims are excluded. Land and buildings which are the subject of business transactions of real property companies ("sociétés immobilières") are considered as merchandise and are thus not depreciable.

Assets need not, however, be effectively used; for instance, assets invested by a corporate business enterprise in a branch, which has been completely closed down because of certain circumstances, are still depreciable. An asset can be invested in a business without being used directly.

3. System of depreciation

BELGIUM3.1 Approved methods of depreciation

Two methods are generally permitted. The straight-line depreciation method is the one normally used. The reducing depreciation is an optional method, which may not, however, be used for intangible assets and for assets which have a useful life of less than six or more than nineteen years. This excludes, for instance, immovable goods since they normally last for more than nineteen years.

The straight-line method consists of depreciation by annual instalments (a fixed percentage of the purchase price or investment value) in proportion to the estimated useful life. The reducing depreciation (declining balance or degressive depreciation) consists of the application of a fixed percentage to the book value of the asset (which gradually diminishes).

3.2 Change-over from one method to another

A change-over from straight-line depreciation to reducing depreciation is not permitted. The reverse is allowed when the applicable amount of straight-line depreciation exceeds the amount of the reducing depreciation.

3.3 Basis of depreciation

The depreciation is based on the purchase or investment value (salvage value need not be recognised). This is interpreted as the price actually paid for the cost of production, if the asset was manufactured by the taxpayer, together with related costs (import duties, cost of transport, installation, assembly etc.) and the costs of any subsequent additions or improvements. The taxpayer may, however, elect to write off the related expenses in the year in which they were incurred, or in the first year of exploitation or in fixed annual instalments the number of which he may himself determine. Charges connected with the financing of the assets because of a delayed payment of the purchase price, are not part of the depreciable base. It is not necessary for assets to be acquired for valuable consideration.

If the taxpayer receives a tax free government premium under the Law on Economic Expansion the amount of the premium will be deducted from the depreciable base. Basically, V.A.T. may not be included in the depreciable base, unless the V.A.T. may not be credited.

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In case of mergers and similar reorganisation under the Income Tax Code, the depreciable base of the assets is determined as if the operations had not taken place (carry over of book value).

3.4 Percentages and duration

3.4.1 Straight-line depreciation

Depreciation periods and corresponding rates are normally fixed by agreement between the taxpayer and the tax administration. For this purpose assets are divided into various categories, based on the nature and the probable period of use of the assets. The rates may also differ according to the intensity of the use. The tax administration has required its inspectors to adopt a lenient attitude in fixing the rates.

All circumstances must be taken into account, irrespective of the cause of the decrease in value. The taxpayer should be allowed a large safety margin to cover unforeseen circumstances such as damage to machinery, necessity of replacement due to technical or economic developments etc. The rates may be adapted if economic circumstances or changes in the conditions of the conduct of the business activities can so justify. For certain assets the administration issued some indications which can serve as a guideline or which may be used by the taxpayer without justification. Examples of such rates are the following:

- Commercial premises, office buildings	3%
- Industrial premises	5%
- Office equipment	10%
- Machinery and equipment	10 to 33%
- Rolling stock	20%

3.4.2 Reducing depreciation

The maximum rate is twice the straight-line rate up to a maximum of 20% of the depreciable base.

3.5 Commencement of depreciation

Depreciation is first permitted at the normal annual rate in the calendar year (or accounting year) in which the assets are acquired or produced.

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There is no prorata depreciation. Assets ordered but not yet in the possession of the taxpayer, may be considered as acquired during the year in question to the extent that they have actually been paid for and entered in the books as assets.

3.6 Special arrangements

3.6.1 Ships

Ships may be depreciated over 8 years the normal rule being that 20%, 15% and 15% may be deducted in the first three years and 10% in the remaining 5 years. The depreciation for the first three years may be deferred to later years provided the total annual deduction does not exceed 20%.

3.6.2 Development areas

A special depreciation (at double the straight-line rate for a maximum of three years) may be granted for investments in industrial buildings, machinery and equipment, under the Law on the Economic Expansion of December 30, 1970.

3.6.3 Miscellaneous

For certain assets special rules have been made, which virtually amount to accelerated depreciation.

a) Equipment used for scientific research may be depreciated over a three year period i.e. at a rate of 33 1/3% per annum. Equipment used for research in normal manufacturing processes is excluded.

b) Buildings for banks

The purchase price of real property acquired to be demolished and rebuilt may be fully written off. The value of the land and recoverable materials must be deducted from the purchase price. After completion of the building an initial depreciation allowance of 33 1/3% is available; the further annual depreciation amounts to 3% of the costs less 33 1/3%.

c) Works of Art may be written off in one or more years, at the taxpayer's discretion. By works of art here is meant those made by residents of Belgium and which are to be incorporated in a newly constructed building. The total depreciation may not exceed 2% of the value of the building. The excess is depreciable according to the same rules as are applicable to the building.

d) Certain small items of expenditure (office supplies, tools, etc.) may be

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written off in the year in which they are incurred. The same applies to "related expenses" (cfr. supra sub 3.3). Also, formation expenses (i.e. notarial costs, travel expenses, costs incurred in relation to special advice and assistance necessary for the setting-up of the business etc.) may be written off all at once in the period in which they were incurred (or in the period in which the actual exploitation starts) or in fixed annuities without interruption, at the taxpayer's discretion. The same applies to deductible expenses, other than formation expenses incurred before the beginning of the actual commencement of the business enterprise.

4. Depreciation on account of extraordinary wear and tear and exceptional loss of value

The annual rate may be increased to take account of a real decrease in value, the remaining useful life may be shortened or the extraordinary decrease in value may be written off all at once or over several years. Higher percentages are permissible in case of intensive use during boom periods or in the case of the conversion of an industry etc.

The annual rate may also be decreased e.g. in periods of economic crisis or in periods of stable development of inventions and know-how.

5. Deferral and recovery

5.1 General

Although the company law of Belgium requires a company to enter the "necessary" depreciation in its annual accounts, there is no obligation from the tax point of view to depreciate assets. A correction will only take place if the depreciation is higher than is admissible for tax purposes. Since the tax inspector cannot require assets to be depreciated, the tax administration will assume that there is no (or only a small) diminution of value if the taxpayer does not (or does not sufficiently) depreciate the assets.

The taxpayer may not depreciate assets for tax purposes if such depreciation has not been included in the annual accounts.

BELGIUM5.2 Recovery of depreciation which has not been fully utilised

Depreciation which corresponds to a diminution in value in preceding years will, in principle, be disallowed. As a matter of practice, the tax administration allows depreciation which has not been fully utilised to be recovered in subsequent years: the amount so recovered may not, however, exceed the normal annual (straight-line) instalment. Therefore, depreciation which has not been fully utilised may be supplemented by depreciation disallowed in preceding years.

Recovery may be deferred to the years following the expiry of the agreed period of depreciation and will be at the same annual rate. An exception to the general rule concerns ships: depreciation, permissible during the first three years may also be deferred to later years of the period involved, the annual instalment being limited, however, to 20%.

These rules apply to the straight-line method as well as to the reducing method. The reducing depreciation instalment must be computed on the basis of the book value even if the assets in question were not depreciated in a previous year.

6. Commercial and fiscal depreciation

Fiscal depreciation can be seen as the apportionment of the costs of an asset over its life-span (spreading of the decrease in value). Commercial depreciation is often regarded as the creation, during the life of an asset, of sufficient funds to renew or replace the asset when necessary (maintenance of the capital). Although the administration recognizes that one of the purposes of depreciation is to maintain capital, it accepts only the original cost or investment value as the capital to be maintained. Since the commercial balance sheets (approved by the general meeting) are the starting point for the computation of the taxable profits, it is obvious that assets which are not commercially depreciated, cannot be depreciated on the fiscal balance sheet. The taxpayer has a free hand as to how he shows the depreciation in his accounts provided he does not exceed the admitted percentage.

BELGIUMC. Taxation of capital gains and losses1. Capital gains in general1.1 Introduction

Generally, all capital gains are included in taxable income as profits, and are, thus, taxed at ordinary rates.

1.2 Non-realised capital gains

Non-realised capital gains, not entered in the accounts (latent or hidden capital gains) are not taxable.

Non-realised capital gains, entered in the accounts are also exempt. However, corporate taxpayers must meet the condition (Art. 105 of the Income Tax Code) that the capital gains are and remain debited in one or more separate accounts and that they are not used for the creation or the increase of the legal reserve, nor for any kind of reward or bonus. If these conditions are not fulfilled the capital gains will be treated as taxable business profits to the extent that they are used or distributed. This does not apply in the case of liquidations or redemption of stock and distribution of capital (see under 2.1, below). However, non-realised capital gains, entered in the accounts from raw materials, manufactured products and merchandise, and from certain immovable property deemed to be "circulating capital" of real property enterprises ("enterprises immobilières") are taxable as business profits. "Circulating capital" or "enterprises immobilières" means immovable property acquired with a view to its sale, or not continually (10 years) used for the business activities; such property must be in the possession of a taxpayer whose activities consist of the purchase or building and selling or letting of immovables.

Fixed capital of such enterprises includes immovables which are not acquired with a view to their sale and which are continually in the possession of the taxpayer.

1.3 Realised capital gains

Capital gains realised on immovable property, plant and machinery, and securities, used for business purposes for less than 5 years, follow the general

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rule, i.e. they are included in the taxable profit.

If the above types of assets are used for more than 5 years the "monetary" capital gains will be conditionally exempt (for those conditions, see 1,2, above). "Monetary" capital gains are defined as gains not in excess of the purchase (investment) price, multiplied by a coefficient, less depreciation or capital losses.

The above coefficient varies in accordance with the year in which the asset was transferred to the company as follows:

<u>Year of purchase</u>	<u>Coefficients</u>
up to and including 1918	16.33
1919	11.49
1920	6.15
1921	6.30
1922	6.43
1923	4.37
1924	3.89
1925	4.02
1926	2.72
from 1927 up to and including 1934	2.35
1935	1.86
from 1936 up to and including 1943	1.70
from 1944 up to and including 1948	1.14
1949	1.10
1950 and after	1.-

Capital gains exceeding "monetary" capital gains will be taxed at a reduced rate (24% for companies and 15% for individuals). The reduced rate applies only to gains realised by corporate taxpayers on assets invested in Belgium. Gains realised outside Belgium may be subject to the reduced tax rate on foreign source business income (see Chapter A, above).

Capital gains on circulating capital of real property enterprises (enterprises immobilières) (see 1.2, above) will be treated as business profits.

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With respect to unbuilt on land which has been in the possession of the taxpayer for more than 5 years, the purchase price (for purposes of computation of capital gains) may be increased annually by 5% from the sixth year of possession up to a maximum of 50%.

Capital gains realised on unbuilt on land by individual entrepreneurs who are not engaged in immovable property business activities, are completely and unconditionally exempt as business income (earned income) but may be taxable under the provisions of "Miscellaneous Income" (gains from speculation in real property). In that case the gain will be subject to 30% tax if the assets have been held for a period of five years or less and at 15% ~~ese~~ if they have been held for more than five years and not more than eight years. With respect to capital gains on shareholdings and other securities, the reduced rate is only applicable to capital gains which exceed previous capital losses. The amount corresponding to such previous capital losses will be taxable as business profits.

2. Special capital gains regimes

2.1 Mergers etc.

Capital gains realised a) on the exchange of shares in connection with the merger, division, transformation or dissolution of a company upon the acquisition of all shares by a single shareholder, or b) on the repayment of capital or redemption of stock, will be treated as follows:

(i) With respect to foreign companies:

- shareholder owns shares for less than 5 years: the gain will be taxed as ordinary income;
- more than 5 years: "monetary capital" gains (see 1.2 and 1.3, above) will be conditionally exempt. The excess will be subject to the reduced rate for capital gains.

Exception:

Taxation of capital gains on the exchange of shares in the circumstances indicated under a) above with a company established in another EEC country will be conditionally (see 1.2, above) exempt if the operation involved in the other country takes place under an exemption system which corresponds to the Belgian privileged

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tax treatment of mergers (Art. 124 of the Income Tax Code).

(ii) With respect to Belgian Companies:

- if the shareholder is a company, the gains are treated as "already taxed income", i.e., 90% or 95% of the gain is exempt from tax. The reason for this treatment is that a special corporation tax replaces the tax which would normally be due by the shareholders on such reorganisations. With respect to corporate shareholders, however, this exemption applies only to the extent of 95% (in the case of industrial and commercial companies) or 90% (in the case of finance companies).
- in the case of individual shareholders, the gains will be unconditionally exempt.

Exception:

Gains realised on an exchange of shares in the circumstances indicated at a), above are in accordance with the Belgian privileged tax treatment of mergers under Art. 124 of the Income Tax Code (see 1.2 and 1.3, above) conditionally exempt.

2.2 Transfer of a branch

Capital gains realised on the transfer to a company, established in Belgium of one or more branches of the business in exchange for stock is conditionally exempt (see 1.2 and 1.3, above). The same applies to the transfer of all branches if both the Minister of Finance and either the Minister of Economic Affairs, or the Minister for the Middle Classes consider this transaction to be productive, combatting unemployment, or rationalizing the economy. It should be noted that capital gains realised on the contribution of assets to a company follow the normal rules applicable to realised capital gains (see 1.3, above).

2.3 Realised capital gains in the form of damages resulting from expropriation or similar events

2.3.1 Gains on raw materials, merchandise, etc.

Gains on raw materials, manufactured products and merchandise are included in taxable profits.

BELGIUM2.3.2 Gains on other assets

Gains on all other assets are completely exempt to the extent that they are reinvested within three years in business assets other than raw materials, products or merchandise. If they are not so reinvested (or not completely) then the general rules as described below (see Chapter C, under 1) apply. Exception: Reinvestment is not required with respect to capital gains from unbuilt on land of taxpayers who are not engaged in immovable property business activities, and on assets used in agriculture; the gains will be exempt in the case of individuals and conditionally (see 1.2, above) exempt for corporations.

2.3.3 Real property enterprises

With respect to real property enterprises ("entreprises immobilières"), gains on circulating capital (see 1.2, above) will always be taxable as profits. The purchase price (for purposes of computing the capital gain) of unbuilt on immovables which have been in the possession of such enterprises for more than 5 years may be increased annually by 5% from the sixth year of possession, up to a maximum of 50%.

2.4 Special provisions for development areas

The Law of December 30, 1970 on economic expansion exempts certain realized capital gains, if they are reinvested in a development area within a period beginning 6 months before the taxable period in which the capital gains were realised and ending 12 months after the same taxable period.

3. Capital losses3.1 Current assets

A reduction of value of raw materials, manufactured products, merchandise, investment portfolios and debt-claims may be taken into account as a capital loss and deducted from income. They will not reduce the amount of capital gain subject to privileged treatment.

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- Non-realised capital losses must be entered in the accounts of the year in which they actually and finally arise.
- Capital losses on raw materials, manufactured products, merchandise and investment portfolios must be proved by a regular inventory. The assets must be valued at cost price, or at replacement cost, whichever is lower.
- A decrease in value of debt-claims will be accepted if there is decisive proof that it corresponds to an indisputable or almost certain loss (Reserve for probable losses (see Chapter D, below)).

3.2 Other assets

Occasional decreases in value and decreases which do not occur regularly, are not treated as normal depreciation. Such losses are deductible all at once or otherwise as indicated above (see Chapter B, under 4, above) (depreciation on account of extraordinary wear and tear and exceptional loss of value).

D. Reserves1. General rule

Generally "true" reserves (accumulated income) and so-called reserves which constitute in fact amounts set aside to meet accrued liabilities, estimated expenses or other contingencies ~~are~~ not recognised in computing taxable profits, irrespective of their designation. Any increases of such reserves during the year are thus added back to taxable profits.

2. Allocation of business expenses to proper year

A reserve, the purpose of which is in fact to allocate business charges and expenses to the year to which they relate, is allowed for tax purposes. This is the case with reserves which correspond to a decrease in value which has actually occurred or charges or debts which are definite and determined.

3. Explicit provisions in the law

On the other hand, the Belgian tax law provides explicitly for the creation of certain tax free reserves.

BELGIUM3.1 Reserves for probable losses

Allocations to such reserves are deductible in computing taxable profits, subject to the following conditions:

concerning the losses:

- the losses must be deductible as business losses;
- the losses should relate to debt claims (not securities); losses related to depreciable assets or losses on stock-in-trade are excluded;
- the losses must be clearly described with respect to their object (thus they are not acceptable if they concern general risks);
- the probability must appear from special circumstances arising during the relevant taxable period and still existing at the end of it.

concerning the reserves:

- the reserves must be built up at the end of the relevant period. Reserves built up during that period may be maintained if the circumstances which make the losses probable, still exist;
- the reserves must be debited against one or more separate accounts.

limitations:

- the total amount reserved from annual profits to cover probable losses may not exceed 5% of the total annual profits;
- the total amount reserved may not exceed 7.5% of the highest profits made in any one of the five preceding years.

If the losses occur they must be deducted first from the reserves and only thereafter from other profits. If no such losses occur, or not to the full extent of the reserves, the reserves (or any unused amount thereof) must be included in taxable profits in the year in which it is established that no such losses will be made.

3.2 Reserves for probable charges

Allocations to these reserves are deductible in computing taxable profits if the following conditions are fulfilled:

- (i) Probable charges must have the character of deductible business charges or expenses and must be attributable to the year in which the reserves are set up. Such charges include those resulting from that year's business

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activity or charges from events occurring in that year. Charges not yet borne but covered in advance by compensation for damages, expropriations etc. are also included. A pro rata share of the costs proportionally related to the relevant taxable period in respect of major repairs to buildings, plant, machinery or equipment (not renewal) which are carried out at regular intervals (maximum 10 years) will also be accepted.

(ii) With respect to the reserves themselves, the same conditions as for reserves for probable losses apply (see 3.1, above), except that there is no limitation as to the percentage of the profits. All reserves are exempt to the extent that they correspond to a fair and reasonable estimate of the probable charges. With respect to later use of reserves, the same rules apply as described for the reserves for probable losses.

3.3 Reserves for social benefits

Allocations to reserves unconnected with any legal or contractual obligation and set up with a view to the granting to personnel or their dependents of benefits, on the occasion of events which are not directly related to their professional activities are deductible in computing taxable profits.

Limitations:

- together with the expenditure effectively incurred for the same purpose, the annual allocation may not exceed 2.5% of the total gross payments paid to the personnel qualifying for the benefits.
- the total amount of reserves at the end of the taxable period may not exceed 5% of the payments mentioned above.

3.4 Certain capital gains

The capital gains, which are conditionally exempt, i.e., which are and remain on the debit side of one or more separate accounts and which cannot be disposed of, can also be regarded as tax-free reserves.

4. Hidden reserves

Hidden reserves are those reserves which do not appear as such on the debit side of accounts. The general rule applies to such reserves. Accordingly, such reserves will be included in taxable profits if they are revealed.

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The following are treated as taxable hidden reserves: disallowed depreciation, underestimation of assets, debts which are not yet definite and determined etc. To a certain extent "legal" hidden reserves which are not taxable also exist. There is no obligation to enter capital gains in the accounts and the reducing depreciation can exceed the actual decrease in value of assets.

E. Other Investment Incentives

1. Introduction

A general investment allowance is not granted in Belgium, but specific incentives and provisions which amount virtually to an investment allowance exist; these are described below.

2. Employees' Dwellings, Facilities and Financial Assistance

Up to 50 % of net profits is deductible if used within twelve months of the end of the fiscal year for:

(i) the construction in Belgium of workmen's dwellings or in providing amenities for employees (cafeterias, rest rooms, recreation rooms for the use of company personnel, holiday homes for employees' children etc.)

(ii) loans to employees to assist them in building or buying houses for their own use, provided such employees have obtained a principal loan from a financial organization which benefits from State guarantees under the Housing Code.

3. Exploitation of petroleum and natural gas

One half of the profits from the sale of products resulting from layers of liquid or gaseous hydrocarbons in Belgium is exempt from income tax, provided that it is reinvested in the Belgian business of such companies or in shares in other Belgian companies within the following five years.

4. Economic Expansion Law (December 30, 1970)

Apart from the incentives already mentioned above (accelerated depreciation, reduced rate of capital gains tax) the capital grants provided for under the law are not subject to income tax in the year received. These grants are deducted, however, from the basis of depreciable assets as well as from the basis for computing capital gains or losses relating to these assets.

5. Anti-pollution incentives

At the taxpayer's request, a similar regime may be applied to the subsidies granted under the Anti-waterpollution legislation (Royal Decree of April 9, 1975). The subsidies will be exempt from individual or corporate income tax, on the condition that no depreciation will be taken on the subsidies.

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The subsidies amount to 45 % in 1975 and 1976, 30 % in 1977 and 1978 and 15 % in 1979 and 1980, of the investment cost incurred for the installation of equipment to either diminish or eliminate water pollution, or for the introduction of new production processes which will have the same result.

6. Temporary Additional Investment Incentives

The law of June 29, 1975, provides a temporary investment allowance for enterprises investing in Belgium between July 1 and December 31, 1975. The investments to which the law applies are those made in depreciable, tangible assets, other than workmen's dwellings and similar projects with a value of more than 50,000 Bfr. The investor-taxpayer may deduct from his profits 15 % of the value of the "additional investments", i.e. those investments which exceed 10 percent of the total investments of the same kind made during the last five years. Furthermore, the value of additional investments in excess of 40 % of the value of all investments made between July 1 and December 31, 1975 may not be taken into account. The deduction may be carried forward for five years.

F. Valuation of Stock-in-Trade1. Introductory remarks

This chapter is based on the situation prior to the passing of the Law of July 17, 1975 on business records and annual accounts, which will enter into force in 1976. This Law empowers the government to make rules relating to the valuation of assets and the contents of the inventory. However, at the time this report was written, no such implementing Royal Decrees have been issued.

The rules will be based on the EEC proposal and the recommendation of the National Business Council. This part of the report will be adapted if implementing legislation is issued.

2. Valuation of Stock-in-Trade

* Stock-in-trade (i.e. raw materials and supplies, semi-finished goods, and merchandise intended for sale or use in production) are valued at

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either the cost or acquisition price actually paid or the market value or replacement price at the date of inventory whichever is the lower.

The value must be determined, taking into account likely risks in the near future relating to the use or sales possibilities, stability of prices, fashion, market trends etc. Considerable price decreases on the world market which result in a lower valuation may be recognized.

Certain textile products benefit from a special treatment. Other specific rulings concern damaged, old fashioned and similar goods and stock-in-trade of department stores.

- 3. Generally the First in, First out (FIFO) inventory system is used. In principle the LIFO and the base-stock methods are not allowed.
- 4. Decreases in value are normally treated as capital losses (see chapter C, above).

3. Special lump-sum deduction regarding stock-in-trade for 1975

To assist enterprises in facing the recent problems resulting from the continuous increase in prices and wages and costs of manufacturing and fluctuations on the world markets, the government granted a lump-sum deduction on the inventory of stock-in-trade, held on December 31, 1974 or at the date on which the financial year ends in 1975 if the year ends before December 31, 1975.

There are limitations such as on the amount of stock-in-trade to which the lump-sum deduction is applicable, the nature of the stock-in-trade and the minimum increase in value of the stocks.

The deduction is equal to a percentage varying from 2.5 % to 3.5 % of the normal value.

4. Relationship between the commercial and tax balance sheet

Under the new Law on Annual Accounts, every enterprise must, at least annually, carry out in good faith and with reasonable care the valuation necessary for it to make up an exact inventory of all its assets and liabilities. The values on the inventory are to be determined without taking into account temporary fluctuations.

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Generally, there is no obligation to enter an increase in value in the accounts. If increases in value of stock are entered in the accounts, they will be included in the taxable profit.

Decreases in value are only deductible during the taxable period in which they became actual and final.

There is no provision concerning so-called tax balance sheets. As already mentioned above (see chapter A, above) the taxpayer is bound by the balance sheet approved by the general meeting of shareholders and this is the starting point for the computation of the taxable income, which is based on the difference in net worth of the enterprise at the beginning and at the end of the taxable period.

G. Set off of business losses

(i) A loss incurred in one taxable year is deductible from the profits of the same year.

(ii) Losses may be set off against successive profits of the following five years. Carry back is not permissible.

(iii) Losses resulting from act of God or accidents incurred after January 1, 1960, are deductible without any time limitation.

(iv) Companies, set up between January 1, 1967 and June 30, 1970 and after December 31, 1971, may carry over losses incurred during the first five years without any time limitation.

* Losses are not deductible from profits made on abnormal benefits obtained from a related enterprise.

DENMARK

DENMARKA. INTRODUCTION

In Denmark, a distinction is made between ordinary income and so-called "special income".

Ordinary income includes, inter alia, income from trade or business, income from employment, and income from property, such as rents, dividends, interest and royalties.

Special income consists of certain capital gains, e.g., capital gains regarding immovable property, shares, trade marks, copyrights, as well as of certain kinds of income of a non-recurring nature, such as lump sum payments received on the termination of contracts etc.

For individual taxpayers, the ordinary income is subject to national income tax imposed at progressive rates, and to usually two taxes imposed by local authorities, at flat rates. An individual's special income, on the other hand, is subject to the special income tax, imposed at a flat rate of 50%, subject to certain exceptions.

However, for corporate taxpayers, both ordinary and special income are subject to corporate income tax, imposed at a flat rate of 37%, although the special income tax law is still relevant for the computation of the amount of special income.

It should be emphasised that the distinction between ordinary income and special income is highly relevant also for taxpayers engaged in a trade or business where the assets concerned are used for the purposes of the trade. Unlike, for instance, in Germany and the Netherlands, where all gains realised with respect to business assets constitute ordinary business profits, subject to certain exceptions, the situation in Denmark is more like the United Kingdom, where gains realised with respect to business assets are, in principle, only included in business income when the taxpayer's trade consists of, or includes, dealing in the assets concerned. As a matter of fact, different rules apply, again like in the United Kingdom, to

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many assets for which depreciation allowances have been claimed.

The main characteristics of the Danish tax system regarding the various topics covered by this report are set out in the following chapters.

DENMARKB. DEPRECIATION OF BUSINESS ASSETS1. INTRODUCTION

The deductibility of depreciation allowances is laid down, in general terms, in sec. 6 of the National Tax Law of April 10, 1922 ("Lov nr. 149 af 10. April 1922 om indkomst- og formueskat til staten"), which states: "In computing taxable income, the following deductions may be made:

a. business expenditure, i.e., expenses laid out during the year in order to produce, secure or maintain the income including ordinary depreciation allowances; etc.

Specific rules for the depreciation of the major types of business assets are given in a special Law on Depreciation Allowances ("Lov nr. 199 af 6. juli 1957 om skattemæssige afskrivninger m.v."). This act is amended from time to time, and the amended version is then normally re-published as a "lovbekendtgørelse" (Law Publication).

With respect to some other assets, the methods and rates of depreciation are based on other legal provisions or on case law.

In all cases, there is no relationship between depreciation for tax purposes and depreciation in the taxpayer's commercial accounts.

A special feature of the Danish system of depreciation allowances is that depreciation is often based on the aggregate book value of assets of a certain class, a system which is also used in Sweden, Finland and, recently, also in the United Kingdom. Another aspect which the Danish system has in common with the United Kingdom system is that depreciation of buildings is restricted to certain types of buildings only. In Denmark, the leading principle is that no depreciation is allowed for tax purposes with respect to buildings which are deemed to retain their original value through proper care and maintenance.

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Since the system of depreciation for tax purposes is completely different for the various types of assets, the survey of actual legal provisions with respect to normal depreciation and accelerated depreciation is given below for each type of assets separately.

In reading the survey it should be noted that throughout the following survey, the terms "purchase" and "sale" are used to denote several transactions which are treated in the same manner. For instance, acquisition or disposal by way of gift are deemed to constitute purchases or sales at a price equal to the value accepted for gift duty purposes.

Also, the transfer of machinery etc. used exclusively for business purposes to exclusive private use, or to partly business, partly private use, and vice versa, are treated as sales and purchases at the normal price which the assets would fetch at the time of such transfer.

Finally, the receipt of a consideration in case of expropriation, and the receipt of insurance moneys for goods damaged or destroyed are normally treated as proceeds of sale.

2. NORMAL DEPRECIATION

2.1. Machinery, equipment and similar assets (excluding ships)

2.1.1. Main system

Machinery, equipment and similar assets used exclusively for the purposes of a business are depreciated on the basis of aggregate book value at the beginning of the year, reduced by the proceeds of assets sold during the year, and increased by the full cost of acquisition of assets acquired during the first half of the year and half the cost of acquisition of assets acquired during the second half of the year. (Law on Depreciation Allowances, sec. 2). The remainder of the cost price of assets acquired during the second half of the year is included in the depreciable basis for the next year.

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For the purpose of this provision, insurance moneys received for assets damaged or destroyed are treated as proceeds of assets sold, and improvements are treated as acquisitions.

The rate of depreciation for any year is at the taxpayer's option, subject only to a maximum rate of 30%. The rate applied, however, must be a full number of percentage points, so that a depreciation of, e.g., 12.5% will not be allowed. The taxpayer is completely free to vary the rate of depreciation from year to year, between zero and 30% (There is some kind of limitation which applies to individual taxpayers only, as of the year 1975. If an individual's taxable income is reduced by depreciation allowances, allocations to the investment reserve or reductions in the value of his stock-in-trade to an amount which is less than his estimated private expenses for the year, then his taxable income may be increased to the amount of private expenses.)

Example:

depreciated book value at the beginning of the year	DKr. 1,000,000
proceeds of assets sold during the year (<u>deduct</u>)	DKr. <u>100,000</u>
	DKr. 900,000
cost of machinery and equipment purchased in first half (add)	DKr. 200,000
machinery and equipment purchased in second half for DKr. 500,000; <u>add one-half</u>	DKr. <u>250,000</u>
depreciable basis for the year	DKr. 1,350,000
depreciation at, say, 20%	DKr. <u>270,000</u>
remaining book value	DKr. 1,080,000
<u>add:</u> remaining one-half of assets purchased during second half of the year	DKr. <u>250,000</u>
depreciated book value at the beginning of next year	<u>DKr. 1,330,000</u>

The above limitation with respect to acquisitions during the second half of the year, is temporarily withdrawn during the years 1975 and 1976, as part of the taxation measures to stimulate the national economy. During those years, the full cost of acquisitions made during the second half of the year may be included in the depreciable basis.

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Although the above system of depreciation on the basis of aggregate book value supplies ample room for sufficient depreciation allowances, there is an additional provision according to which a further depreciation deduction may be claimed if the taxpayer upon disposal of any asset shows proof that for that particular asset the proceeds of sale are less than cost of acquisition minus depreciation allowances taken under the normal rules on the basis of aggregate book value (sec. 4 of the Law on Depreciation Allowances).

Another special rule applies to items of machinery and equipment whose estimated useful life does not exceed three years, or whose cost of acquisition does not exceed DKr. 1,200. In both these cases, the taxpayer may either include the cost of these assets in the aggregate basis, or deduct the full cost price in the year of acquisition, thus in fact taking depreciation at 100% of cost. (sec. 3 of the Law on Depreciation Allowances)

2.1.3. Gains realized at disposal of assets

One of the consequences of depreciation on the basis of aggregate book value, as described above, is that the sale of an asset does not give rise to any taxable gain, but merely reduces the depreciable basis. Only if the aggregate book value becomes negative, i.e., if proceeds of sales in any year exceed the aggregate book value at the beginning of the year plus acquisitions during the year, the negative amount is included in taxable income, unless new investments are made before the end of the next year. This latter period of time may be extended by the Minister of Finance under special circumstances, at the taxpayer's request. (sec. 5 of the Law on Depreciation Allowances) See chapter C for more details on this subject, as well as for special rules on the liquidation of the business.

2.1.4. Machinery and equipment used partially for private purposes

In case of machinery and equipment used partially for business and partially for private purposes, depreciation allowances are not based on aggregate book value, but each item is depreciated separately, at a maximum of 30% of

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cost price in the first year (15% if acquisition takes place in the second half of the year), and at a maximum of 30% of remaining book value in subsequent years. No depreciation is allowed for the year in which the asset is disposed of. Depreciation is limited to that part of the cost price which corresponds to the business use of the asset. Also, no depreciation is allowed at all with respect to that part of cost which exceeds DKr. 40,000 for each asset. The excess of the cost price of any item over DKr. 40,000 has to be included as a separate asset in the balance sheet of the business. (sec. 8 of the Law on Depreciation Allowances)

2.1.5. Motor cars

Virtually the same rules as apply to assets used partially for private purposes (see 2.1.4., above) apply to certain categories of motor vehicles used solely for business purposes. This currently concerns ordinary (passenger) motor cars, cars used for rent-a-car businesses or by driving schools, as well as certain delivery vans and trucks not registered as ordinary transport vehicles (with yellow licence plates). With respect to these categories of motor vehicles, depreciation is granted for each vehicle separately at the same maximum rates as stated in 2.1.4., above, if their cost price exceeds DKr. 40,000. The excess over DKr. 40,000 is not depreciable. (sec. 6A of the Law on Depreciation Allowances) However, the normal rules, as outlined in 2.1.1., above, apply to these types of motor vehicles if they are costing less than DKr. 40,000 and are used exclusively for business purposes.

2.2.1. Ships: Main provisions

Ships used exclusively for business purposes, including machinery and equipment used on board such ships, are depreciated on the basis of their aggregate book value at the beginning of the year, increased by the cost of ships acquired and reduced by the proceeds of ships sold during the year. The system and rates of depreciation are thus the same as for other items of machinery and equipment, as described in 2.1.1., above, except that the aggregate basis for ships is separated from the aggregate basis for other items of machinery and equipment, and that there is no limitation in the amount of depreciation in the year of acquisition with respect to ships

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purchased in the second half of the year. (sec. 12 of the Law on Depreciation Allowances)

2.2.2. Ships used partially for private purposes

There are no express provisions in the law with respect to ships used partially for business and partially for private purposes. It is understood that for these ships a partial depreciation will be allowed to reflect the business use of the ships. No depreciation is allowed for pleasure boats, yachts and other ships used for private purposes only.

2.3. Buildings and installations in buildings

As indicated in the introduction (see 1, above) depreciation with respect to buildings is, in principle, only granted with respect to buildings which do not retain their original value under proper care and maintenance.

Due to this general principle, depreciation is allowed for the following types of buildings used for business purposes (sec. 18 of the Law on Depreciation Allowances):

- a) buildings used for agriculture, fur farming, poultry breeding, fish farming, fishing, forestry, market gardening, industry, retail trade, handicraft, as sports halls, petrol stations, car washes, road hoalage centres, storage buildings used in connection with the said activities, and storage buildings used in the wholesale trade;
- b) movie and other theatres, amusement buildings, community centres, assembly rooms, hotels, restaurants, schools, certified old age and nursing homes, garages, laboratories, as well as storage buildings used in connection with the above activities;
- c) buildings or rooms situated in, or attached to buildings as enumerated under a) and b), above, which are used for the purpose of the business for which these other buildings are used. Also depreciable are roads, parking lots, fences etc. located in the vicinity of qualifying buildings;
- d) other buildings which due to their construction or other special circumstances may be deemed to be subject to such deterioration that their value will not be retained through normal maintenance. In practice, the

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reference to the construction of buildings under heading d) will enable the taxpayer to depreciate buildings made of timber which would not qualify otherwise, and the reference to "special circumstances" is frequently the basis for allowing depreciation on buildings located abroad under unfavourable climatic conditions.

Examples of buildings which do not normally qualify for depreciation allowances are offices and dwelling houses. However, offices attached to or forming part of otherwise qualifying buildings are depreciable under heading c), above. Also, dwelling houses situated in another country and used for business purposes may be depreciated if they are subject to extraordinary wear and tear, due, for instance, to existing climatic conditions.

If a building is only partially used for business purposes, depreciation is also allowable only for that part, whereby the total cost is divided on the basis of floor space occupied for qualifying and non-qualifying purposes. However, no depreciation is allowed at all if less than 30% of total floor space is used for qualifying (business) purposes, unless the floor space occupied for business purposes amounts to at least 300 square meters.

Depreciation allowances are granted separately for so-called "special" installations in buildings, such as central heating, air conditioning and lifts. Not only installations in buildings which themselves qualify for depreciation allowances are depreciable, but also installations in buildings which are not eligible for depreciation, with the exception of "special" installations in one or two family dwelling houses. It is a further prerequisite that the installations are located in buildings used for business purposes. In case of dual use (for business and private purposes), the installation should primarily serve business purposes.

The rates of depreciation allowed are different for the various categories of buildings and installations as follows (secs. 22 and 23 of the Law on Depreciation Allowances):

--for buildings listed under heading a), above, the maximum rate of depreciation is 6% of cost for the year of acquisition and each of the next nine

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years, and 2% annually in subsequent years; thus, the entire cost of acquisition can be written off in 30 years; these rates may be increased if the buildings are subject to such deterioration that their estimated life is less than 50 years from the year of construction which as a matter of fact does not necessarily coincide with the year of acquisition by the taxpayer; the same rates of depreciation apply to buildings listed under heading b), above, which are attached to buildings listed under heading a);

--for buildings listed under heading b), except those attached to buildings under heading a) (see above), for buildings listed under heading d), and qualifying dwelling houses situated in another country, the maximum rate of depreciation is 4% of cost for the year of acquisition and each of the next nine years, and 1% annually in subsequent years; thus, for these buildings the entire cost can be written off in 70 years; the rates may be increased if their estimated life since the time of construction is less than 100 years.

--for buildings, fences, etc. listed under heading c), depreciation is allowed at the same rates as apply to the buildings to which they are attached;

--for "special" installations located in depreciable buildings, the maximum rate of depreciation is 8% of cost in the year of acquisition and in each of the next 9 years, and 4% annually in subsequent years;

--finally, for "special" installation in non-depreciable buildings there is a fixed rate of depreciation of 4% of cost per annum; as in the case of buildings, the annual rate of depreciation may be increased in case of an estimated useful life of less than 25 years.

In all cases, except the last (regarding installations in non-depreciable buildings) the taxpayer may take depreciation in any year at a lower rate and so extend the total period of depreciation as he thinks fit.

2.4. Other assets

For a number of intangible assets the rules for depreciation are laid down in sec. 15 of the Special Income Tax Law (Lov om særlig indkomstskat m.v.). Assets covered by this provision include the following:

--goodwill obtained may be depreciated at a rate of 15% of cost annually;

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--patent rights, copyrights and trademarks and rights derived from profit-sharing or leasing contracts, may be written off in equal annual installments over the years of their existence, and, if the rights are not limited in time, in a period of 10 years, i.e., at 10% per annum.

3. ACCELERATED DEPRECIATION

3.1. Permanent measures for machinery, equipment, buildings and installations

Accelerated depreciation is allowed for certain investments in machinery, equipment and similar assets used exclusively for the purposes of a business and for buildings and installations for which normal depreciation is allowed (secs. 29E et seq. of the Law on Depreciation Allowances).

This accelerated depreciation is subject to the following conditions:

- a) the taxpayer must have concluded a binding contract for the delivery of qualifying assets or he must have decided to manufacture them within his own business;
- b) the qualifying assets must be delivered or be ready for use not earlier than in the year following the year the contract is concluded or the decision to manufacture the assets is taken, nor later than in the fourth year following that date;
- c) the total contracted price or estimated cost must exceed DKr. 700,000.

The accelerated depreciation amounts to a maximum 30% of that part of qualifying expenditure which exceeds DKr. 700,000, subject to a maximum of 15% per annum. Qualifying expenditure includes the contracted price and subsequent price increases are not taken into account. In the case of buildings, the cost of the land on which the building will be erected is excluded.

The accelerated depreciation taken is deducted from the cost of acquisition of the relevant assets for purposes of normal depreciation. If the accelerated depreciation allowance relates to more than one asset, the aggregate accelerated depreciation allowance is expressed as a percentage of total cost of the assets in question, and for purposes of normal depreciation, the cost of each separate asset is reduced by the same percentage.

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The accelerated depreciation may be spread by the taxpayer over the year the contract is concluded or the decision to invest (in case of own manufacture) is made and the three following years, except that it must in any case be taken prior to the year the assets are delivered or put into use, subject to the limitation of 15% per annum.

3.2. Permanent measures for ships

With respect to ships an accelerated depreciation is granted if the contracted price amounts to at least DKr. 200,000. The accelerated depreciation applies only to contracts for the construction of new ships and amounts to 30% of the contracted price.

The accelerated depreciation allowance may be spread over the year the contract is made and subsequent years, but it must be taken prior to the year of delivery, and the annual allowance is subject to a maximum of 15%. The accelerated depreciation allowance taken is deducted from the cost of acquisition for purposes of normal depreciation.

3.3. Temporary accelerated depreciation allowance

As part of the taxation measures to stimulate the national economy, a temporary accelerated depreciation allowance was granted by law of June 26, 1975 (Lov nr. 292 af 26. juni om en ekstraordinær afskrivning og om forhøjede ordinære afskrivninger for 1975 og 1976).

Under this law, an accelerated (additional) depreciation allowance of not more than 15% of cost is granted with respect to machinery and equipment used exclusively for business purposes, purchased during 1975 and 1976. However, this additional depreciation does not apply to certain categories of motor vehicles (see. 2.1.5., above), nor to assets for which the permanent accelerated depreciation allowance (see. 3.1., above) is granted.

The additional depreciation may be spread by the taxpayer over the years 1975 through 1978, for purchases in 1975 and over the years 1976 through 1978 for purchases in 1976. Both the normal depreciation and the temporary

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additional depreciation are deducted in computing the aggregate book value which is the depreciable basis for the next year.

C. TAXATION OF CAPITAL GAINS AND LOSSES1. INTRODUCTION

Generally speaking, unrealised capital gains, i.e. gains originating from revaluation of assets on the balance sheet, are not taxable in Denmark. As a matter of fact, different rules apply if the owner is a dealer in the assets concerned, in which case tax liability will normally be governed by the provisions regarding the valuation of stock-in-trade (see Chapter F, below).

With respect to gains and losses occurring at the disposal of assets, not being stock-in-trade, the taxation consequences will depend on the nature of the assets concerned, the period of time between acquisition or disposal, and whether or not the assets are sold in the normal course of the taxpayer's business.

With respect to the latter point, a distinction must be made between the tax system of, e.g., the German Federal Republic and the Netherlands on the one hand, and of, e.g., Denmark and the United Kingdom on the other. In Germany and the Netherlands, the basic distinction with respect to capital gains is between business property and private property, gains realized on business property normally being taxed in the same way as ordinary business profit, subject to certain exceptions, but irrespective of whether the seller is or is deemed to be a dealer in the assets concerned. In Denmark, on the other hand, like in the United Kingdom, the basic distinction is whether or not the seller is (or is deemed to be) a dealer in the assets concerned. In other words, a taxpayer engaged in business disposing of a factory building and a private person selling a house are basically treated in the same manner, and different taxation consequences emerge only if the seller is a dealer in immovable property or if the transaction is deemed to be of a speculative nature.

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The distinction in actual tax liability with respect to the various types of business assets is closely related to the system of depreciation applicable to the assets concerned, as explained below.

A further interesting point in the Danish system of capital gains is the computation of taxable gains with respect to immovable property. On the one hand, the actual gain in money terms is reduced in order to take account of inflation, but, on the other hand, the resulting "real" gain is, in effect, taxed at a higher rate than other taxable capital gains.

The main provisions regarding the taxation of capital gains are laid down in the special income tax law (Lov om saerlig indkomstskat m.v.), under which capital gains and certain other types of so-called "special income" (mainly certain lump sum receipts) are subject to the special income tax imposed at a flat rate. However, the "special income" of corporate taxpayers, although computed in accordance with the rules laid down in the special income tax law, is subject to the ordinary corporate income tax at the usual rate of, currently, 37%.

2. MACHINERY AND EQUIPMENT (INCLUDING SHIPS) USED FOR BUSINESS PURPOSES

2.1.1. Main provisions

As indicated earlier (see Chapter B, 2.1.3., above), gains realised at the sale of items of machinery and equipment used exclusively for business purposes do not as such give rise to a taxable capital gain: the proceeds are deducted in computing the aggregate depreciable basis and thus only reduce the scope for depreciation allowances in the year of disposal and subsequent years. In practice, this implies that taxable profits are increased over a number of years by an amount equal to the actual gain. The same applies if assets are donated without adequate consideration, if they are taken out of the business by the taxpayer and appropriated to private use, in which cases the assets are deemed to have been sold for their true value. Also, in case of expropriation or damage, the amounts received as compensation are treated as proceeds of sale.

The proceeds of sale etc. of assets having a useful life of three years

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or less or a cost price not exceeding DKr. 1,200 (the cost of which has been deducted in the year of purchase, see Chapter B, 2.1.2., above) are added back to ordinary profits in the year of disposal.

In one instance, the deduction of the proceeds of sale etc. from the aggregate book value may give rise to the recognition of taxable income, i.e., when the aggregate book value becomes negative. In that case, the negative balance is included in taxable income, either for the year of sale or for the next year, at the taxpayer's option, unless the negative balance is offset by acquisitions of assets during the year of sale or in the next following year (sec. 5 of the Law on Depreciation Allowances).

2.1.2. Special rules for motor cars

For some types of motor cars the total depreciation allowable is restricted to DKr. 40,000 (see Chapter B, 2.1.5., above), even if the motor car is used exclusively for business purposes.

If such a motor car is sold at a gain, i.e., if proceeds of sale exceed depreciated book value (including the non-depreciable part of the purchase price), the gain is included in taxable profits. If, on the other hand, a loss is incurred at the sale, i.e., if proceeds of sale are less than depreciated book value, such loss is only deductible to the extent that it exceeds the non-depreciable part of the purchase price (sec. 6A of the Law on Depreciation Allowances).

Example:

A motor car with a purchase price of DKr. 60,000 is sold during the year following the year of purchase for DKr. 35,000. Depreciation taken in the year of purchase amounts to DKr. 12,000 (30% of DKr. 40,000; the maximum depreciation allowed). No depreciation allowance may be taken for the next year, the year of sale. Depreciated book value thus amounts to DKr. 48,000, consisting of depreciable part of purchase price (DKr. 40,000), less depreciation taken (DKr. 12,000), plus non-depreciable part of purchase price (DKr. 20,000). The actual loss incurred amounts to DKr. 12,000 (being the difference between sales price of DKr. 35,000 and book value of DKr. 48,000).

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As this loss of DKr. 13,000 is less than the non-depreciable part of the purchase price (DKr. 20,000), no part of the loss is deductible.

If the motor car has been used partly for business and partly for private purposes, any gain or loss computed as above (i.e., losses only to the extent that they exceed the non-depreciable part of the purchase price), is only partially taxable or deductible, respectively, viz. only to the extent of the use for business purposes. In computing the gain or loss, also depreciation concerning private use although not allowed for tax purposes, must be taken into account (see below for further details).

2.1.3. Special rules for assets used partially for private purposes

With respect to assets used partially for business and partially for private purposes, the first DKr. 40,000 of cost is partially depreciable for tax purposes, viz. to the extent that the asset is used for business purposes, and the excess over DKr. 40,000 is not depreciable at all (see Chapter B, 2.1.4., above).

If such an asset is sold, any gain or loss is computed as the difference between proceeds of sale and depreciated book value, depreciated book value in this context meaning purchase price minus total depreciation (including depreciation related to private use), at the rate used for tax purposes with respect to the business use of the asset. If this computation results in a gain, that part of the gain is included in taxable income which bears the same ratio to the total gain as depreciation for tax purposes bears to total depreciation.

The same applies, mutatis mutandis, if a loss occurs at the sale, except that such loss is only allowable insofar as it is related to business use and to the extent that it exceeds the non-depreciable part of the purchase price (i.e., the excess over DKr. 40,000) (sec. 9 of the Law on Depreciation Allowances).

Example:

An asset used for one-half for business purposes, and for the other half

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for private purposes is purchased for Dkr. 70,000. It is sold for Dkr. 10,000, and total depreciation taken amounted to Dkr. 20,000, one-half of which was allowable for tax purposes.

The total loss is computed as the difference between proceeds of sale (Dkr. 10,000) and purchase price minus total depreciation (Dkr. 70,000 minus Dkr. 20,000 or Dkr. 50,000), and thus amounts to Dkr. 40,000. Of this loss, an amount of Dkr. 30,000 (the excess of the purchase price at Dkr. 70,000 over the amount of Dkr. 40,000) is disregarded completely. The remaining part of the loss (Dkr. 10,000) is deductible to the extent that it relates to business use, i.e. for one-half, so that only Dkr. 5,000 is deductible for tax purposes.

2.2 Speculative sales and sales by dealers

As explained above (see 2.1.1.), sales of machinery, equipment and ships do not normally give rise to a taxable gain.

However, if the seller's business includes the sale of such assets, or if the assets are acquired for purposes of speculation, any gain (or loss) is included in the taxpayer's taxable income, the gain (or loss) being computed as the difference between sales price and depreciated book value.

A transaction is normally deemed to be speculative, if the sale takes place within two years from the date of acquisition, unless the taxpayer shows proof to the contrary. If the period of ownership exceeds two years, the burden of proof shifts to the tax authorities: in that case, the revenue authorities have to show proof that the transaction was a speculative one.

2.3. Sales at the liquidation or transfer of the business

If the sale of machinery and equipment used exclusively for business purposes, and ships occurs on the occasion of the transfer or liquidation of the taxpayer's business, the gain or loss realized (i.e., the difference between amount received and aggregate depreciated book value) is classified as "special income" (sec. 2 of the Special Income Tax Law) which implies

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that individual taxpayers will be subject to the special income tax at a flat rate of 50%, instead of the ordinary national income tax (imposed at progressive rates) and the local income tax (imposed at a flat rate). However, for corporate taxpayers, both ordinary income and special income are subject to the corporate income tax, at a uniform rate of currently 37%.

However, also in this case, any gain or loss is included in ordinary income if the sale took place in the course of a business or by way of speculation (see 2.2., above).

Also, any gain (or loss) realized on the sale of ships or participations in ships is included in ordinary income if the ships are acquired less than 5 years prior to their sale (sec. 3 of the Special Income Tax Law).

3. IMMOVABLE PROPERTY

3.1. Main provisions

Generally speaking, gains on the sale of immovable property are classified as special income, but losses are disregarded.

With respect to immovable property used for business purposes, a special feature is that part of the total gain, viz. that part which is equal to the depreciation allowances taken in the past, is included in special income for its nominal amount, whereas the remainder of the gain, i.e. the total gain on land and the excess of the sales price of the buildings over their original purchase price is adjusted to account for inflation, the adjusted gain then being multiplied, so that in effect, the adjusted gain is subject to special income tax (or corporate income tax) at a higher rate than other types of special income.

The latter (adjusted) part of the gain is defined as the difference between sales price and adjusted cost of acquisition (sec. 7A of the Special Income Tax Law).

For this purpose, the cost of acquisition is adjusted as follows:

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If the entire property is acquired on or after January 1, 1966, the cost of acquisition and of subsequent improvements (improvements costing DKr. 1,000 or less in any year are disregarded) are first increased by a fixed addition of 30%, and secondly by an annual addition for each year of ownership (excluding the year of sale). This annual addition amounts to 8% for each of the first three years, 9% for each of the next three years, and 10% annually for subsequent years.

If the property is acquired prior to January 1, 1966, the adjusted cost of acquisition may be computed in the same way, except that the annual addition of 8, 9 or 10% is not given with respect to years prior to 1966.

Alternatively, if the entire property is acquired prior to January 1, 1966, the taxpayer may take the value as at the 13th general property valuation as a basis, increased by the value of improvements not taken into account at ~~after~~ the 13th general valuation, and carried out before January 1, 1966. This alternative valuation is then also increased by the fixed addition of 30%, and by an addition of 8% for the years 1966 through 1968, 9% for the years 1969 through 1971, and 10% thereafter.

The adjusted gains (equal to sales price less adjusted cost of acquisition and improvements) realized in any year are then reduced by DKr. 40,000, increased by a further deduction of DKr. 60,000 if the alternative calculation for property acquired prior to January 1, 1966 is used. This deduction of DKr. 40,000 or DKr. 100,000, however, is granted only once in every four years. The resulting net gain is finally increased by 50% for individual taxpayers and by 100% for corporate taxpayers, which implies an effective rate of 75% for individuals (150% of the gain taxed at 50%), and of 74% for corporate taxpayers (200% of the gain taxed at 37%).

Example:

A factory building is purchased in 1968 for DKr. 500,000, and sold in 1976 for DKr. 2,000,000. According to the latest general valuation, DKr. 100,000 of the total purchase price was attributable to the land and Dkr. 400,000 to the building itself. Of the total sales price, DKr. 500,000 is attributed to the land and DKr. 1,500,000 to the building. Total depreciation taken with respect to the building amounted to DKr. 160,000. The total actual

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gain in respect of the building amounts to DKr. 1,100,000 (being the difference between DKr. 1,500,000 and DKr. 400,000), but only an amount of DKr. 160,000 (equal to depreciation allowances taken) is included in special income for its nominal amount.

For the remaining gain (the excess of sales price of land and building over their cost of acquisition), the adjusted taxable gain is computed as follows:

purchase price	DKr. 500,000
add: fixed addition of 30%	DKr. 150,000
: Annual addition:	
3 times 8% for 1968 through 1970	
3 times 9% for 1971 through 1973	
2 times 10% for 1974 and 1975	
in all 71%	DKr. 355,000
adjusted purchase price	DKr. 1,005,000
sales price	DKr. 2,000,000
adjusted gain	DKr. 995,000
less special deduction (granted only once for every four years)	DKr. 40,000
adjusted taxable gain	<u>DKr. 955,000</u>

The amount of DKr. 955,000 is then increased by 50% for individual taxpayers, and the resulting amount taxed at 50%, and increased by 100% for corporate taxpayers, the resulting amount being taxed at 37%.

Thus, the total amount liable to tax in this case consists of DKr. 160,000 (equal to prior depreciation allowances), which is taxed at 50% for individuals and at 37% for corporate taxpayers, plus DKr. 955,000, which through the multiplication factor is taxed at 75% for individuals and at 74% for corporate taxpayers.

In case of expropriation, an additional deduction may be granted in computing the adjusted taxable gain.

DENMARK3.2. Speculative sales and sales by dealers

As in the case of machinery and equipment (see 2.2., above) the total net gain (or loss), without adjustments is included in the taxpayer's ordinary income and taxed at ordinary rates.

3.3. Sales at liquidation of the business

There are no special provisions regarding the sale of immovable property at the time of liquidation or transfer of the business.

3.4. Replacement of immovable property

There is no exemption or relief on the sale of immovable property used for business purposes and its replacement by other immovable property used for the same purposes.

Only the payment of the tax due may be postponed in this case, upon the taxpayer's request to the Ministry of Finance, subject to several conditions (sec. 7B of the Special Income Tax Law).

4. OTHER BUSINESS ASSETS4.1. General

Other fixed business assets, the sale of which will give rise to taxable gains or losses include: goodwill, patents, copyrights, trademarks and other rights limited in time, and shares. The gains and losses with respect to these assets are all included in special income and taxed accordingly. As in the case of other assets, however, the gains and losses will be included in ordinary income in case of speculation or dealing in the assets concerned.

4.2. Goodwill, patents, copyrights, trademarks, etc.

The taxable gain (or loss) is computed as the difference between sales price on the one hand, and purchase price as reduced by depreciation allowances taken, on the other. The resulting gain (or loss) is included in special income for its nominal amount, and taxed accordingly (i.e. at 50% for individual taxpayers,

and at 37 % for corporate taxpayers).

As indicated earlier, the gains or losses are included in ordinary income if the assets concerned are acquired for the purpose of speculation, or in the framework of a trade carried on by the taxpayer. The latter case only applies, if the taxpayer's trade consists of, or includes, dealing in the assets concerned.

4.3. Shares.

Gains and losses on the sale of shares and similar securities, of subscription rights to such shares and similar securities are also included in special income. In general, the gain (or loss) is computed as the difference between sales price and cost of acquisition. There are special provisions concerning the computation of gains (or losses) if only a part of a shareholding is disposed of. In that case, the aggregate purchase price is attributed for a proportionate part to the shares sold.

If the shares etc. are acquired in the framework of a trade carried on by the taxpayer, or within two years before the date of sale, the gain or losses are included in ordinary income. Thus, in this case, a fixed time limit of two years is applied in order to determine whether or not the transaction should be deemed to be speculative.

5. MERGERS

5.1. Introduction

The taxation aspects of mergers are currently governed by a law of May 2, 1967, as amended from time to time (Lov nr. 143 af 2. maj 1967 om beskatning ved sammenslutning af aktieselskaber m.v.). Under sec. 1 of this law a merger is deemed to take place, where a company transfers its entire property to another company or when it is absorbed by another company.

The law not only deals with the taxation consequences for the companies involved, but also with the eventual tax liability of shareholders.

5.2. System of the law on mergers; implications for companies

The provisions of the law on mergers will apply upon request to the Ministry

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of Finance, which may impose certain conditions, apart from two conditions laid down in the law itself, viz., that at least 90% of the value of the shares in the absorbed company will be paid for in shares in the absorbing company and that the absorbed company will be struck off the companies register within eight months after the merger is reported to the registrar.

The law does not apply to so-called stock mergers, whereby a company acquires all outstanding shares of another company. However, in such cases the companies concerned may apply for joint taxation, subject to certain conditions, so that also in that case a merger type situation will be effected for tax purposes as far as the companies are concerned. In this case, there are no exemptions for the shareholders of the company taken over.

If all conditions required by the Ministry of Finance and by the law on mergers are satisfied, the effects are as follows:

--all income and outgoings of the absorbed company prior to the merger will be included in the computation of the absorbing company's taxable income, to the extent that they were not taken into account in previous tax assessments of the absorbed company.

--all assets of the absorbed company are deemed to be acquired by the absorbing company at the time and for the price they were acquired by the absorbed company. Thus, no taxable gains will arise. Also, depreciation and reductions in stock-in-trade values are deemed to have been taken by the absorbing company. Also, allocations to the investment reserve made by the absorbed company are deemed to be made by the absorbing company in the same years.

--losses incurred prior to the merger by either the absorbed or the absorbing company may not be set off against profits realized by the absorbing company after the merger.

--the transfer of assets from the absorbed to the absorbing company does not affect the question whether such assets have or have not been acquired in the framework of a trade or for speculative purposes.

5.3. Implications for shareholders

The implications for the shareholders in an absorbed company in case of a

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qualifying merger are that no gain or loss is realised to the extent that they receive shares in the absorbing company in exchange for their shares in the absorbed company. If the new shares are subsequently sold, they are deemed to be acquired at the time and for the price the shares in the absorbed company were acquired. This will affect the computation of the gain or loss realised at the sale of the shares in the absorbing company, and also whether such gain (or loss) is taxed as ordinary income or as special income (see 4.3., above).

To the extent that a shareholder in the absorbed company receives assets other than shares in the absorbing company, e.g., a payment in cash, he is deemed to have sold shares in the absorbed company to the extent that their value at the time of the merger is equal to such payment. If the shares in the absorbed company were acquired at different moments (and at different prices), it is presumed that the shares first acquired are sold in this way. It is to be noted, however, that at least 90% of the total consideration given by the absorbing company to all shareholders together, should consist of shares in the absorbing company.

D. RESERVES

1. INTRODUCTION

The allocation to reserves, being either "true" reserves or reserves for future expenses, is recognised in Denmark for tax purposes in a few cases only.

With respect to reserves for future or expected losses or expenses, the general rule is that such reserves cannot be created for tax purposes, because of the underlying principle that losses and current expenses are not deductible for tax purposes until they are actually incurred.

The basic legal provisions regarding this principle are to be found in sec. 6 of the National Tax Law of 1922; where business expenses are defined as expenses incurred in the course of the year etc. and where it is explicitly stated that the income is taxable no matter how the income is used by the

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taxpayer, whether for private purposes, for increasing or improving his property, for the expansion of his business or for allocation to reserves, etc.

For instance, no general reserve may be created for bad debts, and losses on outstanding debts are only recognised with respect to any particular debtor, if the taxpayer is able to prove that the debtor will not pay his debt, due to bankruptcy or some other reason. Only banks and hire-purchase enterprises may create reserves for bad debts, if they can show that a certain percentage of outstanding debts has usually been irrecoverable over a number of years.

Also, rather strict rules are laid down in case law, regarding the creation of reserves with respect to guarantee- or service commitments which may arise with respect to goods sold by the taxpayer. Allocations to reserves for service commitments are not allowed at all. Any expenses are only deductible in the year in which they are actually incurred. The same applies to guarantee commitments, where the period of guarantee does not exceed one year, unless a definite claim has been received in that year, in which case the estimated cost of meeting the claim may be deductible even if actually expended in the next year. If the guarantee period exceeds one year, allocations to a reserve may only be made if the taxpayer is able to prove that considerable amounts have been involved in meeting such claims in previous years.

Allocations to reserves in order to meet heavy expenditure on maintenance will also generally be unallowable for tax purposes.

Although the normal rules for the computation of taxable income are thus rather strict with respect to allocations to reserves, an important feature in Danish tax law is the so-called "investment reserve", to which all taxpayers engaged in a trade or business may allocate a substantial part of their pre-tax profits. This reserve must be used at a future date for new investments in qualifying business assets, and the amounts of the reserve to be used are deducted from the cost of the new assets as a preliminary depreciation allowance. One of the reasons for introducing the

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investment reserve was to rectify to a certain extent the situation that ordinary depreciation is based on historic cost, so that depreciation allowances alone are not sufficient to warrant the continuity of a business under circumstances of rising prices. The main provisions regarding this investment reserve are set out under 2, below.

2. THE INVESTMENT RESERVE

The provisions regarding the investment reserve are currently laid down in a law of November 30, 1973, as amended (Lovbekendtgørelse nr. 627 af 30. november 1973 om investeringsfonds).

Allocations to the investment reserve, which are deductible for tax purposes, may be made by individual and corporate taxpayers who are engaged in a trade or business.

The annual allocation is subject to a maximum of 25% (prior to 1975--20%) of adjusted taxable business profits, i.e. taxable business profits increased by deductible interest payments made, and reduced by any interest and dividend payments included in business profits. The minimum allocation amounts to DKr. 500 in any year in which an allocation is made (sec. 4 of the Law);

The maximum allocation to be computed has to be reduced by any accelerated depreciation for ships and by any accelerated depreciation for substantial investments in machinery etc. and buildings (see Chapter B, under 3.2 and 3.1 , above) taken during the year (sec. 4 (2) of the Law).

The amount of the allocation must be deposited in a special blocked account with a Danish bank or approved savings institution. However, if the taxpayer keeps proper accounting records, only 50% of the allocation has to be deposited (sec. 5 of the Law).

The allocation must be used, not earlier than in the year following the allocation, nor later than at the end of the 12th year following the year of allocation, for a preliminary depreciation of qualifying investments (sec. 6). The normal and accelerated depreciation allowances otherwise

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available (see Chapter B, above), are only granted to the extent that the cost price of the qualifying investments exceeds the amount used from the investment reserve for the purpose (sec. 7). Thus, in effect, use of the investment reserve implies a full or partial depreciation of qualifying investments at the time the allocation to the reserve is made, but the total depreciation is still limited to the cost of the investments, in that depreciation allowances otherwise available are reduced by the amount of the reserve used for the investment in question.

The time limit of 12 years may be extended by the Ministry of Finance if the taxpayer is able to prove that the delay is caused by circumstances beyond his control (sec. 6 (2)).

If the taxpayer notifies the tax authorities that he has chosen to use the investment reserve, in whole or in part, a corresponding amount of the blocked deposit is released, provided the tax authorities are satisfied that the reserve is used for qualifying investments and that all further conditions are met (sec. 8).

Qualifying investments for which the reserve may be used are: machinery and equipment, etc., used exclusively for business purposes, ships used for business purposes, buildings eligible for depreciation allowances, and special installations in such buildings (sec. 3). However, the reserve may not be used for machinery, equipment, etc. with an estimated useful life of not exceeding 3 years, or a cost price not exceeding Dkr. 1,200, nor for special installations in buildings which are themselves not eligible for depreciation allowances. Neither may the reserve be used for any assets prior to their delivery or manufacture by the taxpayer himself (sec. 3).

If the reserve, or any part of it, is not used for qualifying investments within the stated time limit (usually 12 years following the year of allocation), the unused amount is added back to taxable profits of the year the time limit is exhausted, increased by 5% for each year the unused amount has been reserved. Under special circumstances, the Ministry of Finance may allow an earlier release of unused reserves, in which case the 5% increase

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will apply for each year from the year following the allocation up to and including the year of release. In these cases, the amount deposited in the blocked account is not released, but is used as security for payment of the tax due (sec. 9).

Special provisions apply in case of death or bankruptcy of the taxpayer or upon the liquidation of a company or termination of a business. In these cases, the unused amount of the reserve is added to taxable profits of the year or years for which the allocations were made, but without the increase of 5% per annum. Only in case of termination or liquidation without bankruptcy proceedings, the amount of tax due as a result of the restored tax liability for the allocations is increased by 5% interest for each year of delay, computed from the end of the respective years of assessment (sec. 10).

If, apart from the provisions of secs. 9 and 10 considered above, the allocations to the investment reserve are used for other than qualifying purposes, such allocations are added back to taxable profits of the years in which the allocations were made, and the tax due as a result of this tax liability is increased by a 100% penalty (sec. 11).

E. OTHER INVESTMENT INCENTIVES1. INTRODUCTION

Apart from the rather generous depreciation allowances and the investment reserve available to businesses in Denmark, there are only very few other investment incentives available in the field of taxation.

For example, no investment allowances, which would enable a taxpayer to write off more than 100% of the cost of certain investments are normally available.

However, investment allowances are used from time to time as a temporary incentive measure to stimulate the economy.

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At present, there are two laws granting investment allowances, for investments before the end of the year 1976 in buildings and machinery and equipment, respectively. These allowances are considered under 2 and 3, below.

In recent years, an investment allowance has also been granted for investments in qualifying buildings in certain development areas in Denmark during the period from October 1, 1968 until December 31, 1970. The allowance amounted to 5% of the investment, in each of the years 1970 through 1973. As this investment allowance is now no longer in force, it will not be discussed in this survey.

2. TEMPORARY INVESTMENT ALLOWANCE FOR BUILDINGS

By law of June 26, 1975 (Lov nr. 294 of 26. juni 1975 om midlertidigt investeringsfradrag) a temporary investment allowance is granted with respect to the construction, reconstruction or improvement of business buildings.

The investment allowance applies to:

--the construction of a new building, or the reconstruction of an existing building which was not eligible for depreciation allowances prior to the reconstruction, commenced during the period from April 1, 1975 to December 31, 1976, provided that the building is completed without interruption and taken into use not later than 2 years from the start of the construction work for purposes which qualify the building for ordinary depreciation allowances;

--the reconstruction or improvement of existing buildings eligible for depreciation allowances, commenced, completed and taken into use as set out above.

The allowance is granted for the year in which the building is completed and taken into use and for the next year and amounts to 5% per annum (i.e., 10% in all) of the cost price of the building (including the cost of special installations in the building), or of the cost price of the reconstruction or improvement, as the case may be. The investment allowance, however, is granted only on that part of the cost price which exceeds DKr. 60,000.

The investment allowance does not affect the size of depreciation allowances

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available under the normal rules (see Chapter B, above). This implies that the allowance is granted over and above depreciation of the full cost of qualifying buildings, etc., so that the taxpayer is entitled to aggregate deductions amounting to 110% of the cost price of the qualifying buildings etc.

3. TEMPORARY INVESTMENT ALLOWANCE FOR MACHINERY AND EQUIPMENT

Following the temporary investment allowance for buildings, a similar allowance was introduced for machinery and equipment by law of September 16, 1975 (Lov nr. 443 af 16. september 1975 om midlertidigt investeringsfradrag for maskiner, inventar og lignende driftsmidler).

This investment allowance is granted with respect to machinery, equipment and similar assets used exclusively for business purposes which are subject to ordinary depreciation on the basis of collective book value, except for those motor vehicles which are subject to special rules (see Chapter B, under 2.1.5., above), provided that the machinery, equipment and similar assets are acquired during the period from September 20, 1975 to December 31, 1976.

The allowance, which is effected through a deduction from taxable income for the year in which the investments are made, amounts to 20% of the difference between the cost of qualifying assets acquired during the stated period on the one hand, and the proceeds of assets sold during the same period on the other. Cost of improvement is also considered as cost of acquisition for the purposes of the allowance, and considerations received in case of expropriation as well as insurance moneys received in case of loss or damage are treated as proceeds of sale. The allowance does not apply to acquisition through gift or inheritance, nor to transactions between closely related companies or between a company and an individual, where the individual has a decisive influence on the carrying on of the company's business.

The allowance does not affect depreciation allowances available, so that a total of 120% of cost of qualifying investments can be deducted through use of the investment allowance.

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However, use of the investment allowance may affect the use of the temporary accelerated depreciation allowance (see Chapter B, under **3.3.**, above) or vice versa.

The relevant provision (sec. 3(2) of Law no. 443 of September 16, 1975) states that if the taxpayer has notified the authorities which percentage of temporary accelerated depreciation will be used by him for the years of income 1975 and/or 1976, the investment allowance will not apply. It seems, therefore, that the temporary accelerated depreciation allowance and the investment allowance are mutually exclusive.

DENMARKF. VALUATION OF STOCK-IN-TRADEI. MAIN PROVISIONS

The valuation of stock-in-trade for tax purposes is currently governed by a law publication of May 10, 1973 (Lovbekendtgørelse nr. 255 af 10. maj 1973 om skattemæssig opgørelse af varelagre m.v.).

The basic rule is that each taxpayer engaged in a trade or business, whether individual or corporate body, may choose for each separate category of goods in his stock-in-trade, one of the following three bases of valuation, viz.:

--market price as at the close of the accounting year;

--cost price, including freight charges and customs duties etc.; (although the law is not specific on this point, it appears that both LIFO and FIFO methods may be used in identifying the goods); or

--cost of manufacture, if the goods are produced in the taxpayer's own business. No rules are given as to how the cost of manufacture must be computed; in general, it seems to be allowed to exclude most indirect and overhead expenses.

The value as computed under the above basic rule, i.e., cost or market value, may be reduced by the taxpayer by a maximum of 30%, for all stocks of goods, raw materials, finished or semi-finished products, packaging materials, and auxiliary goods, including fuels, belonging to the business at the close of the year. Thus, the actual valuation may amount to between 70 and 100% of cost or market value, as the taxpayer elects.

The actual percentage of the reduction used by the taxpayer must be shown in the balance sheet or in the tax return. The same value as taken at the end

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of any year must appear on the opening balance sheet for the next year.

2. SPECIAL RULES FOR GOODS ON ORDER

Until the year 1976, taxpayers were entitled to an additional deduction with respect to goods definitely ordered during the year but actually delivered in the next year. Originally, the maximum deduction under this provision amounted to the difference between the contracted price and 70% of market value at the close of the accounting year, but this special deduction has been gradually phased out over the years 1973 through 1975. In 1973, 1974 and 1975, the maximum deduction amounted to the difference between contracted price and 75%, 80% and 90%, respectively, of market value at the close of the accounting year.

3. SPECIAL ANTI-AVOIDANCE RULES FOR STOCKS-IN-TRADE ABROAD

The main provisions, as set out under 1, above, also apply, in general, to stocks-in-trade located abroad. However, the special reduction of up to 30% may not be fully allowed if the income from the foreign business activity is exempt from Danish tax pursuant to tax treaty provisions, and the use of the reduction causes a loss from the foreign business activity, which is deductible in Denmark notwithstanding that a profit would be exempt. Thus, if after the said reduction the foreign business activity shows a loss, which is deductible in Denmark, the reduction is disallowed to the extent of the loss, but not further than up to the point where the same reduction applies as the one taken by the taxpayer at the close of the previous year. For example, if in year I the foreign business activity operates at a profit, after a reduction in the valuation of its stock-in-trade of 20%, and in year II, there is a loss incurred by the foreign business activity, after a reduction in the valuation of its stock-in-trade of 30%, this reduction may be disallowed for up to 10%, to arrive at the same reduction as applied in year I, viz., 20% of cost or market value.

G. SET OFF OF LOSSES

1. GENERAL RULE

In general, only a limited carry forward of losses is available for both

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individual and corporate taxpayers: losses incurred in a certain year may be set off against profits of the two following years. However, the taxpayer is not free to divide the loss over those two years as he thinks fit: the loss must first be set off against profits of the year immediately following the year of loss, and only if those profits are insufficient to cover the entire loss may the remainder of the loss be carried over to the second year.

2. CAPITAL LOSSES

Capital losses, i.e. losses incurred by individual taxpayers pursuant to the provisions of the special income tax law, may be set off against ordinary income of the same year; they may not be carried forward; conversely, if ordinary income shows a loss in any year, such loss must first be set off against "special income" gains, and any excess may be carried forward and set off against ordinary income of the next two years as outlined under 1, above.

As indicated earlier (see chapter C, above) the "special income" of corporate taxpayers is not taxed separately but included in their ordinary income subject to corporate income tax. This implies that capital losses incurred by corporate taxpayers are treated in the same way as ordinary business losses, considered under 1, above.

3. TEMPORARY CARRY BACK PROVISIONS

Normally, only a limited carry forward of losses is available.

However, by a special law of June 26, 1975 (Lov nr. 290 af 26. juni 1975 om skattemæssig tilbageførsel af underskud i aktieselskaber m.v.) some kind of carry back is granted to resident companies with respect to losses incurred in the year of income 1975-'76.

This carry back is effected in such manner that companies may deduct from the corporate income tax due for the year 1974-'75 an amount equal to 37 % (i.e., the rate of the corporate income tax) of an "adjusted loss" incurred in 1975-'76. This "adjusted loss" is computed on the basis of the actual loss for tax purposes, but reduced by:

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- (i) any accelerated depreciation allowances taken for ships and for investments in buildings, machinery and equipment exceeding Dkr. 700,000;
- (ii) allocations to the investment reserve;
- (iii) deductions regarding stock-in-trade definitely ordered but not yet delivered (see chapter F, under 2, above); and
- (iv) a deduction from the value of stock-in-trade (up to 30 %, see chapter F, under 1, above), to the extent that the deduction exceeds the deduction taken for the previous year.

To the extent that the loss is actually carried back under the above provisions, it cannot be carried forward under the main rule.

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A. INTRODUCTION

The concept of business profits is defined in the Individual Income Tax Act 1964 (hereinafter referred to as I.B.) which is applicable to individual taxpayers. The Corporate Income Tax Act 1969 (hereinafter referred to as Vpb) refers to the relevant sections of the i.B. concerning the concept of business profits. Corporate bodies are subject to the Vpb. Thus, business profits as defined in I.B. covers profits made by both individuals and corporate bodies.

With regard to individuals and some corporate bodies, e.g. a cultural foundation which carries on a business, the amount of business profits, if any, depends upon resolving two questions: what is to be considered a business and which property of the entrepreneur is to be included in his business. In answering the second question, case law has developed three sorts of property: property which is mandatorily deemed to be private property; property which is mandatorily deemed to be business property and a category in between, in which the entrepreneur has the discretion to choose whether the property involved will be private or business property. It is very important whether property owned by individuals constitutes business property or private property because there is no general capital gains tax in the Netherlands. Private capital gains made by individuals are normally tax-free. Both these questions do not arise with respect to a corporate body, defined as a company with a capital divided into shares, a cooperative association, or a mutual insurance society, because section 2 (5) Vpb states that this sort of corporate body is deemed to carry on a business with all its property, so that all property constitutes business property.

Section 7. I.B states: Business profits are the amount of the aggregate benefits which, under whatever name and in whatever form, are enjoyed from a business. This very broad concept includes among other things: trading income; realised or unrealised capital gains on assets; excess of liquidation proceeds over book value of assets; regular or irregular, intended or unintended benefits; legal or illegal benefits; remissions of debts, etc; all of these enjoyed at any time during the life of the business. This is the concept of "total profits" as opposed to "annual profits", for which more specific rules are given.

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Some exceptions to the "total profits" concept of section 7 I.B. are laid down in section 8 I.B. and 11 I.B. Section 11 I.B. provides an investment allowance which will be dealt with in Chapter E, below. Some exceptions listed in section 8 I.B. concerning capital gains are dealt with in Chapter C, under 4, below.

The other exceptions are: 1. profit from forestry in the Netherlands, with the exclusion of exploitation of coppice; 2. some exceptions concerning special pension rights; 3. an exception concerning payments for cessation based on a governmental sanitation-of-business ruling; and 4. an amount of fl. 15,000 in case of cessation of the business.

Total profits have to be divided into profits attributable to calendar years. This allocation to yearly periods is governed by a small number of sections of the i.B. of which the most important is section 9: profits made in a calendar year have to be determined in accordance with sound business practice, in observation of a consistent policy which is independent of the presumable result and which can only be changed if sound business practice justifies such change.

The concept of "sound business practice" is not further defined in the law. It is a dynamic concept which means that it may develop in the course of time and is not necessarily the same for enterprises which differ in the type of business activity and size. As a general rule, it can be assumed that a system of determination of annual profits for tax purposes will be in accordance with sound business practice if such a system is based on what in business economy is generally accepted as the right principle of computing profits, but this general rule will not apply if such principles of business economy would conflict with any pertinent provision of tax law or would fail to recognise the general intention or a principle of tax law.

Other sections of I.B. which are of prime importance for the computation of annual profits are: section 10 regarding depreciation of fixed assets (see Chapter B); section 13 regarding the cost equalisation reserve and the reserve for certain uninsured risks (see Chapter D) and section 14 regarding replacement reserves (see Chapter C, under 3).

THE NETHERLANDSB. DEPRECIATION OF BUSINESS ASSETS1. NORMAL DEPRECIATION1.1. General Rules; Qualifying Assets

Normal depreciation for tax purposes is based on section 10 (1) I.B. which reads: the depreciation of assets which are used to carry on a business (fixed assets) has to be determined yearly as such part of the not-yet-depreciated acquisition price or construction costs which is attributable to that year. Thus, depreciation is only possible with regard to assets which serve the business in a permanent way as opposed to current assets like stock-in-trade, debtors and securities (portfolio investments). Some important assets included in fixed assets are buildings, plant and machinery, other fixtures, cars, tools and equipment. Also intangible fixed assets may be depreciated provided that they comply with the condition of diminishing in value by use. In this category are included: acquired goodwill, patents, concessions and similar rights. Normally the assets will be owned by the taxpayer, but if a taxpayer has the economic ownership without being the legal owner, depreciation on such assets is also allowed.

1.2. Depreciable Basis

The depreciable basis is, in principle, equal to actual cost of acquisition or construction, which means that the invested capital is maintained from a nominal point of view, but that the diminishing purchasing power of the invested capital is not taken into account. Cost of acquisition includes all additional expenses directly related to the purchased asset, like import duties and non-creditable V.A.T.

The cost of acquisition or construction is reduced, for purposes of depreciation, by any subsidies received as well as by any amount used from a replacement reserve (see Chapter C, below). Such part of the cost of acquisition or construction as is attributable to elements of the depreciable asset which do not diminish in value by usage, e.g., the cost of the site on which a building has been erected, is also deducted in computing the depreciable basis, as is the case with any salvage value of the asset.

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Depreciation allowances can be taken only from the moment the asset is taken into use and not already at the moment the asset is ordered. If the asset is acquired during the year, the allowance is granted pro rata temporis.

1.4. Method of Depreciation and Rates

The i.B. act does not prescribe methods of depreciation, nor are allowable rates of depreciation laid down in the act. In principle all methods are allowed if in accordance with sound business practice. Normally the straight line method is used. Degressive depreciation is allowed if the asset is indeed diminishing in value more in the first years than in later years. Systems based on production hours, distances covered, etc., may also be used.

Actual rates of depreciation have to be negotiated between the taxpayer and the tax inspector and no official guidelines are available.

Assets of slight value have to be depreciated at once in the year of purchase or construction (section 10 (2) I.B.) provided that the acquisition or construction costs normally are considered to be a business expense.

1.5. Consistency of Depreciation

Due to the general principle (see Chapter A, above) that annual profits have to be determined in a consistent manner independent of the presumable results of the business, depreciation allowances must also be taken in years in which a loss is incurred.

Under the same principle it is generally not allowed to change from one system of depreciation to another, unless justified by sound business practice, e.g., when the original system is no longer deemed to be in accordance with sound business practice (in which case a change over is mandatory) or if another system is superior to the existing system.

1.6. Relationship Between Commercial Depreciation and Depreciation for Tax Purposes

There is no relation between depreciation in commercial accounts and de-

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preciation for tax purposes. This implies that depreciation for tax purposes is not limited to the amounts which are shown in commercial accounts. In practice it often occurs that commercial depreciation differs from depreciation for tax purposes, both in respect of rates of depreciation and of the system used.

2. ACCELERATED DEPRECIATION

2.1. Introduction

Section 10 (3) i.B. provides the possibility of an accelerated depreciation. According to this provision, one-third of the acquisition price or the construction costs of a fixed business asset may be depreciated at the taxpayer's own discretion, providing acceleration of depreciation. However, the Minister of Finance can:

- (i) limit the accelerated depreciation to a maximum per calendar year e.g., one-third, subject to a maximum of 16 2/3% per calendar year.
- (ii) declare the limitation applicable to all types of assets or in particular to some types of assets only, e.g., one-third with a maximum of 16 2/3% per calendar year for all assets except buildings and vessels.
- (iii) declare the limitation of the accelerated depreciation of buildings only applicable to buildings in a certain area of the country, e.g., one-third with a maximum of 16 2/3% per calendar year for all assets except buildings in all provinces of the Netherlands except North and South Holland.
- (iv) declare the accelerated depreciation not applicable, either in general or in particular for some types of assets--and as regards buildings--also for buildings in a certain area, e.g., the accelerated depreciation is not applicable except for vessels and buildings in the province of South Limburg.

2.2. Current Provisions

The accelerated depreciation allowance is used as an instrument to encourage or slow down economic activity. The possibility of accelerated depreciation

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was limited several times and a division of several categories of assets, each with their own percentages of accelerated depreciation, was made.

At this moment, the accelerated depreciation provisions apply as follows:

- ocean going vessels and fishing ships duly registered in the Netherlands: one-third without annual limitation.
- buildings, except for dwelling purposes located outside the western part of the Netherlands: one-half with a maximum of 25% per annum (in this case, the increase to one-half is based on a change in the text of sec. 10 (3) of the Act).
- no accelerated depreciation is currently allowed for other assets.

If investment in qualifying assets is made after February 19, 1975, the accelerated depreciation may be taken as soon as the taxpayer enters into the agreement to purchase the assets instead of the moment the asset is put into use, up to the amount which has actually been paid for the asset.

Example: Qualifying vessel ordered November 1, 1975. Acquisition price is 900,000. Salvage value is 60,000. Amounts paid: December 1, 1975, 100,000 and on the first of each of the 8 subsequent months, 100,000. Delivered and put into use in September 1976. Financial year equals the calendar year. Estimated useful life: 10 years.

Acquisition price	900,000	
Salvage value	<u>60,000</u>	
	<u>840,000</u>	
Subject to normal depreciation	600,000	-/- 60,000
		Salvage value = 540,000
Subject to accelerated depreciation	300,000	

a. The taxpayer wants to depreciate the vessel as quickly as possible.

Financial year 1975: maximum accelerated depreciation	100,000
Financial year 1976: maximum accelerated depreciation	200,000
Normal depreciation 4/12ths of 54,000	18,000
Financial years 1977 through 1985: normal depreciation	
9 times 54,000	486,000
Financial year 1986: normal depreciation	
8/12ths of 54,000	36,000

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b. The taxpayer wants a maximum depreciation in 1977.

Financial year 1975:	no depreciation	
Financial year 1976:	normal depreciation 4/12ths of 84,000	28,000
	normal depreciation	54,000
Financial year 1977:	accelerated depreciation	
	300,000 ÷ 10,000	290,000
Financial years 1978 through 1985:	normal depreciation	
	8 times 54,000	432,000
Financial year 1986:	normal depreciation	
	8/12ths of 54,000	36,000

As shown in the example it is at the taxpayer's own discretion if and when he will depreciate in an accelerated way, but of course the normal depreciation at 10% of cost minus salvage value is always the lower limit, as shown for instance in part b. of the example for the year 1976, where the amount of normal depreciation taken includes an amount of 10,000 out of the amount of 300,000 eligible for accelerated depreciation; the remainder of the latter amount is in this part of the example taken in 1977.

THE NETHERLANDSC. TAXATION OF CAPITAL GAINS AND LOSSES1. GENERAL

Apart from a small number of exceptions all unrealised capital gains or losses resulting from the valuation system applied and all realised capital gains or losses are included in normal business profits and are taxable at the normal rate.

With regard to unrealised capital gains or losses, sound business practice allows valuation systems which defer a capital gain until the moment of alienation of the asset and, on the other hand, enable the taxpayer to take a capital loss immediately. Mention should be made of the system of valuation at historic cost (purchase price) or lower market value at balance sheet date. This system can be applied in general to all current assets, such as securities (excluding shares which constitute a substantial participation) and stock-in-trade. However this system gives only a deferral of the capital gain until the moment of alienation. For further details on the various methods of valuation concerning stock-in-trade, see Chapter F.

Fixed assets (excluding substantial participations, see Chapter C, under 5) may also be valued at lower going-concern value.

An unrealised capital gain or loss is computed as the difference between the book value at balance sheet date and acquisition price or book value of the previous balance sheet date. Realised capital gains and losses are computed as the difference between proceeds of sale and book value. With respect to fixed assets which have been subject to depreciation allowances, this implies that allowances taken may be added back to taxable profits to the extent that the proceeds of sale exceed depreciated book value.

2. DECISIONS OF THE SUPREME COURT CONCERNING EXCHANGE OF ASSETS

The effect of a number of decisions of the Supreme Court is that if a

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new asset in a functional and an economic way has the same place in the business as an old asset, which it replaces, the acquisition price may be fixed at the book value of the old asset so that no capital gain is deemed to arise. In practice, these decisions give relief only in few circumstances because the court will not assume very readily that the condition of the same functional and economic place is fulfilled. Also, the current extensive application of the replacement reserve (see under 3, below) has restricted the need for the taxpayer to refer to these decisions.

3. REPLACEMENT RESERVE

Section 14 I.B. provides that indemnities for loss or damage or proceeds at alienation of tangible assets may be allocated insofar as they exceed the book value of the asset, to a tax free replacement reserve, if the taxpayer has the intention of replacement of the asset. Replacement has to take place not later than during the fourth year subsequent to the financial year in which the reserve is created. Otherwise, the reserve is added back to taxable profits. The period of four years may be extended if more time is needed for the replacement or repair.

If an amount out of the replacement reserve is attributed to a new asset, then this amount has to be deducted from the acquisition price of the new asset in order to determine its book value. Furthermore, the amount so deducted is deemed to be included in any accelerated depreciation available, so that that part of the acquisition price which is subject to accelerated depreciation is reduced by the amount taken from the replacement reserve. Thus, if in the example given in Chapter B, under 2.2., above, an amount of 250,000 can be allocated to the investment of 900,000, the accelerated depreciation applies only to an amount of 50,000 (300,000 minus 250,000). If at the occasion of replacement it appears that the acquisition price reduced by the amount of the replacement reserve is lower than the book value of the alienated asset the difference has to be added to taxable profits of that year.

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Example: Alienation price of asset is 100,000. Book value is 20,000; i.e., a gain of 80,000 which may be put in a tax free replacement reserve. Acquisition price of the new asset: 90,000. Deduction of the amount of the replacement reserve would cause a book value of 10,000. However, the book value of the new asset may not be lower than the book value of the old one (20,000). Thus, only 70,000 can be used from the reserve and an amount of 10,000 has to be added to taxable profits.

4. VARIOUS EXEMPT CAPITAL GAINS

Certain capital gains are exempt from individual or corporate income by express provisions of the I.B. Act.

These exemptions include:

- gains resulting from an increase in the value of land used in the business of agriculture, to the extent that the increase in value has not occurred due to the carrying on of the business (sec. 8 (b) I.B.);
- gains resulting from cancellation of debts by creditors of the business, if those business debts are incollectable by the creditors, and only insofar as the amount exceeds the normal losses of the financial year and previous losses which may be carried forward.

5. EXEMPTION WITH RESPECT TO SUBSTANTIAL PARTICIPATIONS

In computing the profits of a corporate body, any profit or loss resulting from a substantial holding of shares in a resident or non-resident entity with a capital divided into shares or a qualifying fund or a membership of a cooperative association is exempt (sec. 13 (1) Vpb.). To qualify for this participation exemption, the shareholding must amount to at least 5% of the share capital of the subsidiary; the shareholding must have existed from the beginning of the financial year of the parent company and be uninterrupted. With regard to non-

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resident subsidiaries, two additional conditions have to be met: (i) the foreign company has to be subject to a tax on profits; and (ii) the shareholding of shares of the foreign company may not constitute a portfolio investment.

The exemption applies to any profit or loss. Thus, it includes regular income, such as dividends and eventual constructive dividends, and "irregular" income, such as alienation profit or loss and increases or decreases of the value of the participation. Costs (e.g., financing costs, cost of control) related to the shareholding in a foreign company generally are not deductible from taxable profits of the Dutch parent company. The only exception to the exemption for income derived from a subsidiary is that losses incurred by the parent company at the liquidation of the subsidiary are deductible.

6. MERGERS

6.1. Introduction

The two main forms of merger, i.e., stock merger and enterprise merger have different tax consequences. Tax problems arising from stock merger mostly concern individual shareholders who own a substantial interest. The tax consequences of an enterprise merger, on the other hand, are on the corporate income tax level.

6.2. Enterprise Mergers

An enterprise merger is effected by the transfer of the business (all assets and liabilities) of one company to another company (the absorbing company) against a certain consideration. At the time of transfer, a taxable gain arises if the sales price of the business exceeds the aggregate book value of assets and liabilities. Since taxation of this gain at the normal corporate income tax rate might prevent the necessary concentration of industry, a qualifying enterprise merger is facilitated under sec. 14 Vpb.: if a taxpayer (corporate entity) transfers his enterprise or an independent part of his enterprise in a merger operation to another taxpayer, any gain made at the transfer will be tax deferred, provided (i) that neither the absorbing nor the absorbed company have non-recovered losses, (ii) that the acquisition by the absorbing company is effected by issuing new shares; (iii) that the ultimate taxation of the postponed gain is assured; (iv) that

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the newly issued shares will not be alienated by the absorbed company within three years after the acquisition; and (v) that both companies are subject to the same rules regarding the computation of profits. The absorbed company, which will not automatically dissolve according to civil law, has to value the acquired shares in the absorbing company at the same book value as the book value of the enterprise which was transferred in exchange. The absorbing company must value the acquired enterprise at the same book value as this enterprise was valued by the absorbed company.

6.3. Stock Merger

This type of merger is effected by the transfer of the shares of the absorbed company to another company. The absorbing company may pay in cash or in newly issued shares. In normal cases, the difference between alienation price and acquisition price of shares held by individuals as a private investment is not subject to income tax. However the alienation of shares held by individuals who own a "substantial interest" in the company are subject to the individual income tax although at a special fixed rate of 20%. A "substantial interest" exists if an individual owns or has owned within the previous five years before alienation, directly or indirectly, alone or together with his next of kin at least 33 1/3 percent and alone or together with his spouse more than 7 percent of the nominal paid-in capital of a company. This taxation of substantial interest gains also has a restraining influence on cooperation in the form of a merger and also in this type of merger a deferral of taxation is granted. Section 40 (I.B.) states that on request of the taxpayer, the gain realised at the alienation of shares in a qualifying merger will not be taken into account in the computation of income for the year of transfer. A qualifying merger is a merger which makes the following conditions: (i) the absorbing company which has to be a company resident in the Netherlands, must acquire the shares of the absorbed company against newly issued shares; and (ii) the object of the merger must be to permanently unify the business of both companies from an economic and financial point of view.

The newly acquired shares constitute a "fictitious" substantial interest and a subsequent sale of these new shares may result in a taxable substantial interest gain. In computing the gain in the latter case, the new shares are valued at the cost of acquisition of the former "substantial interest" shareholdings.

THE NETHERLANDS7. TRANSFER OR CESSATION OF A BUSINESS BY INDIVIDUALS

Gains made at the transfer of the entire business by individuals are taxable although in special cases, taxation of the gains can be postponed or the gains may be taxed immediately, but at special rates. If the gain ("cessation gain") is taxed immediately the first Dfl. 15,000 of such gain are exempt while in certain cases further amounts may be deducted from the gain if these are destined for taxable installments of a life annuity.

THE NETHERLANDSD. RESERVES1. GENERAL

In the Netherlands a distinction is made between "true" reserves, i.e. accumulated income set aside for specific purposes, and "so-called" reserves (or provisions) which constitute amounts in the balance sheet, set aside to meet accrued liabilities, future expenses or other contingencies, the extent of which cannot be exactly determined.

Generally speaking, allocations to "true" reserves are not allowed for tax purposes in the absence of specific provisions in the law, and such allocations can thus only be made out of after-tax profits.

The other type of reserve (or provision), intended to meet future liabilities or expenses can often be created under the general rule concerning the computation of annual business profits, if allocations to such reserves are in accordance with "sound business practice". Examples are reserves for guarantee- or service liabilities and reserves for bad debts.

Apart from the above cases, where a "so-called" reserve (or provision) can be created on the basis of the general concepts of annual business profits, there are three reserves, which can be formed under specific provisions of the income tax act, viz. (i) the replacement reserve under sec. 14 I.B., which is a "true" reserve, although for a limited period of time. This reserve is considered in detail in Chapter C, above; (ii) the reserve for uninsured risks; and (iii) the cost equalisation reserve, under sec. 13 I.B. These latter two reserves, which are discussed below, are usually considered as "so-called" reserves (or provisions), although the reserve for uninsured risks might also be considered as a "true" reserve.

2. THE RESERVE FOR UNINSURED RISKS

This reserve can be formed by a taxpayer with respect to risks which are "normally", i.e. by other taxpayers, insured to a considerable extent.

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The intention of this provision is to ensure that entrepreneurs who do not actually take insurance with respect to any risk, are not put in a worse position, tax wise, than entrepreneurs who do insure all risks incurred in their business.

In general, the annual allocation to the reserve may not exceed the premium which would be payable for an insurance on the same risk. There is virtually no limit to the total amount of a reserve that can be formed over the years with respect to any risk. If damage is suffered, the amount of the damage has to be deducted from the reserve, so that taxable profits are not affected by such damage.

3. THE COST EQUALISATION RESERVE

This reserve may be formed for costs which only occur once in a number of years, but which should in fact be attributed to each year. An example is the survey of ships which will occur every 5 or 10 years. In computing the yearly allocation to this reserve a presumable future rise of costs may not be taken into account, but each subsequent year the allocation may be increased by a pro rata part of the estimated costs that would have occurred if the costs had been incurred in that year.

An example may clarify this system:

In 1970 the cost of a survey is Dfl. 100,000. A certain ship is surveyed in 1969 and the next survey will take place in 1979. Thus, an amount of Dfl. 10,000 will be attributable to 1970 and the allocation to the reserve for 1970 is equal to that amount. In 1971, the cost of a survey would be Dfl. 110,000. The allocation to the reserve in 1971 will, thus, be one-tenth of this amount or Dfl. 11,000 which brings the total reserve to Dfl. 21,000 etc. In 1979 the actual costs are reduced by the amount of the reserve, the excess of costs being deductible at once.

THE NETHERLANDSE. OTHER INVESTMENT INCENTIVES1. GENERAL

Section 11 I.B. provides an important investment incentive in the form of an "investment allowance", i.e. an amount, computed in relation to qualifying investments made, which is deductible in computing taxable profits. A subsection provides that the Minister of Finance may limit the investment allowance in amount or to limit the allowance to certain categories of investments or declare the allowance not applicable. It is further provided that a "disinvestment addition" is added to taxable income if assets which qualified for the allowance are disposed of within 6 years.

2. MAIN PROVISIONS

If in a calendar year an amount exceeding Dfl. 2,000 is invested in fixed assets, a certain percentage of the amount invested may be deducted from the profits of the calendar year as well as of the subsequent calendar year. The percentage of deductions for the various categories of qualifying fixed assets are currently as follows:

Business buildings, excluding dwelling houses: 8% for two years, i.e. 16% in all;

Ships, other than sea-going vessels: 5% for two years, i.e. 10% in all;

Aircraft used in international traffic: 8% for two years, i.e. 16% in all;

Other fixed assets: 4% for two years, i.e. 8% in all;

Sea-going vessels registered in the Netherlands: 5% for five years (due to a special provision in the law), i.e. 25% in all (for further details, see under 6, below).

3. TIME OF GRANTING THE ALLOWANCE

The investment allowance is granted with respect to qualifying assets at the time the taxpayer enters into an obligation to purchase or improve the asset, or incurs expenditure on their manufacture, to the extent that

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the investment is borne by the taxpayer. The total investment in qualifying assets in any year must exceed Dfl. 2,000 in order to be eligible for the allowance. Transactions between close relatives, or between a company and a shareholder who owns, directly or indirectly, at least one-third of the paid-in capital of the company, are excluded.

4. DISQUALIFIED ASSETS

The act contains a list of assets for which the investment allowance is not applicable. These assets are:

- a) land, including the building site on which a qualifying building is erected;
- b) dwelling houses, including parts of business buildings used for dwelling;
- c) certain passenger cars;
- d) houseboats, pleasure yachts, as well as sea-going vessels--not being fishing boats in commercial use for coastal fishing activities--not duly registered in the Netherlands;
- e) securities, debts receivable and goodwill;
- f) bottles, boxes and other packaging materials;
- g) assets of minor value;
- h) other assets as indicated by the taxpayer.

The latter category of assets excluded gives the entrepreneur the possibility to abandon the allowance, if he does not want to have it.

5. "DISINVESTMENT ADDITION"

In order to prevent abuse, a recapture of the investment allowance is provided if assets are sold within 6 years after the beginning of the calendar year in which the allowance was enjoyed. However, the addition may not exceed the investment allowance granted at the time the investment was made.

THE NETHERLANDS6. SPECIAL PROVISIONS FOR OCEAN-GOING VESSELS

With regard to ocean-going vessels and sea-fishing vessels which are duly registered within the Netherlands, the allowance of 5% can be taken during 5 years, thus totalling 25%. To prevent the use of losses caused by this allowance to offset other source income, the allowance can be deducted only from income of shipping. However, losses from shipping caused by the investment allowance can be carried back to the previous year and carried forward to eleven subsequent years, which exceeds the usual time limit (see Chapter G, below). It should be noted that the special provisions regarding ocean-going vessels are worded in such a way that ocean-going vessels not duly registered in the Netherlands do not qualify for the allowance at all, not even for the usual two year allowance granted other ships.

THE NETHERLANDSF. VALUATION OF STOCK-IN-TRADE

Generally speaking, any system of valuation of stock-in-trade, which complies with "sound business practice" and is used consistently over the years, is permitted for tax purposes.

Systems commonly used include:

- (i) valuation at historic cost;
- (ii) valuation at market value at balance sheet date; and
- (iii) valuation at the lower of historic cost or market value at balance sheet date.

In determining the cost or market value of fungible goods obtained at various times and for different prices, both the last in-first out (LIFO) and first in-first out (FIFO) methods may be used.

Another system allowed in the Netherlands, is the so-called "base stock" (ijzeren voorraad) system which can be used in two distinct ways, viz. with or without a reserve for shortage of stock.

The base stock method allows the taxpayer to value permanently his normal stock (goods of the same kind) at the historic cost price or market value which, applied at the moment he adopted this method. The normal stock is related to the size of the business also at the moment of adopting this system. If in subsequent years the normal stock has to be increased due to an increase of business activities this additional part of the normal stock has to be permanently evaluated at the price level at the moment of increase of the normal stock. The normal stock is a quantity which does not need to be always actually present in storage. It may happen that on balance sheet date the actual stock is in excess of the normal stock. This excess part has to be valued at historic cost at market value or at the lower of historic costs or market value in the normal way. If at balance sheet date the actual stock shows a shortage as compared to the normal stock, the amount present will still be valued at the "base stock" value, and a subsequent increase up to the normal stock is also valued at the same level. However, it may be allowed in such cases of shortage to

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create a so-called "reserve for shortage of stock", i.e. the "base stock value" applied to the normal stock is reduced by the amount needed to purchase the shortage at actual market price on balance sheet date.

Example:

Normal stock at introduction of the method 1,000 units, price: Dfl. 5

Increase of normal stock in a subsequent year 100 units, price: Dfl. 6

The base stock must be valued at Dfl. 5,600

1) Actual stock: 900 units, market price Dfl. 8, thus shortage of 200 units

Evaluation:	Normal stock value	Dfl. 5,600
	Reserve for shortage: 200 units at Dfl. 8	Dfl. <u>1,600</u>
	Actual stock value for tax purposes	Dfl. <u><u>4,000</u></u>

2) Actual stock: 1,200 units at market price Dfl. 8, thus surplus of 100

Evaluation:	Normal stock value	Dfl. 5,600
	Surplus 100 units at Dfl. 8	Dfl. <u>800</u>
	Actual stock value for tax purposes	Dfl. <u><u>6,400</u></u>

THE NETHERLANDSG. SET OFF OF LOSSES

The individual income tax is a tax on total income from all sources. This implies that negative income from any source (business, employment, property) is first of all deducted from any positive income obtained by the taxpayer from other sources during the same year. There is only one exception to this rule: if a taxpayer incurs a loss on the sale of "substantial interest" shares (i.e., shares in a company in which the shareholder owns, together with close relatives at least one-third of paid-in capital, and together with his spouse also more than 7% of such capital) such loss is not deductible from other income, but 20% of the loss is deductible from the income tax due for the year of sale, the year preceeding the year of sale or any of the six years following the year of sale.

For corporate taxpayers, the above situation does not occur, because all taxable income of corporations is deemed to be a business income.

If the total income for any year results in a loss, such loss can first be set off against income of the previous year, and the remainder can be carried forward to the six years following the loss year, but the loss must be taken at the first possible time. If, for instance, the income of the preceeding year is sufficient to cover the entire loss, the taxpayer is not free to set off the loss against the income of any year following the year of loss.

Business losses, incurred during the first 6 years of the existence of a business may be carried forward indefinitely; thus, for these losses the 6 year limitation does not apply.

By way of a temporary measure, losses incurred in 1974, 1975, and 1976 may be carried back two years instead of one year.

A special provision also applies in relation to the investment allowance for ocean-going vessels registered in the Netherlands (see Chapter E, above). If the income from shipping becomes negative in any year due to the invest-

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ment allowance for qualifying vessels, such negative income--to be distinguished from total business profits--is not taken into account in computing total business profits for the year, but carried back to the previous year (temporarily to the two previous years), or to any of the eleven following years, but only insofar as such negative income does not exceed the investment allowance (less any disinvestment addition) received. Thus, the special provisions regarding negative income from shipping (i.e., exclusion from total business profits for the year in question and extended carry forward) apply only to such amount of negative income, if any, as does not exceed the difference between any investment allowance deducted and any "disinvestment addition" added to profits.

FRANCE

A.

INTRODUCTION

Taxable business income can be defined as net profits from all operations including capital gains derived from the sale of fixed assets (Code général des impôts (CGI), Art. 38(1)).

CGI, Art. 38(2) further defines the term "net profits" as the difference between the taxpayer's net worth at the beginning of the taxable period and his net worth at the end of this period, adjusted for additional contributions to capital and distributions to the owners of the business.

A distinction is made between "ordinary business income" and "capital gains". Capital gains are again sub-divided for tax purposes into short-term and long-term capital gains.

Ordinary business income as well as short-term capital gains (roughly gains derived through the sale or other disposition of fixed assets which have been held for less than two years) are subject to the normal rates of individual and corporate income tax. However, the taxation of short-term capital gains may be spread over 3 subsequent years. Long-term capital gains (roughly gains derived through the sale or other disposition of fixed assets which have been held for 2 years or longer) are subject to a reduced rate of income tax, i.e. generally 15%, but 25% in case of building sites (terrains à bâtir). See for more details Part C, below.

B.

DEPRECIATION OF BUSINESS ASSETS

1. Introduction

The deductibility of depreciation allowances is laid down in CGI, Art. 39(1)(2^o) which provides that depreciation which has been taken within the limits allowed by business practice (including depreciation which was deferred in loss years) may be deducted to arrive at "net income".

2. Depreciable assets

2.1. In general

Depreciable assets may generally be defined as all tangible, movable and immovable, new and second hand assets, which are owned and used in the conduct of business activities (other than inventory) and which necessarily diminish in value over time and have a limited working life of more than one year.

In general, unimproved real property (land) may not be depreciated since it generally does not decrease in value merely due to time. Thus in depreciating improved real property, a distinction must be made between the value of the improvements and the value of the land.

Neither is depreciation permitted with respect to intangible assets such as goodwill, trademarks, copyrights, secret processes etc. The only exception to this rule applies to patent rights which may be written off during their legal life or their useful economic life if the latter is shorter. In certain cases it is possible to take depreciation on manufacturing processes which have been purchased by the enterprise provided that they are subject to obsolescence.

Note, however, that on the value of non-depreciable intangible assets and land a write-off may be taken which must be placed in a reserve (provision, see Parts B, para. 4 and D below) where the value of the business as a whole is reduced and a substantial fall in profits is demonstrated.

2.2. Some special cases

Assets of little value: Costs connected with such assets are generally deemed to be current expenditures and may be written off as expense in the year in which they are incurred. These include machinery and equipment purchased in an accounting year which closes after October 15, 1973 and whose value does not exceed 1,000 Fr.frs. (including TVA) and office equipment whose value does not exceed 200 Fr.frs. (including TVA).

Buildings: The general principle is that only the cost of the construction is depreciable and that the cost of the land may not be taken into account. Costs^{incurred} for the demolition of an old building which will be replaced by a new one must be entered as part of the cost of the new construction. Costs incurred for major repairs and improvement of a building must also be treated as part of its cost and consequently depreciated.

Formation expenses (frais d'établissement): i.e. expenses connected with the creation of an enterprise, the increase of its capital, the issuance of bonds and debentures or acquisition of fixed assets (registration taxes, filing fees and professional fees). These expenses may at the option of the taxpayer either be expensed in the year in which they are incurred or treated as an asset and written off (generally three to five years).

Mineral sources: No depreciation is permitted with respect to sources producing mineral waters. However, depreciation may be taken on the construction surrounding the sources which are necessary for the exploitation of the source.

Motor cars: Depreciation is generally allowed. However, no depreciation is permitted with respect to that part of the cost of a passenger car which exceeds 35,000 Fr.frs.

Quarries: No depreciation is permitted if they are not being exploited. If they are exploited they are considered to consist of the subsoil (which is not depreciable) and of the deposit (which is deemed to correspond to stock-in-trade). In other words, in such a case a write-off is permitted which reflects the quantity of material which is extracted.

Rented assets: The lessee cannot take depreciation; it is the lessor who is entitled to deduct such depreciation from his income.

Securities: No depreciation is possible on stocks and bonds with the exception of certain shares in real property companies which are deemed to represent such real property. (See, however, Part C, para. 2.1.6., below).

3. System of depreciation

3.1. Approved method of depreciation

Two methods are generally approved, i.e. the straight-line method and a form of declining balance depreciation. Straight-line depreciation is always permitted, whereas the declining balance depreciation is optional and may only be used with respect to certain new assets, i.e.:

- machinery and equipment used for industrial processes and transportation (including engines, generators, transformers, ovens, forges, rolling stock, such as coaches, locomotives, ships, tractors, trucks etc. but generally exclusive of passenger cars);
- machinery and equipment used for handling (inclusive of beer barrels but exclusive of bottles and crates);
- air and water pollution control installations (including internal air conditioning and filtering);
- steam, heating and energy producing equipment (including steam engines, heating installations (such as a central heating system and kitchen equipment for industrial canteens));
- security, alarm and safety equipment;
- medical-social installations (in general those installations whose purpose it is to control the health of the personnel, such as hospital equipment, clinics, day nurseries, medical-social centers with the exception of installations for a purely social purpose such as sport halls and the like);
- office machines (including calculators, stamping machines, invoicing machines, but excluding typewriters);
- scientific or technical research material and equipment;
- storing and warehousing equipment (including cold storage rooms, etc. but not the building or the enclosures involved);
- hotel buildings and equipment (but not for camping sites);
- light industrial buildings with a useful life not exceeding 15 years, which are light constructions and which are independent of the buildings in which the manufacturing or transformation operations are performed, such as buildings which have been constructed for the purpose of protecting or containing material; buildings used for the storing of materials, products or supplies; buildings used for research activities and buildings used to house medical-social installations.

As stated above declining balance depreciation is only available with respect to new assets with the exclusion of second hand assets. However, the tax administration is prepared to deem the following assets to be new so that they qualify for declining balance depreciation:

- (i) assets which have been renovated by the manufacturer according to the latest technical developments and whose price is consequently not much lower than that of new assets;
- (ii) assets which have been acquired under a company reorganization (see Part C, para. 3 below);
- (iii) assets which have been used abroad by building contractors and which are repatriated to France, provided that they
 - were new when acquired by the enterprise; and
 - were acquired after December 31, 1959; and
 - their remaining useful life is not less than 3 years;
- (iv) second hand ships, whether they have been renovated or not, used for maritime transportation and second hand fishing ships (the latter are written off in 6 years).

The straight-line method consists of depreciation by annual instalments (a fixed percentage of the purchase price or production cost) in proportion to the estimated useful life. Declining balance depreciation consists of the application of a fixed percentage to the book value of the asset (which gradually diminishes).

No declining balance depreciation is permitted where accelerated depreciation has been taken (see Part B, para. 3.6. below) or where the useful life of the asset is less than 3 years.

In certain cases the tax administration has allowed the rate of depreciation to be adapted to the intensity of the use of the assets, e.g., where the assets are used in double or triple shift work, such as steel mills. The taxpayer must prove, however, that the intensive use will result in a shorter useful life of the asset. The economic useful life of assets will in many cases be determined by the expected development of technology which will make replacement of the assets necessary before they are actually exhausted, so that shift work will in many cases have little influence on the depreciation rates.

In some cases the value of an asset may diminish through extraordinary wear and tear, sudden new inventions or natural calamities. Losses of this type may be compensated by a special write-off equal to the actual loss in value.

3.2. Change-over from one method to another

A change-over from the straight-line method of depreciation to the declining balance method is permitted, provided that declining balance depreciation is authorized for the asset in question. A change-over from declining balance depreciation to straight-line depreciation is always permitted.

3.3. Basis of depreciation

The depreciable base is generally the historic cost, i.e. the acquisition price (or the cost of production, when the assets are manufactured by the taxpayer) (increased by related costs such as transportation costs, customs duties, cost of installations, assembly costs and the like. The cost of production for assets manufactured by the taxpayer includes both direct costs (raw materials and labor) and indirect costs (their pro rata share in overhead cost, depreciation etc.). The cost of any subsequent additions and improvements is added to the depreciable base. The turnover tax on added value (TVA) included in the price of the assets may generally not be included in the depreciable base, since this tax is in principle fully creditable against TVA imposed on sales effected by the taxpayer. However, in those cases where full credit is denied, that part of TVA which cannot be credited is included in the depreciable base. Consequently enterprises exempt from TVA such as banks and insurance companies may take depreciation on full cost price, including TVA.

Government premiums which are granted, for instance, for special housing projects, for the hotel industry, for regional development, for tertiary sector decentralization, for anti-pollution installations and the like are generally included in the depreciable base.

In those cases where an initial depreciation has been taken (see para. 3.6., below) normal depreciation is taken on the acquisition price (or cost of production) less the initial depreciation. The same rule applied to the investment credit which is currently discontinued (see part E, para. 1, below).

In case of a merger or other company reorganization or in case of the transfer of a sole proprietorship to the owner's heirs, spouse, or relatives in the direct line of consanguinity or in case a sole proprietorship is continued by a general partnership, limited partnership or limited liability company (société à responsabilité limitée) between the heirs, etc. mentioned above or between the above mentioned persons and the transferor, who continue the business, certain roll-over provisions apply, i.e. the book value of the assets is carried over to the new owners or to the new business.

3.4. Percentages and duration

3.4.1. Straight-line depreciation

Depreciation rates are computed taking into account the normal useful life of the asset according to the usages of each industry, commerce or business. Generally, every type of asset will have a percentage which is determined by earlier decisions of the Supreme Court (Conseil d'Etat) representing its permitted annual depreciation. If an asset is acquired during the course of a year, straight-line depreciation is only granted on a pro rata temporis basis, i.e. with respect to the remaining months.

Some examples of typical rates are:

industrial and commercial buildings	5%
office and residential buildings	4%
fixed industrial machinery and equipment	10-20%
office furniture and machinery	10-20%
tools	10%
automobiles, trucks etc.	15-25%
patents	generally over the number of years during which they are legally protected or over their normal useful life, whichever is shorter.

3.4.2. Declining balance depreciation

The taxpayer is not free to choose any system of declining balance depreciation since there is only one system which is authorized (and which is optional). A further restriction is that declining balance depreciation is only permitted with respect to a limited number of assets (see para. 3.1., above). The depreciation deduction is determined by multiplying the usual straight-line depreciation rate of the particular asset by a prescribed coefficient. These coefficients are currently:

- 1.5 if the normal useful life of the asset is 3 or 4 years;
- 2 if the normal useful life of the asset is 5 or 6 years; and
- 2.5 if the normal useful life of the asset exceeds 6 years.

As a disincentive to investment (in order to combat inflation) these coefficients were reduced to 1, 1.5 and 2 respectively for qualifying assets which were acquired during the period from July 1, 1974 through March 31, 1975.

As an incentive to investment the coefficients are increased to 2, 2.5 and 3 respectively for assets which are purchased in 1977 (if ordered before June 1, 1977) or manufactured in 1977. This increased declining balance depreciation is a permanent feature for energy saving equipment acquired from January 1, 1977 onwards, listed in a Ministerial Decree.

If an asset is acquired during the course of a year declining balance depreciation is only granted on a pro rata temporis basis, i.e. with respect to the remaining months.

Since a change-over from declining balance depreciation to straight-line depreciation is permitted, the taxpayer may adopt the latter method when the depreciation deduction computed according to the declining balance method is less than the deduction which is allowed under the straight-line method (i.e. the deduction based on dividing the net depreciable balance by the remaining number of years of useful life).

3.5. Commencement of depreciation

A depreciation deduction may generally first be taken at the end of the accounting year in which the asset has been acquired.

If straight-line depreciation is adopted the general rule is that depreciation may not commence before the asset has been put in service, unless it can be proved that its value diminishes because of obsolescence. Under the declining balance method depreciation may commence even if the assets have not been put in service. In both cases depreciation must be computed on a pro rata temporis basis. Under the declining balance method, however, the computation is made on a monthly rather than on a strict daily basis.

3.6. Special arrangements

3.6.1. Accelerated depreciation

In a number of cases taxpayers may take an initial depreciation deduction in the year that the assets are acquired or manufactured. In the case of depreciable assets -- which are mostly immovable -- the residual value may then be written off in equal annual instalments (straight-line depreciation) over the normal useful life of the asset. In all other cases -- generally investment in certain shares -- no further depreciation is allowed. Under previous legislation accelerated depreciation in the form of higher annual depreciation deductions rather than an initial deduction was accorded, which is also discussed under this heading (see vi, below).

Accelerated depreciation is available in the following cases:

- (i) Industrial and agricultural enterprises which construct immovable property which is destined to prevent water pollution may in the year that the construction is completed apply an initial depreciation deduction of 50% of the cost price of the asset. This accelerated depreciation is available for qualified constructions which were completed before December 31, 1977, provided that they are incorporated in immovable property which was completed on January 1, 1976.
- (ii) Similar provisions apply to enterprises which construct immovable property destined to prevent air pollution and bad odors. They may also apply a 50% initial depreciation deduction in the year that the installations are completed. The accelerated depreciation applies to qualifying assets which were completed before December 31, 1977 provided that they are incorporated in immovable property which existed on January 1, 1976.
- (iii) Industrial and commercial enterprises may apply a 25% initial depreciation deduction on the cost price of newly constructed industrial and commercial buildings whose construction begins before December 31, 1977. This initial depreciation deduction is subject to the approval of the Minister of Economic Affairs and Finance which must consult the Board of the "Fonds de Développement Economique et Social". Approval must be obtained for each separate case.

The approval may be granted by the regional Director of Taxes provided that the investment over a period of three years does not exceed 5 million Fr.frs. No approval is needed if the investment is part of an investment program which is exempt from business tax (taxe professionnelle) under the provisions of CGI, Art. 1473bis.

In order to qualify for the 25% initial depreciation the buildings must be constructed in special zones (generally, less developed areas) indicated by Ministerial Decree and they must result within a period of time of at least 3 years in new employment for at least 10 persons.

- (iv) Investment in buildings, material and equipment used for scientific or technical research qualifies for an initial depreciation deduction of 50% of the cost price of these assets in the year that these assets are acquired. However, this provision is as of January 1, 1965 only applicable to investment in buildings. The tax administration has extended the benefit of this initial depreciation to investment in buildings which are used for the study, construction and testing of industrial prototypes which precede their industrial manufacture.

The 50% initial depreciation also applies to the cost price of shares in Government approved research companies and organizations and may be taken in the year of payment of the subscription. If such shares are sold more than 3 years after subscription, the resulting capital gains are not taxable to the extent of the 50% initial depreciation deduction which was previously taken.

- (v) In certain cases an initial depreciation deduction may be taken on the cost price of shares of other Government approved companies provided that the shares were acquired at the creation of such companies or at the later increase of their share capital. This initial depreciation is 100% of the cost price on the subscription in shares of Government approved companies for the development of agriculture, industry and commerce.

A 50% initial depreciation is accorded on the subscription in Government approved "financial innovation companies" (sociétés financières d'innovation). There is no further depreciation allowed, but if the shares of a financial innovation company are sold more than three years after their acquisition, the capital gain thereon (if any) is not taxable to the extent of the initial depreciation taken.

Under previous legislation an initial depreciation deduction was accorded on the cost price at the subscription in shares of Government approved real property companies. The subscribers could opt between two different treatments: (a) they could take a 50% initial depreciation deduction, in which case the dividends from the shareholding were subject to normal income tax or (b) they could opt for the exemption of the dividends from the shareholding provided that the income from the shareholding did not exceed 3.5% of the invested amount, in which case they could only take a 25% initial depreciation. This initial depreciation deduction only applies to subscription in shares before July 1, 1964 which were fully paid in before January 1, 1966.

- (vi) Under previous legislation accelerated depreciation was allowed with respect to ships of the merchant marine. Those ships could be depreciated in 8 years (50% of the cost price could be written off during the first three years, with a maximum of 20% per annum; 25% in the fourth and fifth year with a maximum of 15% per annum and in the sixth through the eighth year the remaining 25% with a maximum of 10% per annum. Fishing vessels could be depreciated in 6 years, i.e. 50% in the first and second years with a maximum of 30% per annum; 30% in the third and fourth years with a maximum of 20% per annum and 20% in the fifth and sixth years with a maximum of 15% per annum. This accelerated depreciation is no longer available for ships which were acquired or constructed after December 31, 1964. With respect to ships acquired or constructed between January 1, 1960 and December 31, 1964 the taxpayer could opt between accelerated depreciation or declining balance depreciation.

Under current legislation the taxpayer may take declining balance depreciation with respect to ships. Since he may assume that the useful life of ships of the merchant marine is 8 years and that of fishing ships 6 years, the rate of depreciation is respectively 31.25% and 33.33%.

3.6.2. Special depreciation for the iron and steel industry and the mining industry

Under previous legislation enterprises which were classified as iron, steel or mining industries could benefit from an additional depreciation deduction which was based on the turnover of the enterprise. The rates varied from 4% to 20% depending on the category of industry.

However, this special depreciation (which in so far as it resulted in a total depreciation exceeding the actual wear and tear of the assets can be considered to be tantamount to an accelerated depreciation) was abolished when declining balance depreciation was introduced. However, during a transitional period of time from January 1, 1960 through December 31, 1966 taxpayers could opt between declining balance depreciation and the special depreciation together with straight-line depreciation. Therefore, in theory, starting from January 1, 1967, assets acquired by these industries must be written off in the normal manner, i.e. either by using the straight-line or the declining balance method. However, during a second transitional period from January 1, 1967 through December 31, 1971 the enterprises were permitted to use declining balance depreciation and apply an additional annual write off which is computed by multiplying the rates of declining balance depreciation by a certain coefficient, i.e. 2 in 1967; 1.6 in 1968; 1.2 in 1969; 0.8 in 1970; 0.4 in 1971. However, for assets whose useful life was less than 10 years the following maximum depreciation rates had to be taken into account: 75% in 1967; 65% in 1968; 55% in 1969; 45% in 1970 and 35% in 1971. In so far as the additional depreciation was not utilized it could be carried over to the next accounting year but not later than December 31, 1975.

3.6.3. Special depreciation for export enterprises

This accelerated depreciation was granted under the French efforts in 1957 to increase exports. The special depreciation (which was given in addition to straight-line depreciation) was computed by multiplying the total amount of depreciation deductions available to the enterprise by the ratio between the enterprise's export sales and total sales of that year. In 1959 the special depreciation was increased by 50%, i.e. it then was 150% of the ratio between export sales and total sales times the available normal depreciation deduction. The export deduction was only available to those enterprises which possessed an "exporter's card". It was in principle abolished for assets acquired on or after January 1, 1969 by the introduction of declining balance depreciation. However, during a transitional period of time from January 1, 1960 through December 31, 1964 the taxpayers could opt between declining balance depreciation or the continuation of the special export deduction. As of January 1, 1965 this special depreciation has been definitely terminated.

4. Depreciation on account of extraordinary wear and tear and exceptional loss of value

Losses of this type with respect to depreciable assets may in principle be compensated for by simply deducting an amount equal to the real loss in value. This exceptional depreciation deduction is considered to be a logical application of the legal depreciation provisions. In practice a number of reasons for such an additional write-off have been accepted by the tax administration such as scrapping, destruction, taking out of service, technical obsolescence, economic crisis and shift work.

However, extraordinary depreciation with respect to non-depreciable assets must be entered into a special reserve (provision) (see Part D, para. 2.3., below).

5. Deferral and recovery

5.1. General

Prior to 1965 there was no obligation to depreciate fixed assets so that the manner and timing of depreciation was completely left to the commercial accounting policy of the business involved. The Law of July 12, 1975 (currently CGI, Art. 39B) obliges enterprises (whether owned by individuals or companies) to depreciate a certain minimum for income tax purposes. Accumulated depreciation recorded at the end of each accounting year may not be less than accumulated depreciation (asset by asset) calculated on a straight-line basis and spread over the normal useful life of the assets. If the enterprise does not conform to this requirement it is penalized by the loss of any unrecorded straight-line depreciation in subsequent years.

This does not mean, however, that depreciation may not be deferred in certain cases.

5.2. Deferral and recovery of non-utilized depreciation

A distinction must be made between deferral of depreciation in profits and in loss years.

a) Profit Years

In profit years the minimum depreciation must be taken in conformity with the rules set out above. If too little has been written off for income tax purposes the difference between actual depreciation and prescribed depreciation is definitively lost. However, in those cases where the accumulated depreciation exceeds prescribed accumulated depreciation it is possible to defer depreciation. If straight-line depreciation is used, the deferred depreciation may only be deducted in the accounting years following the normal useful life of the asset at the normal rates. If the asset is sold or scrapped the deferred depreciation may be taken at once. If declining balance depreciation is used the deferred amount may also be spread over the remaining useful life of the asset by applying the normal rate of depreciation to the residual book value.

b) Loss Years

In loss years a distinction must be made whether the enterprise records the depreciation at the end of the loss year or not.

If depreciation is so recorded, the enterprise may consider the depreciation to be deferred, provided that it includes the depreciation in a special appendix to the balance sheet. The depreciation may then be taken in the first profit year and if there is a balance, it may be carried over to the next profit year until the amount of deferred depreciation has been absorbed. There is no time limit.

If the depreciation is not recorded at the end of the loss year it must first be established whether the accumulated depreciation equals at least the amount of prescribed accumulated depreciation based on straight-line depreciation over the normal useful life of the asset. If it appears that accumulated depreciation is less than the prescribed depreciation, the difference is lost. If, however, the deferral is in conformity with the law, deduction may be deferred to the first year in which a profit is made. It may be taken after losses of previous years and normal depreciation have been deducted. Any balance may be carried forward to following profit years. There is no time limit. If declining balance depreciation is used, the taxpayer may opt to spread the deferred depreciation over the remaining useful life of the asset by applying the normal rate of depreciation to the residual book value.

6. Commercial and fiscal depreciation

As was stated under 5 above accumulated depreciation may not be less than accumulated depreciation (asset by asset) computed on a straight-line basis and actually recorded in the commercial accounts.

C. TAXATION OF CAPITAL GAINS AND LOSSES1. Capital gains in general1.1. Introduction

Capital gains derived by a business are generally included in taxable income and subject to either individual or corporate income tax, mostly at a reduced rate.

1.2. Realized and non-realized capital gains

The French Tax Code only mentions realized capital gains. Non-realized capital gains which have not been recorded are not subject to income tax. Non-realized but recorded capital gains are considered to be taxable income which cannot benefit from any privileged treatment which is available for realized capital gains. They may, however, increase the depreciable base in case of depreciable assets.

Note that in general the recording of non-realized capital gains will be disadvantageous, since the normal rate of income tax will apply on the total amount of the gain. However, taxpayers who have losses of previous years which cannot be carried forward (the normal time limit for the carry forward of such losses is 5 years) may find it advantageous to revalue their depreciable assets thus absorbing such losses and increasing the depreciable base of such assets.

1.3. Capital losses

Capital losses may be deducted if they have been realized and in general also if they have been recorded. In the latter case the loss must be entered into a reserve (provision). Special rules apply to portfolio holdings and participations in other companies, debts claims and foreign currency.

2. Principles for the computation and the taxation of capital gains

2.1. Industrial and commercial enterprises

2.1.1. In general

Industrial and commercial enterprises are for the purpose of this report defined as enterprises which carry on industrial, commercial or mining activities, including manufacture, transformation and transportation. Companies subject to corporate income tax are always deemed to carry on industrial or commercial activities.

2.1.2. Qualifying assets

The Law No. 65-566 of July 12, 1965 introduced a special regime for the computation and the taxation of capital gains which are derived from the disposal (sale, contribution to a company, exchange, expropriation etc.) of the fixed assets of an enterprise. Gains derived from the disposal of goods normally sold in the course of business -- mainly inventory -- do not come under this regime. Neither does this special regime apply to capital gains or losses which are merely recorded and not realized.

Fixed assets include depreciable and non-depreciable assets as well as portfolio investments, participations in other companies (see para. 2.1.6., below) and "industrial property" (see para. 2.1.7., below).

The special regime applies to disposal of fixed assets during the life and also at the discontinuation of the enterprise.

2.1.3. Short-term capital gains and losses

Short-term capital gains are defined as: (i) gains realized on the disposal of fixed assets which are held for less than two years and (ii) that portion of the gains of fixed assets which are held for two years or more, which corresponds to the depreciation which has been deducted from taxable income. Short-term capital losses are: (i) losses realized on the disposal of non-depreciable fixed assets held for less than two years and (ii) losses realized on the disposal of depreciable fixed assets regardless of the number of years held. Short-term capital gains and losses must be netted at the end of the accounting year. If there is any balance of short-term capital gain over short-term capital losses it will be taxable at the full rate of income tax (progressive rate for individuals and 50% for corporations). However, the taxpayer may elect to spread the gain over three consecutive years.

There are two exceptions to this rule, each of which allow the short-term capital gain to be spread over 10 consecutive years, i.e.:

- short-term capital gains which result from certain reorganizations of activities of enterprises which have obtained an exemption from business tax (taxe professionnelle);
- short-term capital gains which result from the receipt of an indemnity for assets which were destroyed or expropriated and which relate to:
 - i) either depreciable fixed assets which are written off in conformity with the straight-line method over a period exceeding 5 years;
 - ii) or depreciable fixed assets which are written off in conformity with the declining balance method over a period exceeding 8 years.

Net short-term capital gains are immediately taxable in full on the sale or discontinuance of the enterprise, i.e. in such a case the spreading of the income is not permitted and any short-term capital gains of preceding years whose taxation was deferred also become immediately taxable.

Note that individual taxpayers may in such a case request that this gain (provided it exceeds the taxpayer's average income of the last three years) be spread over the year in which it was received and over the preceding years to which the statute of limitations does not apply (generally a period of 4 years).

In a number of cases capital gains which come under the definition of short-term capital gains are treated as if they were long-term capital gains (see para. 2.1.4., below).

Examples are:

- (i) capital gains which appear at the death of an individual entrepreneur, unless his heirs apply for the application of the normal provisions;
- (ii) capital gains resulting from the liquidation of certain inactive companies with a view to cleaning up the economy;
- (iii) capital gains resulting from the adding back to income of reserves (provisions) which have been created to write-off securities and which have lost their purpose (see para. 2.1.6., below);
- (iv) the disposal of certain "industrial property", i.e. the sale or licensing of industrial rights (see para. 2.1.7., below).

Net short-term capital losses are deductible from the current accounting year's taxable income. If current income is insufficient to absorb the loss, it may be carried forward against operating income of the five following years as if it were an ordinary loss.

2.1.4. "Ordinary" long-term capital gains and losses

"Ordinary" long-term capital gains can be defined as: (i) gains on the disposal of non-depreciable fixed assets other than "building sites" (see 2.1.5., below) which are held for two years or more and (ii) gains on the disposal of depreciable fixed assets held for two years or more to the extent that they exceed the recaptured depreciation on such assets. Long-term capital losses are: (i) losses on the disposal of non-depreciable fixed assets other than building sites (see para. 2.1.5., below) held for two years or more and (ii) losses resulting from the adding back to income of provisions created to write-off on securities (see para. 2.1.6., below).

"Ordinary" long-term capital gains and losses must be netted at the end of the accounting year. If there is a balance of "ordinary" long-term capital gain over "ordinary" long-term capital loss the balance may at the option of the taxpayer be used in any order he elects to compensate:

- (a) any deficit of the current accounting year;
- (b) ordinary operating losses of the previous 5 years which may be carried over;
- (c) deferred depreciation of preceding years;
- (d) "ordinary" net long-term capital losses of the previous 10 years which have not yet been compensated.

If the balance is a gain, this gain is subject to a reduced rate of income tax of 15 percent (10% for long-term capital gains derived in accounting years closed before December 1, 1973). The payment of the tax may be postponed for 2 years (except in the case of discontinuation of the enterprise's activities) in case of long-term capital gains resulting from the receipt of an indemnity from an insurance company (in case of destruction) or in case of expropriation of buildings.

Taxpayers subject to corporate income tax must place the ordinary long-term capital gain less the 15% tax in a special reserve, which may not be distributed. If the gain is distributed it is added back to income subject to tax at 50% (with a credit for the 15% tax previously paid) except in the following cases:

- (i) if the reserve is used to compensate ordinary operating losses or "ordinary" long-term capital losses of the following 10 years;

- (ii) if the reserve is incorporated into capital upon payment of 12% (in certain cases 7%) registration duty;
- (iii) if the reserve is distributed upon liquidation.

If the balance is a long-term capital loss it may be set off against:

- (i) "ordinary" long-term capital gains of the next 10 years;
- (ii) or the special reserve for "ordinary" long-term capital gains which must be created by taxpayers subject to corporate income tax.

In case of the discontinuance of the enterprise or in case of its sale part of any "ordinary" long-term capital loss can be deducted from the income of the last accounting year, i.e.:

- (i) one-fifth of the amount of capital losses which can be carried forward and which have been incurred in accounting years closed before December 1, 1973; and
- (ii) three-tenths of the capital losses incurred in accounting years closed on or after December 1, 1973.

2.1.5. Long-term capital gains and losses connected with "building sites"

Long-term capital gains and losses connected with "building sites"(terrains à bâtir) as defined in CGI, Art. 150 ter(I) (in general unimproved, non-agricultural land and land with buildings of little value or destined to be demolished) received the same treatment as "ordinary" long-term capital gains and losses, but they must be computed separately from such "ordinary" long-term gains and losses since any net gain is subject to a flat 25% rate (instead of 15%). The main consequences of this separate treatment are:

- (i) long-term capital gains connected with "building sites" can neither be added to "ordinary" long-term capital gains nor can they be set off against ordinary long-term capital losses of the current or previous years;
- (ii) any net amount of long-term gain connected with "building sites" must be credited to the long-term capital gain reserve in such a manner that it can clearly be established which part of the gain is an "ordinary" gain and which part is connected with "building sites";
- (iii) the amount credited to the special reserve is the gain less 25% tax. At distribution (except if the reserve is used to compensate capital losses incurred on "building sites" of the following 10 years, if the reserve is incorporated into capital or at liquidation) the reserve is added back to income subject to 50% corporate income tax (with a credit for the 25% tax paid).

2.1.6. Securities

Under current legislation a distinction is made between "portfolio holdings" (i.e. diversified holding of securities) and "participations" (which have been acquired with a view to ensure the control over a company or to the possibility to exercise a certain influence on such a company and which the enterprise envisages to hold for a longer period of time).

2.1.6.1. Portfolio holdings

Securities which belong to the enterprise's portfolio holding must be entered in the balance sheet at the price for which they have been purchased or at their subscription price. They must be valued at the end of each accounting year. Securities which are quoted at the stock exchange must be valued for their average value of the last month of the accounting year and non-quoted securities must be valued at the price for which they probably can be sold. Gains and losses are then determined for each group of securities separately, i.e. only those gains and losses are netted where the securities have been issued by the same entity and give the same rights to their holders. If the balance shows a gain (and no depreciation has been taken on these securities) such gain is not recorded and is disregarded for tax purposes.

Losses, however, may be credited to a reserve (provision) (see Part D, para. 2.2., below) for the depreciation of securities which must be adjusted at the end of each accounting year. The amount credited to the reserve is treated as a long-term capital loss (see para. 2.1.4., above), i.e. it cannot be deducted from operating losses. If the securities increase in value, the reserve is reduced by the amount of the increase up to a maximum of the amount of reserves, i.e. any increase beyond the amount of the reserve would result in a taxation of an unrealized capital gain and is not obligatory. Such reduction of the reserve is treated as a long-term capital gain. Similarly, if securities are sold which have previously been written off, the difference between the sales prices and the book value of the securities less the depreciation is treated as a long-term capital gain up to the amount of the reserve. See para. 2.1.3., above.

In the case of an abnormal and temporary decrease in value of certain securities the enterprise may refrain from entering the decrease in the reserve if and in so far as the decrease is compensated by an increase in value of the other securities held by the enterprise. The tax administration ruled that if a taxpayer has thus opted not to credit a decrease of value of securities to the reserve he may not do so in later years (with the exception for the years 1971, 1972 and 1973 in which it was permitted to carry the deduction over to the next year).

With respect to the sale or other disposal of securities the normal rules with respect to the imposition of short-term and long-term capital gains and losses apply (see para. 2.1.3. and para. 2.1.4., above), provided that the securities are part of the enterprise's fixed capital.

In those cases where the purpose of the enterprise is the trade in securities (e.g. in the case of a stockbroker) any gains and losses connected with the disposal of the securities are treated as normal operating gains and losses, even if the securities were held for 2 years or longer.

In all other cases (even in the case of banks) securities are deemed to be part of the enterprise's fixed capital if they have been held for:

- 2 years or longer; or
- less than 2 years, provided that the enterprise holds other shares of the same kind which have been held for more than 2 years.

If all the shares of the same kind have been held for less than 2 years before their disposal gains or losses are treated as normal operating gains or losses. When determining how long securities have been held, the FIFO system (first-in, first-out) is applied.

2.1.6.2. Participations

As of January 1, 1974 special rules apply to "participations", which include shares held by so-called parent corporations (sociétés mères) in their French or foreign subsidiaries (generally a participation of 10% or more in the subsidiary's share capital). They must at their acquisition be entered in the balance sheet at their original cost (purchase price increased by additional costs connected with the purchase, value surrendered at their contribution to the capital of a company etc.). At the end of each accounting year the same procedure applies as in the case of portfolio holdings, i.e. each type of share must be valued separately. However, a loss may only be credited to the reserve discussed above if there is a real decrease of value which must be justified by the enterprise not only in conformity with their value at stock exchange or probable sales price, but also in conformity with other economic data such as the average yield of the shares etc. If a loss can be determined it is credited to the special reserve and it is treated as a long-term capital loss. Otherwise the same provisions apply as for portfolio holdings (see para. 2.1.6.1., above).

2.1.6.3. Special cases

- (a) Capital gains derived from the disposal of the so-called "emprunt Pinay" (the 4½% State bond loan 1973 replacing the preceding 3½% State bond loan 1952 and the 3½% State bond loan 1958) are exempt from individual income tax but not from corporate income tax.
- (b) Shares in Government approved research companies and organizations qualify for a 50% initial depreciation (see Part B, para. 3.6.(iv), above). If such shares are disposed of, the capital gain (if any) to the amount of the initial depreciation deduction is exempt from income tax provided the disposal takes place at least three years after they have been subscribed to.
- (c) Shares in Government approved companies for the development of agriculture, industry and commerce entitle their subscribers to a 100% initial depreciation deduction. Similarly a subscription to shares of a Government approved "financial innovation company" entitles the subscriber to a 50% initial depreciation (see Part B, para. 3.6.(v), above). If these shares are disposed of the capital gain (if any) is exempt from income tax to the extent of the initial depreciation taken.
- (d) Certain Government approved real property companies instituted under the provisions of the Decree No. 58-876 of September 24, 1958 for the financing, the construction and the administration of dwelling houses were accorded privileged treatment under previous legislation, most of which have been abolished in 1963. As a transitional measure capital gains derived from the disposal of shares in such companies (provided they were created before March 17, 1963 and the shares were subscribed to before July 1, 1964 and were paid in before January 1, 1966) are exempt from income tax to the extent of the 50% or 25% initial depreciation deduction which was available at that time or to the extent of certain other depreciation deductions.
- (e) The exchange of shares for other shares may be effected without attracting income tax on any resulting capital gain, provided that the shares received are entered in the balance sheet at the same value of the shares which were given in exchange. However, this exemption is only granted if the exchange constitutes a legal means to arrive at a specialisation or a concentration of enterprises.

- (f) There exists a roll-over provision in case an enterprise is continued by an individual taxpayer's spouse or relatives (see Part B, para. 3.3., above).

FRANCE2.1.7. Industrial property

Gains derived with the disposal or licensing of industrial property held for at least 2 years are considered to be long-term capital gains in the following cases:

- (a) the disposal of patent rights, work methods and technical procedures;
- (b) the granting of an exclusive operating license (including the granting of an exclusive right to use certain work methods or technical procedures, even in the case that they are not accessory to the disposal or the granting of an exclusive right to use a patent);
- (c) the granting of an operating license for a certain geographical area or for a specially defined use;
- (d) the disposal of or the granting of an exclusive license to patents which have been applied for.

Proviso is that the disposal or the licensing of a patent must have as a result that the patent ceases to form part of the enterprise's fixed assets either in full or partially for a certain geographical area or for a specially defined use. With respect to a license this means that the license must be granted until the expiration of the patent.

Another condition is that the rights, work methods and technical procedures must be considered to be fixed assets, i.e. they do not qualify for long-term capital gain taxation if it is the enterprise's purpose to acquire such rights, work methods and technical procedures with a view to their later sale, even if effected after two years.

In addition, long-term capital gains taxation is denied to royalties received for the disposal or licensing of industrial property if these royalties may be deducted for purposes of the French income tax and if there exists directly or indirectly a relationship between the two enterprises. Thus royalties paid by a non-resident enterprise do not come under this disqualification.

2.2. Non-commercial enterprises

Non-commercial enterprises comprise liberal professions (medical, doctors, lawyers, notaries etc.) and all other lucrative activities which do not fall in any other category.

Capital gains and losses are generally treated as ordinary profits and losses subject to the normal progressive rates of individual income tax. Special treatment, however, is accorded to capital gains derived with the disposal of fixed assets at the discontinuance of the activities or at the sale of a part of the enterprise and also with respect to any compensation received for the discontinuance of a profession or for the transfer of goodwill. These gains are subject to a reduced flat rate of 6% individual income tax provided that disposal, discontinuance etc. take place more than 5 years after the profession or goodwill was created or otherwise acquired or results from the death of the owner. In all other cases qualifying for special treatment the capital gain is only included in taxable income for half of its amount.

2.3. Agricultural enterprises

Capital gains and losses receive generally the same treatment as in the case of industrial and commercial enterprises (see para. 2.1. above).

However, short-term capital gains are, unless the taxpayer elects to be subject to the normal provisions, treated as long-term capital gains.

There exists a roll-over provision in case an enterprise is continued by the taxpayer's spouse or relatives. (Cf. part B, para 3.3. above).

3. Company reorganizations

Special provisions apply to company reorganizations, i.e. mergers, divisions and spin-offs. They apply with respect to companies subject to French corporate income tax.

If the approval of the Ministry of Economic Affairs and Finance has been obtained, privileged tax treatment may also be accorded where assets and liabilities are transferred to a non-resident corporation. One of the conditions which will ordinarily be imposed is that these assets and liabilities must remain in France, i.e. they must appear in the books of an enterprise (for instance a branch office of a foreign firm) subject to income tax in France. The law does not extend the privileged treatment to transfers of assets and liabilities by non-resident corporations to French corporations if the former are not subject to French corporate income tax. However, the tax administration is prepared to apply the privileged treatment to all merger operations by which a foreign corporation is absorbed by a French corporation.

3.1. Mergers (fusions)

Mergers are defined as transactions whereby two or more companies combine all their assets and liabilities to form one single company. This may be effected through the absorption by one company of the assets and liabilities of one or more other companies in exchange for shares of the former company or by the creation of a new company which absorbs the assets and liabilities of two or more companies in exchange for its shares.

The following privileged tax treatment is accorded with respect to mergers:

3.1.1. Absorbed corporation(s)

- (i) The absorbed corporation is exempt from corporate income tax on net capital gains arising from the transfer of fixed depreciable and non-depreciable assets (i.e. the difference between their book-value and the actual value at the time of the merger). However, it may elect to pay the reduced rate of corporate income tax (15% or 25%) on all or part of the long-term capital gains on the depreciable assets which are transferred under the merger operation. The amount which is thus taxed reduces the amount of taxable capital gains on which the absorbing corporation is subjected to income tax over a period of 5 years (see para. 3.1.2., below);
- (ii) The absorbed corporation is (for mergers which are effected prior to January 1, 1978) exempt with respect to capital gains arising from any shares it holds in the absorbing corporation;
- (iii) The absorbed corporation may (for mergers which are effected prior to January 1, 1978), if the approval of the Ministry of Economic Affairs and Finance has been obtained, pass over any operating tax losses (or carry-over of losses of previous years and deferred depreciation) which are not absorbed by taxable income and capital gains to the absorbing corporations: If the absorbed corporation sustains a net capital loss (balancing net long-term and short-term capital gains and losses) on depreciable assets which are transferred to the absorbing corporation it may first deduct this loss from taxable income in the year of the merger and any balance may be carried over for 5 years as an ordinary tax loss by the absorbing corporation without Government approval.

3.1.2. Absorbing corporations

- (i) The absorbing corporation must enter non-depreciable assets in its books at their book value with the absorbed corporation;
- (ii) The absorbing corporation enters in its balance sheet the depreciable assets transferred from the absorbed corporation at their (stepped-up) merger value. Then it recomputes the remaining useful life of these assets and depreciates them on a straight-line or declining balance basis as if they were new assets. The capital gain (whether long-term/^{or short term} on depreciable fixed assets is then subject to the full 50% standard rate of corporate income tax. The capital gain may, however, at the option of the taxpayer be spread over the year of the merger and the 4 next years but the minimum amount attributed to each year may not be less than one-fifth of the gain (in certain cases a longer period of time is permitted);
- (iii) The absorbing corporation may carry over the long-term capital gains provision (see para. 2.1.4., above) and any other reserves of the absorbed corporation which have not borne full corporate income tax;
- (iv) The absorbing corporation must add to taxable income the deferred portion of capital gains which the absorbed corporation would have had (e.g. short-term capital gains and deferred capital gains resulting from a previous merger in which the absorbing corporation was involved);
- (v) The absorbing corporation takes over and enters in its records any reserves of the absorbed corporation which are deemed to be necessary, such as the reserve for price increases, for commodity market fluctuations, medium and long-term credit risks abroad (see part D, below) and depletion allowances (see part E, below);
- (vi) Any capital gain resulting from shares which the absorbing corporation held in the absorbed corporation is exempt from income tax provided that the merger takes place prior to January 1, 1978;

(vii) Operating loss carry-overs of the absorbing corporation are generally not affected by a merger operation unless the sole purpose of the merger operation was to evade corporate income tax by absorbing expiring losses. However, a merger operation may affect so-called "deemed" deferrals of depreciation from previous years (i.e. the depreciation which is taken and which corresponds to a tax loss (see part B, para. 5, above)). The amount of any losses of previous years corresponding to the amount of "deemed" deferred losses may generally be carried forward indefinitely. However, upon a company reorganization "deemed" deferred depreciation is automatically converted, retroactively, to losses subject to the normal 5-year carry-over limitation (see part G, below) which may cause the absorbing corporation to lose some of its old loss carry-overs. If the economic interest of the merger is sufficiently important, the tax administration may, however, restore the indefinite loss carry-over for "deemed" deferred depreciation.

3.1.3. Shareholders

The shareholders of the absorbed company receiving shares of the absorbing company upon liquidation of the former company are neither subject to individual nor to corporate income tax with respect to the value of the shares received. The recipients must for tax purposes value the shares received at the same value as the shares surrendered.

3.2. Division (scission)

A company division is defined as a transaction whereby one corporation contributes all its assets and liabilities to two or more existing or newly created corporations in return for shares of the latter. Divisions receive practically the same privileged tax treatment as mergers (except for special rules with respect to the prorating of capital gains, carry-over of reserves etc. among the absorbing corporations). However, privileged treatment is in principle only available provided that:

- (i) the Ministry of Economic Affairs and Finance has given its prior approval;
and
- (ii) the agreements under which the assets and liabilities of the absorbed corporation are contributed to the absorbing corporations take effect on the same date and result in the immediate dissolution of the absorbed corporation.

3.3. Spin-off or partial merger (apport partiel d'actif)

Spin-offs are defined as transactions whereby one corporation transfers part of its assets and sometimes also part of its liabilities to one or more corporations in return for shares of the latter.

Spin-offs receive in principle the same privileged treatment as mergers.

Two cases can be distinguished:

- (a) A prior approval of the Ministry of Economic Affairs and Finance has been obtained. The transferring company is subject to income tax on the operating income of the branch of operations (or assets) transferred up to the moment of transfer, including income of inventory transferred and any provisions related to the assets transferred. If a capital loss arises on depreciable assets transferred it may be carried over to the recipient corporation and deducted from the income of the year of transfer and the 4 next years, provided that Government approval has been obtained.
- (b) No prior approval of the Ministry of Economic Affairs and Finance is needed where the corporation transfers a complete branch of activity and if the two following conditions have been met:
 - (i) the contributing corporation must commit itself to holding the shares received in consideration for the contribution for at least 5 years; and
 - (ii) the contributing corporation must commit itself to computing any capital gains on the transfer of these shares based on the value of the assets in the records of the contributing corporation.

3.4. Revaluation of non-depreciable assets

The 1977 Finance Law provides for the revaluation of non-depreciable business assets, including participations included in the balance sheet of the first accounting year closed after December 31, 1976. This revaluation is in principle optional but it is obligatory for, inter alia, companies whose shares are quoted on the stock exchange or which solicit funds from the general public. It is also obligatory for those companies whose shares are held by a company whose shares are quoted on the stock exchange if the participation qualifies for consolidation of income under French law.

The revaluation must be effected in the first accounting year closed after December 31, 1976 or the following year.

The gain resulting from the revaluation is exempt from income tax but must be entered in a special reserve which may not be distributed. The reserve may, however, be used to increase the capital.

When the asset is sold or otherwise disposed of, the resulting capital gain or loss is computed on the basis of the book value of the asset before revaluation.

D.

RESERVES1. In general

A distinction should be made between the "réserves" (reserves proper) which denote accumulated profits and the "provisions" (provisions) which are amounts deductible from taxable income and set aside in the taxpayer's books to meet accrued liabilities, estimated expenses or other contingencies.

Reserves proper include the legal reserve (a minimum of 5 percent per year of net profits after taxes which must be set aside until the fund amounts to 10 percent of corporate capital), the reserve account for capital gains (discussed in part C, para. 2.1.4., above) and the reserve for revaluation of non-depreciable assets (see part C, para. 3.5., above).

2. Ordinary provisions

Provisions may be set up for any purpose, however, any contribution to these provisions may only be deducted from taxable income if the following six conditions have all been met:

- (i) the provision must have been set up for a specific purpose and must concern a specific item of loss or expense;
- (ii) the provision must concern losses or expenses which are deductible for tax purposes;
- (iii) the loss or expense must be probable, i.e. no deduction is permitted for possible risks;
- (iv) the loss or expense must result from a fact which happened during the course of the financial year, with exceptions for certain future expenses;
- (v) the provision must be entered in the taxpayer's books;
- (vi) the provision must be reported in a summary attached to the taxpayer's annual tax return.

The most important deductible provisions are summarized below.

2.1. Provision for doubtful debts

Debt claims are entered in the balance sheet at their face value. If they become unrecoverable in a given year they may be written off as an exceptional loss. If full or partial payment at the end of the financial year is doubtful, the taxpayer is permitted to set up a doubtful debt provision. The computation of the provision must be based on a debt ^{by debt} assessment of the probability of its payment and estimated as to the amount which is not recoverable.

Doubtful debt provisions which are based on the amount of the debt claims outstanding or on the taxpayer's turnover will generally be disallowed.

2.2. Provision for depreciation of securities

This provision is discussed in part C, para. 2.1.6., above.

2.3. Provision for extraordinary depreciation of fixed assets (in particular non-depreciable assets)

A loss in value of any non-depreciable asset (e.g. land, goodwill, trademarks etc.) may be expressed in the taxpayer's books by the creation of a special provision. (See part B, para. 4, above).

2.4. Provision for depreciation of stock

Where the value of stock-in-trade (inventory) is less than cost it must be valued at the (lower) market value. The difference between the cost and market value must be placed in a separate provision. (See part F, para. 1, below).

2.5. Provision for deductible taxes

A provision may be created for taxes which are payable provided that they (i) are deductible, (ii) are annually assessed, (iii) result from events which have occurred in the year in which the provision is created and (iv) the law does not provide otherwise.

2.6. Provision for employee remuneration

If the taxpayer is committed to pay employee remuneration (such as bonuses) but which are not yet paid at the end of the financial year they may be entered into a provision.

2.7. Provision for moving expenses

A provision may be created for moving expenses where a leasehold has expired and the move is certain.

2.8. Provision for expenses which are spread over a number of years

Substantial expenses which should be spread over a number of years such as extensive maintenance or repair, restoring leased premises and quarries or mines at the end of the lease may be entered into a provision.

3. Special provisions

The law permits the taxpayer to create a number of special provisions which are subject to detailed rules. The following discussion only outlines these provisions.

3.1. Provisions connected with investment abroad

Two different provisions may be created with respect to the establishment of a foreign branch office or a foreign subsidiary.

The first one is connected with foreign branches or foreign subsidiaries which are deemed to be commercial enterprises. Initial losses incurred during the first five years of their existence may be placed in a tax deductible provision up to an amount not in excess of the foreign investment if such investment is made in one of the other E.E.C. countries. Investment outside an E.E.C. country may be fully entered into a provision. The provision must be added back in 5 equal annual instalments to taxable income starting from the sixth year following the first year of investment.

The second provision relates to investment abroad in industrial enterprises (either a foreign branch office or a foreign subsidiary). The provision in this case may not exceed 50 percent of the capital invested, otherwise similar rules apply. See for more details part E, para. 3, below.

3.2. Provision for employee profit sharing

All French employers with an average of more than 100 employees in a year are obliged to participate in the employee profit sharing plan (participation des salariés aux fruits de l'expansion des entreprises). One of the aspects of this system is that as of January 1, 1968 qualifying employers must create a provision which equals

$$\frac{\left(I - \frac{5 \times C}{100} \right) \times \frac{P}{V}}{2}$$

where:

I is domestic source income less corporate income tax

C is "capital proper" (capital, reserves, accounting profit (or loss) brought forward, non-deductible provisions carried over and provisions deducted from corporate income tax (except the participation provision) by virtue of a specific article of the French law)

P is payroll

V is value added as defined in the law.

The provision is only deductible in the taxable year following that on the result of which it has been calculated, i.e. the provision based on 1976 net income, capital and payroll is deductible in 1977.

3.3. Investment provision

Another aspect of this employee profit sharing scheme is that the employer receives a sort of bonus in the form of an "investment provision" which currently may not exceed 50 percent of the amount which is placed in the profit sharing provision (see part E, para. 2, below).

3.4. Provision for price increases

A provision for inventory price increases may be created on an item per item basis if the price of a given material or product within a period of not more than two successive financial years increases by more than 10 percent. (See part F, para. 2, below).

3.5. Provision for commodity market fluctuations

Enterprises whose main purpose is the processing of certain listed raw materials may create a provision for world price fluctuations. (See part F, para. 3, below).

3.6. Provision for credit risks

Enterprises which carry on business operations abroad, i.e. sales of goods or construction activities for which they grant medium-term credit may create a provision for credit risks which is deductible from taxable income. The enterprise does not exceed to justify the risk incurred. In general the credit must be for a period of 2 to 5 years, but may be for a longer or shorter period of time if a so-called COFACE guarantee is acquired. The amount of the provision may not exceed 10 percent of the credit granted.

3.7. Provisions for credit risks incurred by banks

Banks and other credit institutions may create two different provisions. The first one is for risks relating to middle and long-term credit operations. The amount which may be annually contributed to this provision varies from 0.5 percent to 40 percent of annual income depending on the credit institution. The total amount which may be placed in the provision is either 0.5 percent or 3 percent of the credits outstanding depending on the type of credit institution.

The second provision may be created for risks connected with middle and long-term credit operations with respect to sales on the carrying on of construction activities abroad. This provision could only be created during 1966-1975.

3.8. Provisions for insurance and re-insurance companies

Insurance and re-insurance companies may create a provision for exceptional risks connected with the coverage against natural calamities, atomic risks and damage claims because of pollution. The amount of the provision is subject to a double limit:

- (i) The annual contribution to the reserve may not exceed 75 percent of the technical profit of the category of risks concerned. The technical profit is defined as the difference between:
 - the amount of premiums which were received in the accounting year less premiums refunded and amounts contributed to provisions; and
 - the amount of payments made increased by costs.
- (ii) The total amount of the reserve is also limited to a certain percentage of the net premiums received (e.g. 200 percent for insurance against freezing, and 500 percent for insurance against atomic risks).

Other provisions which may be or in a number of cases must be created by insurance companies are the so-called mathematical reserve (or provision) (this is obligatory for e.g. life insurance companies and some other categories of insurance companies), a provision against the reduction of value of the securities held by the insurance company and the decrease of the income received from such securities and the provision which must be created by, inter alia, life insurance companies in order to guarantee the obligations of the insurance company should the mathematical reserve appear to be insufficient.

3.9. Provision for newspapers and magazine enterprises

Newspaper and certain magazine enterprises may create a tax deductible provision of a certain part of their income, i.e. 90 percent in accounting year closed in 1970, 80 percent in accounting year closed in 1971 and, in accounting years closed in 1972-1975, 80 percent for daily newspapers and 60 percent for other publications. The Law No. 76-1233 of December 29, 1976 extends the latter regime to the accounting years 1976-1979. However, for the accounting years 1978-1979 the above percentage of 80 percent is reduced to 70 percent and the percentage of 60 percent to 50 percent.

The provision must be used for the acquisition of business assets which are needed to publish newspapers and qualifying magazines or participations in printing enterprises within 5 years after the amounts were entered into the provision.

See for more details part E, para. 4, below.

3.10. Provision for oil, gas and mineral depletion

Companies engaged in the research and exploitation of oil and gas or in the extraction of certain solid minerals indicated in the law may create a deductible depletion provision (see part E, para. 5, below).

E.

OTHER INVESTMENT INCENTIVES

A general investment allowance is not granted in France but a number of other incentives are granted which in some cases are tantamount to an investment allowance.

1. Investment credit

Under previous legislation an investment credit was provided (which could be taken against the value added tax or TVA) for assets ordered after April 30, 1975 and before January 8, 1976 for investment in plant and machinery which qualify for declining balance depreciation (see part B, para. 3.1., above). Delivery may take place up to 3 years after ordering. The investment credit may neither exceed the amounts paid during that period nor 10 percent of the acquisition cost of the assets.

The investment credit must be deducted from the depreciable base of the assets acquired.

2. Investment allowance in connection with employee profit sharing

Employers who participate in the employee profit sharing scheme discussed under D.3.2. above may create an "investment provision" (exempt from income tax) which currently may not exceed 50 percent of the amount which is placed in the participation. This provision must be used to purchase or manufacture depreciable or non-depreciable business assets not later than 12 months following the end of the year in which it was created. If the amounts thus set aside are not used within the prescribed period of time they are added back to taxable income.

3. Aid for investment abroad

As indicated in D.3.1. above a French enterprise investing abroad either in a foreign branch office or in a foreign subsidiary may create a tax deductible provision for losses or investment of the first five years.

However, this provision must be added back to taxable income in 5 equal instalments starting from the sixth year following the first year of investment.

3.1. Commercial enterprises

The first provision relates to investment in foreign commercial enterprises (branch offices or subsidiaries). However, in order to be able to deduct the amounts placed in the provision Government approval is required. This approval is deemed to have been obtained if no reply is received from the tax administration within 2 months after application.

Commercial enterprises are defined as sales offices, research offices or offices to collect information.

The amount which may be entered into the provision is limited to the lesser of (i) the accumulated amount of the losses of the first five years computed in conformity with French tax law and (ii) the accumulated amount of the investment, if the investment is made in one of the other Common Market countries. If the investment is made in a country not belonging to the Common Market the full amount of the investment may be placed in the provision. Note, however, that in such a case generally Government approval will be obtained only if the investment is made in a development country.

Investment through a subsidiary will only qualify if the participation of the French enterprise in the foreign subsidiary amounts to at least 50 percent of the latter's shares (or the maximum participation which is allowed under the law of the subsidiary's country of residence, if such law forbids a 50 percent participation by a foreign parent corporation).

3.2. Industrial enterprises

The second provision relates to investment in foreign industrial enterprises (branch offices or subsidiaries). For this provision an express Government approval is required, which will generally be granted only for investment in a development country.

The amount which may be placed in the reserve may not exceed 50 percent of the accumulated investment of the first five years of the subsidiary's existence. Otherwise the same provisions apply as in case of investment in foreign commercial enterprises.

4. Investment relief for certain publishing enterprises

Newspaper and certain magazine enterprises which publish either a monthly or bi-monthly magazine which is to a large part devoted to the dissemination of political information (i) may deduct from their taxable income costs incurred for the acquisition of business assets which are necessary for their operations and (ii) may create tax deductible provisions for the acquisition of such assets (see also part D, para. 3.9., above).

Up to and including accounting years closed in 1969 100 percent of the income could be thus deducted or placed in a provision. As of accounting years closed in 1970 these amounts were restricted to a certain percentage of profits as follows:

accounting years closed in 1970	: 90 percent
accounting years closed in 1972-1977	: 80 percent (daily newspapers) and 60 percent (other publications)
accounting years closed in 1978-1979	: 70 percent (daily newspapers) and 50 percent (other publications)

The deduction or provision may only be made with respect to machinery and equipment, buildings, land and participations in companies which are strictly necessary for the operation of the business.

Where a tax deductible provision was used for the acquisition of the assets indicated above the amount of the provision must be written off from the depreciable value of the assets acquired.

5. Depletion allowance for oil and gas extraction

Enterprises which are engaged in the exploration for and the exploitation of oil and gas are accorded an annual depletion allowance, i.e. they may deduct from taxable income the lower of:

- (i) 23.5 percent of the amount of gross sales of products extracted from gas and oil fields subject to income tax in France; or
- (ii) 50 percent of the net taxable income attributable to the sale during the taxable year, before or after processing, of products extracted from oil or gas fields.

To qualify for the depletion allowance the oil or gas must be extracted from continental France, the French overseas "départements" (Martinique, Guadeloupe, Guyane and Réunion), the French overseas territories (Comoro Islands, New Caledonia and the small islands of French Polynesia), the African States which were part of the former French Community and Morocco, Tunisia, Algeria, Togo and Cameroon.

Amounts deducted pursuant to the depletion allowance must be placed in a tax free provision (provision pour réconstitution des gisements) and must be reinvested in assets or activities connected with the oil industry or in shares or in other interests in oil or oil research enterprises within 5 years. The depletion provision may only be fully used if reinvestment takes place in certain areas indicated by decree. If reinvestment is made in another area (but within the countries listed above) the depletion provision may only be used to finance a maximum of one half of the expenses incurred or fixed assets purchased. The amounts used to invest in depreciable assets need not be deducted from the (depreciable) value of such assets. If the reserve is not completely exhausted after 5 years, the excess will be added back to taxable income.

6. Depletion allowance for solid minerals

A similar depletion allowance may be created by enterprises which extract certain solid (non-ferrous) minerals, which are of interest to the French economy and listed by decree. This list includes aluminium, antimonium, arsenic, beryllium, chromium, copper, manganese, silver, zinc etc.

The depletion allowance amounts to the lower of:

- (i) 15 percent of the amount of sales of products extracted from mineral deposits and which are included in taxable income in France; or
- (ii) 50 percent of the net taxable income from sales, before or after processing of these products.

To qualify for the depletion allowance the mineral must be extracted in one of the countries listed under the depletion allowance in para. 5, above. Resale of mineral products purchased from foreign subsidiaries in which the French enterprise owns directly ^{or indirectly} a voting control of at least 50 percent (or at least 20 percent after approval has been obtained from the Minister of Economic Affairs and Finance) also qualifies for the computation of the limit under (ii) above.

The depletion provision must be reinvested in fixed assets, research expenditure or research company shares within 5 years, otherwise it is added back to taxable income.

7. Deduction of certain dividends

The normal rule is that dividends are not deductible from taxable income. The Finance Law 1977, however, provides that corporations which are created or which increased their capital between January 1, 1977 and December 31, 1980 may during the first five years following such creation or increase, deduct dividends distributed on the newly issued shares, provides that (i) the contributions were made in cash and (ii) that the shares are quoted at a stock exchange within 3 years. The amount of the deduction may not exceed 7.5 percent of the capital contributed.

8. Investment incentives in or relating to French overseas départements

A number of tax incentives are granted which only apply with respect to the French overseas départements Guadeloupe, Réunion, Martinique and Guyane. These incentives include the following.

8.1. Mining companies which carry on activities in the overseas "départements" and which before December 31, ¹⁹⁷⁷ have requested the approval of the French Minister of Economic Affairs and Finance, may apply for favored tax treatment for a period of 25 years. (This period may be extended by another 5 years). This privileged tax treatment includes:

- (i) The exemption from corporate income taxation of corporate income which is reinvested in the enterprise or in similar enterprises in the overseas "départements";
- (ii) the "freezing" of the rate of tax applicable during the period of time for which the privileged treatment was afforded at the rate which was in force on January 1 of the year in which the approval of the Minister of Economic Affairs and Finance was obtained unless more favorable provisions are subsequently enacted. The present rate is, as in metropolitan France, 50 percent;
- (iii) the "freezing" of the taxable base under the same conditions as for the rate of tax discussed at (ii) above. The present taxable base is two thirds of otherwise taxable income computed after the exemption discussed at (i) above.

Companies which qualify for this favored treatment must, however, pay a royalty based on the weight of materials which they extract.

See for the tax holiday for mining companies below.

8.2. Certain other types of companies: The above privileged treatment is also accorded to companies carrying on agricultural, forestry and industrial activities in Guyane and to companies whose exclusive purpose it is to carry on industrial activities in Guadeloupe, Martinique or Réunion, provided that they invest a certain minimum amount which is fixed by the Minister of Economic Affairs and Finance. Non-mining companies are not subject to the payment of royalties. Application for Ministerial approval must be made before December 31, 1977.

- 8.3. Tax holiday: Companies which have been created before December 31, 1977, and which have obtained the approval of the Minister of Economic Affairs and Finance may, if they are considered to further the economic and social development of the overseas "départements" and the creation of employment in these "départements", be wholly or partially exempt from corporate income tax during the first 8 years from the date they begin operating. A similar exemption may be granted to existing companies which start new activities before December 31, 1977. In order to stimulate mining activities in Guyane, the duration of the tax holiday is 10 years.
- 8.4. Deferral of income tax: Corporate or individual income tax otherwise due on profits derived in the overseas "départements" by industrial, commercial or agricultural enterprises may be deferred to the extent that such profits are reinvested in certain activities which are considered to be essential for the economic and social development of these "départements" or in housing projects. Such deferral, however, requires that the Minister of Economic Affairs and Finance approve the investment project. Reinvestment may also take place in shares or bonds of companies whose activities are considered to be essential for the economic and social development of the overseas "départements". This provision expires on December 31, 1977. The profits on which tax is deferred may not exceed 200,000 Fr.Frs. for each new job created if the investment is connected with plant (équipement d'exploitation). Otherwise there is no limitation on the amount of such profits.

Under this deferral scheme, reinvested profits are not included in taxable income in the year in which they are earned. These amounts are then added back to taxable income during subsequent years. In the case of profits reinvested in depreciable assets, this "recapture" must be effected at the same time and in the same amount as depreciation is taken with respect to such assets. In the case of profits reinvested in non-depreciable assets, this "recapture" must generally be effected in ten equal annual instalments. However, if a condition of Government approval of the deferral has been that such assets may not be alienated for some specified period of time, then "recapture" must be effected in equal annual instalments the number of which is the same as the number of years for which the assets may not be alienated.

8.5. Reinvestment of income: Profits derived in metropolitan France by industrial or commercial enterprises may be exempt from corporate or individual income tax if they are reinvested in enterprises of the same nature or in hotel enterprises in the overseas "départements". The investment must be approved by the Minister of Economic Affairs and Finance. A similar exemption may be granted to reinvested profits if such reinvestment amounts to at least 1 million Fr.Frs. and is effected in shares of newly created corporations established in the overseas "départements" whose purpose is to carry on activities in the hotel, tourism, food, textile, fishing or forestry sector and which will create at least 20 new employments. This provision expires on December 31, 1977.

F.

VALUATION OF STOCK-IN-TRADE

1. In general

Stock-in-trade (inventory) includes raw materials, merchandise, supplies, scrap, work-in-progress and products manufactured by the enterprise. It also includes packing material which is not returnable by the customers and which is identifiable.

GCI, Art. 38(3) provides that stocks must be valued at the lower of cost or market value at inventory date. Cost for valuation purposes means the actual cost of purchase or manufacture, including all additional charges such as transportation, customs duties etc. The cost of items which are manufactured by the enterprise is the aggregate of the purchase price of the materials, direct and indirect manufacturing cost such as depreciation and general overhead and administrative cost. Market value means the probable sales price on inventory date. If market value is lower than cost a provision for depreciation of stock must be created in which the difference between cost and market value is entered.

Products which are being manufactured and in general work in progress are only valued at cost.

Inventory must, in principle, be valued inclusive of taxes imposed on the goods. However, with respect to VAT (provided that it is creditable) the taxpayer may choose between two options:

- (i) the VAT which is still creditable at the end of the accounting year is not entered in the balance sheet as an asset and the cost of the stocks is computed inclusive VAT; or
- (ii) the VAT which is still creditable at the end of the accounting year is entered in the balance sheet and the cost of the stocks is computed exclusive of VAT.

The last in/first out (LIFO) of inventory determination is not permitted. In practice some form of the first in/first out (FIFO) system or the average cost method is permitted.

Enterprises may create two types of tax deductible provisions.

2. Provision for price increases

Enterprises are permitted to create a tax deductible provision for price increases with respect to given materials or products (with the exception of those materials for which a provision for commodity market fluctuations may be created) provided that the price increase of the materials or products concerned during a period not exceeding two accounting years is in excess of 10 percent. Only that part of the price increase which exceeds 10 percent may be taken into account.

The provision is computed by multiplying the quantity of the materials or products at the end of the accounting year by the difference between:

- (i) their value per unit on the balance sheet; and
- (ii) an amount which equals the lesser of ^{110 percent of} the value per unit on the balance sheet at the beginning of the preceding accounting year or 110 percent of the value per unit on the balance sheet at the beginning of the current accounting year.

If the unit value at the beginning of the preceding accounting year has been taken, the amount of the provision must be reduced by the amount of any provision for price increases which was created at the end of that accounting year.

The provision must be computed for each individual material or product and may in general be kept in the enterprise's books for a period of 6 years, i.e. the provision must be added back to taxable income of the accounting year which is closed 6 years after the accounting year in which the provision was created. However, those enterprises whose stock rotates normally over a period of time in excess of 3 years the provision is added back after a period of time which is twice as long as the normal rotation period.

EXAMPLE:

Unit value of the stock at the beginning of the preceding accounting year	:	1,000
Unit value of the stock at the close of the current accounting year	:	1,500

If the enterprise owns at the end of the current accounting year 5 units it may create a provision for price increases of $5(1,500 - 1,000)$ or 2,500 less any provision which was created at the close of the preceding accounting year.

3. Provision for commodity market fluctuations

The purpose of this provision is to enable enterprises whose main business is the processing of certain raw materials purchased on the world market to create a tax deductible provision in order to offset the frequent price fluctuations to which these materials are subject.

This provision may be created by enterprises whose main purpose is the first processing in France of raw materials acquired on the international world market or the processing of raw materials acquired on the French market, if the prices in the latter cases are closely related to the prices of the world market. The list of qualifying materials includes various kinds of ore, textiles, oil seeds, rubber, wood pulp, crude oil, skins, cotton, cocoa, silver, gold, scrap iron, castor oil etc.

The computation of the reserve for commodity market fluctuations is extremely complicated and its provisions differ for enterprises which were allowed to create such a provision prior to the 1959 tax reform law or after that reform and they may also differ depending on the category of material. For instance, for crude oil there is an extra limitation which restricts the amount of the provision to 69 percent of the maximum which is allowed for other products.

The general rule is that the provision is available only for a certain base stock, which is expressed in the average quantity in inventory at the close of certain accounting years. The price of the US dollar is used to eliminate fluctuations of the value of the Fr.Frs. The provision must be computed for each material separately and the total amount of the reserve is adjusted each year. If, for instance, the provision which was created in the past exceeds the maximum amount permitted at the end of a given accounting year the difference must be added back to taxable income.

G. SET OFF OF LOSSES

Ordinary operating losses and losses resulting from the reduction of value (depreciation) of fixed assets are deductible from the income of the current year. They may also at the option of the taxpayer be deducted from net long-term capital losses of the current year (see C, 2.1.4., above).

Ordinary operating losses which cannot be compensated by current income may be carried forward against operating income of the five following years or at the option of the taxpayer against long-term capital losses of the five following years. There is no loss carry back.

Special rules apply in case of deferred depreciation. Depreciation which is either deferred or deemed to be deferred in tax loss years may be carried forward for an indefinite period of time. See for more details B.5.2. above.

With respect to capital gains and losses short-term capital losses are generally taxed as ordinary operating losses. Long-term capital losses can only be set off against long-term capital gains of the same year and of the following 10 years or against the reserve for long-term capital gains. See for more details C.2.1.3., 2.1.4. and 2.1.5. above.

The general rule is that foreign source business losses incurred by French corporate taxpayers are in principle not deductible from taxable income. This follows from the fact that corporate taxpayers are in principle only subject to corporate income tax on French source business income. Foreign source business income if derived through either a foreign permanent establishment, a representative based abroad or a so-called complete business cycle (cycle complet d'opérations) is not subject to corporate income tax and thus foreign source losses cannot be deducted.

However, there exist certain exceptions to the above rule.

By virtue of CGI, Art. 209 quinquies French corporations which have received the approval of the French Minister of Economic Affairs and Finance may consolidate their foreign-source and French-source income and losses. In such a case foreign losses are deductible from aggregate income.

In certain cases aggregation of the income of French parent corporations and their subsidiaries is possible provided that Government approval is obtained. Such aggregation is permitted if a French domestic corporation owns directly or indirectly at least 95 percent of the capital of one or more domestic corporations. Approval will in general only be given for spin-offs or similar company reorganizations but it may also involve outside corporations.

Aggregation of income between French parent corporations and their foreign subsidiaries is also possible provided that the French corporation owns directly or indirectly at least 50 percent of the voting power of the foreign subsidiary. In this case foreign income (and losses) is attributed to the French parent corporation on a prorated basis. If the French parent has also domestic subsidiaries aggregation of income is also extended to those domestic subsidiaries.

Note that foreign income tax and foreign withholding taxes on consolidated income may be credited against French corporate income tax.

The general rule is that losses of one enterprise cannot be transferred to another one. An exception to this rule where losses of parent and subsidiary companies can be aggregated was discussed above. Other examples are where company reorganizations are involved. In case of a merger which is effected prior to January 1, 1978 and if the approval of the Ministry of Economic Affairs and Finance is obtained the operating losses of the absorbed corporation may be carried over to the absorbing corporation. Net capital losses on depreciable assets which are transferred to the absorbing corporation may also be carried over to the absorbing corporation.

See for more details part C, para. 3.1.1., above.

GERMAN FEDERAL REPUBLIC
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Preliminary remarks

1. As of January 1, 1977 a new system of corporate income taxation will be applied in the German Federal Republic. Under this new system the so-called "economic double taxation" of distributed corporate profits (at the corporate level and at the shareholder's level) is completely avoided. In principle, distributed profits will be subject to corporate income tax at a reduced rate of 36%. The dividend received by the shareholders, grossed up with the 36% corporate income tax attributable to the dividend, will be included in their taxable income, and then a credit will be granted for the full amount of the corporate income tax. This credit will apply to resident shareholders only, and as yet no alleviating provisions have been enacted for non-resident shareholders.

In the following report, reference to the provisions of the new law will be made where necessary.

2. Besides the individual and corporate income taxes, also a trade tax (Gewerbesteuer) is levied on resident individual and corporate businesses, but it is a deductible expense in calculating taxable income for purposes of individual or corporate income tax. The trade tax is calculated on two or sometimes three bases: business income, business net worth and, if applicable, gross payroll. For purposes of the trade tax based on business income (by far the most important base), the taxable base is the amount of profits shown in the tax balance sheet, adjusted by a number of additions and deductions. Total trade tax may amount to up to 20 percent of taxable income for individual or corporate income tax purposes, but, as indicated, it is considered as a deductible expense for purposes of the income taxes.

A.

INTRODUCTION

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The basic rules concerning the computation of profits are laid down in paras. 4 to 7e of the Individual Income Tax Law (Einkommensteuergesetz, hereinafter referred to as EStG). The concept of "profits" applies to three categories of income, namely income from agriculture and forestry, income from business enterprise and income from independent work. According to para. 8(1) of the Corporate Income Tax Law (Körperschaftsteuergesetz, hereinafter referred to as KStG), the rules on the computation of profits as laid down in the EStG also apply to corporate income taxpayers.

Para. 4(1) of the EStG gives the general rule for determining profits, viz. the difference between the business's net worth at the end of the financial year and at the end of the previous year, increased by the value of withdrawals and decreased by the value of additional capital invested during the year. Furthermore, it states that the provisions on business expenditures, on valuation and on depreciation for wear and tear or depletion must be applied. Para. 4(3) permits taxpayers who are not legally required to keep proper accounting records and who actually do not do this, to determine profits on a cash basis. In addition, a special method of determination of profits on an average basis can be applied to income from agriculture and forestry according to para. 13a EStG, but only if there is not a legal requirement for bookkeeping, and the taxpayer has not chosen one of the two methods mentioned above for determining his profits.

Para. 5 EStG gives a supplementary rule for business entrepreneurs who are legally required to keep proper accounting records and to draw up a balance sheet regularly or who actually do this. They must apply the method of net worth comparison as abovementioned in the following manner. The business's net worth is computed according to the accounting and valuation principles set out in the Commercial Code (Handelsgesetzbuch) for purposes of the commercial balance sheet, except however in as far as these principles conflict with a mandatory rule of tax law.

The net worth comparison method has the result that business profits or losses occur from any change in assets and liabilities, or in their valuation. Gains or losses from the sale or other disposal of business assets are part of business income and taxed at normal rates, although under certain circumstances as discussed under C, deferral of tax may be permitted. It appears from the abovementioned facts that it is important to know which property of an entrepreneur is to be included in his business, the more so since a general capital gains tax does not exist in Germany. For those corporations, which are required by the Commercial Code to keep proper accounting records (e.g. companies) this problem does not arise. Para. 8(2) of the KStG states that all income of such corporations is deemed to originate only from business enterprise.

For other entities and for individuals, case law has developed three kinds of property; namely, property which is mandatorily deemed to be business property, property which is mandatorily deemed to be private property, and property of a kind in between, where it is up to the discretion of the taxpayer whether the property is considered as private or business property.

Although there is no general capital gains tax in Germany, there are a few cases where gains on the disposal of private property are taxed, namely when they arise from disposition of a substantial interest, i.e. a participation of 25% or more in a company's share capital or when they are considered as speculative income, e.g., where securities are disposed of within six months after their acquisition; and where real property is disposed of within two years after its acquisition. In addition, draft legislation is in conference regarding a tax on the soaring value of privately held real estate (Bodenwertzuwachssteuer) and regarding a tax on the increase in land values resulting from the opening of land for construction and development or from local improvements (Wertsteigerungsabschöpfung).

DEPRECIATION OF BUSINESS ASSETS
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B.

1. General outline

Paras. 6 and 7 of the EStG are the legal base of fiscal depreciation. According to para. 6, fixed business assets which decrease in value through wear and tear must be valued at cost of acquisition or manufacture, minus accumulated depreciation in accordance with para. 7. However, they may be valued at their lower going concern value (Teilwert). Going concern value is defined as that amount of the total purchase price which a buyer of the entire business would allocate to the individual asset on the assumption that he would continue the business.

Depreciation may be claimed by the person bearing the burden of capital expenditure for the asset in question. Thus the beneficial owner of property may claim depreciation if the legal owner is another person.

Para. 7(1) provides that fixed business assets which are held for income-producing purposes and whose useful life according to experience exceeds one year must be depreciated in equal annual installments on the basis of acquisition or production cost and of expected useful life. Although the heading of para. 7 only refers to a decrease in value through wear and tear and through depletion (Absetzung für Abnutzung oder Substanzverringierung), a decrease in value resulting from economic reasons is deemed to be included.

2. Depreciable assets

Specifically mentioned as non-depreciable assets are land, participations, goodwill and current assets (para. 6(2)). These assets may only be valued at their cost of acquisition or production, or at lower going concern value (see for exceptions to this rule under parts C and F below).

Depreciable assets include:

- immovable property, including a dwelling house which constitutes a business asset, but not the land on which it is erected; in case where buildings constitute "current assets" of an immovable property trading company, no depreciation is permitted;
- changes and improvements to immovable property; these are depreciated according to the rules as apply to the immovable property of which they are components e.g. elevators, heating and air-conditioning installations; if they serve a purpose different from that of the building as a whole e.g. special business installation, machinery and equipment attached to the ground, they are depreciated as movable property;
- movable property, like machinery and equipment, including ships.
- intangible property such as:
patents, unprotected inventions, secret processes of formulae, trade marks, copy-rights, concessions, leases, etc., if acquired for a consideration and for a limited period of time; goodwill, although basically not depreciable, may be depreciated if acquired for a consideration by taxpayers exercising a profession like doctors, lawyers etc.; research cost must be entered in the balance sheet as an asset as soon as such cost has turned into development cost, and is then depreciable; since it is difficult to distinguish between research and development, 2 percent of the total cost incurred for research of developing a product may be considered as the value of the asset.

Intangible property is deemed to be immovable; this is primarily important in answering the question of which method of depreciation must be applied. Movable assets of a value up to 800 DM each, not being part of a homogeneous unit, may be amortized in the year of acquisition.

3. Depreciable basis

Generally the basis for depreciation is equal to the actual acquisition or production cost. Cost includes non-creditable VAT; irrecoverable tax invoiced by suppliers, such as the investment tax which was levied as a stability measure to combat inflation on tangible depreciable business assets ordered or constructed during the period from May 9, 1973 until December 1, 1973; expenditure for repairs if they increase the value of an asset; and, in principle, all expenses directly related to the acquisition of the purchased assets, like import duties, freight cost, etc.

A residual value is not taken into account, unless it can be expected to be considerable, which is generally only the case for ships. Any subsidies derived from private or public sources may, at the choice of the entrepreneur be deducted from the acquisition or production cost, or be treated as business income, in which case the depreciable basis is not decreased. Investment allowances as granted under the Berlin Aid Law and the Investment Premium Law do not decrease the depreciable basis of a qualifying asset (see also part E, below).

4. Starting point of depreciation

The depreciation period starts at the moment that the acquisition or production is fulfilled, which may differ from the moment that the asset is put into use; mostly however these moments coincide. For practical reasons, calculations may be made to the nearest half year at the taxpayer's option.

5. Normal depreciation

5.1. Methods of depreciation; rates

The straight line method is permitted for all fixed business assets, and is mandatory for immovables. The rates of depreciation for buildings are set out in EStG, para. 7. The rate on a building completed after December 31, 1924, is 2 percent per annum; for buildings completed before January 1, 1925 it is 2,5 percent per annum. Where the actual life of a building completed after December 31, 1924 can be shown to be less than 50 years, and of a building completed before January 1, 1925 to be less than 40 years, rates may be based on the actual life time of the building.

An exception to the rule that immovables may only be depreciated according to the straight-line method is laid down in para. 7(5) EStG. At the discretion of the person who incurred the cost and risk of construction (Bauherr) of a building completed after December 31, 1964 and for which the construction permit was applied for before May 9, 1973, declining balance depreciation is permitted according to the following rates of the original cost of the building:

year of completion and following 11 years:	3,5%
following 20 years	2 %
following 18 years	1 %

The same still applies for buildings completed after December 31, 1964 if more than 66,2/3% of them is devoted to dwelling purposes for which government allowances under certain laws to encourage the erection of dwelling-houses have been granted.

The normally permissible changeover to straight-line depreciation is not allowed if the election for declining balance depreciation is exercised for buildings.

Intangible fixed assets are deemed to be immovable and thus are as a rule depreciated by the straight-line method over the period of statutory protection of the rights involved. Film copy-rights and similar fast depreciation assets, including patents, may be depreciated over shorter periods, e.g., 5 years for patents.

For movables the entrepreneur may choose between the straight line and the declining balance method. A change over from declining balance to straight line is permitted, but the reverse is not allowed.

The rates for movables are set out in official recommended tables, published by the Federal Ministry of Finance. A general table applies to all business enterprises, while other tables (over 90) are classified by branch of industry and commerce. Deviations from those tables may be allowed in individual cases, if reasonable.

Declining balance depreciation must take place according to a fixed rate applied to the declining book value of the asset at year end; this annual rate is limited to twice the allowable straight-line rate with an overall maximum of 20% per year. Variations of the declining balance method are allowed if the maximum percentages as mentioned above are not exceeded in the first year and in total, not in the first three years.

Depreciation on a production basis is allowed for movable fixed assets where economically justified.

Mines, quarries and other natural resources subject to exhaustion may be depreciated under the straight line method or according to the actual, proportional depletion of the asset. The depletion method is not permitted for natural resources discovered on the taxpayer's own property; in this case valuation at lower going concern value can take place.

5.2. Normal depreciation at increased rates

The rates of normal depreciation may be increased in case of unusual technical and economical obsolescence, unless the declining balance method is applied.

Also business assets used during two work-shifts may be depreciated at the normal straight line rate increased by 25%; if used during three work-shifts the rate increase may be 50%. If the declining balance method is applied, the use in more than one work-shift may also be taken into account, but the maximum annual rate of 20% (see para. 5.1. above) may not be exceeded.

5.3. Compulsory character of depreciation

As laid down in the EStG, para. 7, normal depreciation must be taken into account, also in years in which a loss is incurred. If in a certain year depreciation is purposively not carried out, there is no possibility to recover it in a later year.

5.4. Relationship between Commercial Depreciation and Depreciation for Tax Purposes

Normal and special depreciation deductions must be reflected in the commercial accounts (balance sheet) and any excess so recorded over the amount allowable for tax purposes is included in taxable income.

Basically the useful life of an asset must be the same for commercial and for tax purposes. If depreciation in the commercial balance sheet is taken according to the straight-line method, this system must also be used for tax purposes.

For buildings, there is no connection between depreciation in the commercial accounts and depreciation for tax purposes, neither in case of the straight-line method, nor in case of the declining balance method, since the rates of depreciation for tax purposes are obligatory.

Only if the actual lifetime of the building is less than 40 or 50 years, and the rates are based thereon (see para. 5.1., above), this must be reflected in the commercial account.

6. Accelerated depreciation allowances

Special additional depreciation is allowed for certain types of assets, and for assets located in certain areas. For assets acquired or produced after December 31, 1974, additional depreciation may not result in the creation or increase of a loss. If for these assets additional depreciation can be claimed on the basis of more than one provision in the law, only one of these provisions can apply.

The relevant provisions can be summarized as follows:

a. Agricultural and forestry

- Taxpayers who derive income from agriculture and forestry and who keep proper accounting records: in addition to the straight-line depreciation, an additional depreciation is allowed on assets acquired or produced before the end of the financial year 1976/1977. The additional depreciation may amount to up to 50% of the cost price of movable assets and up to 30% the cost of immovables as enumerated in a list added to the EStG; this depreciation is to be taken in the year of acquisition and the two following years.

If, however, a subsidy has been granted, 50% of the subsidy, divided over the first three years, may be deducted above the straight-line depreciation in lieu of the additional depreciation allowance.

- If no books are kept, or if profits are computed on an average basis, the rates of additional depreciation are 25% of cost for movables, and 15% of cost for immovables (with a maximum of 2000DM for taxpayers whose profits are computed on an average basis), and only 25% of any subsidy is deductible.
- The cost of dwelling-houses for employees in agriculture or forestry erected at the latest in the financial year 1976/1977 may be depreciated at the rate of 100% in the year of erection, or with 33¹/₃% in each of the first three years.

- b. Equipment for the prevention of air and water pollution; noise abatement equipment and certain drainage equipment acquired or produced before January 1, 1981:

Instead of normal depreciation, up to 60% of cost may be depreciated in the first year, while up to 10% may be depreciated in each of the following years.

- c. Research and development equipment:

Additional depreciation can be claimed on research and development equipment if acquired or produced before January 1, 1975, as follows: up to 50% of cost in case of movables and up to 30% of cost of immovables within the first five years after acquisition in addition to the straight-line normal depreciation, if the assets remain within the same enterprise for at least three years after acquisition. The residual value must be depreciated according to the straight-line method

- d. New merchant ships, deep sea fishing boats and international transport aircraft registered in the Federal Republic of Germany and acquired before January 1, 1979: under certain conditions, 40% of cost may be deducted, to be divided over the year of acquisition and the following four years in addition to normal straight-line depreciation. The residual value must be depreciated according to the straight-line method.

- e. Certain mining equipment and facilities:

In addition to the straight-line depreciation, additional depreciation is allowed amounting to up to 50% of cost of movables and up to 30% of cost of immovables within the first five years after acquisition.

- f. Private hospitals:

In addition to the straight-line depreciation, up to 50 percent of cost of movables, and up to 30 percent of cost of immovables may be deducted within the first five years after acquisition.

g. Factory buildings, store houses and buildings used in agriculture or forestry:

An additional depreciation of up to 10% of cost per annum is granted in the year of construction and the following year, provided the buildings are constructed after December 31, 1951 by taxpayers who are "displaced persons".

h. West Berlin:

A special depreciation instead of the normal one may be applied by West Berlin enterprises:

75% of the cost of both movable and immovable fixed assets remaining in a West Berlin enterprise for at least three years (for ships acquired or constructed after May 15, 1973 eight years) after acquisition or construction may be depreciated in the first and the next four years. Buildings must be used for more than 80% in the taxpayer's own enterprise.

i. Development areas bordering the German Democratic Republic:

In addition to normal depreciation according to the straight-line method, up to 50% of the cost of movables and 30% of the cost of immovables may be depreciated in the first and the next two years.

j. Dwelling-houses within the Federal Republic including Berlin, if the construction permit was applied for after December 31, 1974:

A special depreciation instead of the normal one of up to 5% annually in the year of completion and the next seven years (for dwelling houses in West Berlin up to 10% divided over the first two years and 3% annually in the next ten years). For the remaining 60% a straight-line depreciation of 2.5% annually applies. For one-family dwelling and dwelling in absolute ownership the above provision does not apply to that part of the construction cost which exceeds 150,000 DM (for two-family dwellings: 200,000 DM). The declining balance method for buildings as mentioned in para. 5.1., above is also applicable to dwelling houses ^{and} apartments, if the construction permit was applied for before October 10, 1962. If the construction permit was applied for after October 9, 1962 and was granted before January 1, 1965, the following percentages of cost may be deducted instead of the normal depreciation allowances mentioned above: 7,5% annually in the first two years and 4% annually in the third to tenth year.

This applies only to buildings in the Federal Republic (with the exclusion of West Berlin) for that part of cost not exceeding 120,000 DM.

2. Realised gains or losses

A gain or loss is realised and thus taxable or deductible, as the case may be, as soon as an asset is disposed of by way of alienation, exchange, loss or destruction, or by way of a contribution in kind to the capital of a company, etc. (see, however, paras. 5 and 6, below).

Deferral of tax on certain capital gains is possible in two cases:

- According to para. 35 of the Individual Income Tax Regulations (Einkommensteuerrichtlinien, hereinafter referred to as EStR), where unvoluntarily realised capital gains result from an act beyond the taxpayer's control, e.g. fire, expropriation, the tax liability on the capital gain may be deferred if replacement assets are acquired within the same financial year. If the new asset is not acquired within the year the capital gain was realised a tax-free reserve may be created during a maximum period of one year in case of movable assets, and two years in case of real estate or buildings. These statutory periods may be extended under certain circumstances.

- According to para. 6b of the EStG, where voluntary disposals of qualifying fixed assets result in capital gains, tax liability may be deferred if replacement assets are acquired within the same financial year. Otherwise, a tax-free reserve may be created during a maximum period of two years, or four years in case of buildings and ships whose construction has begun within the two-year period. Qualifying assets for the purpose of this relief are: real estate, buildings, depreciable movable assets with a useful life of at least 25 years, ships, stocks or shares of corporate entities (not being circulating capital for the owner), and certain fixed assets of agricultural and forestry enterprises. A six year holding period prior to sale is required for the application of the relief, except for live-stock of an agricultural enterprise and, since the introduction of the Tax Conversion Law (see *infra*), certain transfers of minority shareholdings.

Qualifying replacement assets include: all depreciable movable assets; real estate to the extent that the gains arose on the rule of real estate; buildings to the extent that the gain arose on the sale of real estate, buildings or participations in corporate entities; and investments in shares of corporate entities, to the extent that the gain arose on the sale of a similar investment and the Federal or State Ministry concerned certifies that the new investments are deserving governmental support.

In both cases of deferral of tax, the amount of the gains or the replacement reserve created must be deducted from the cost of the replacement asset, and future depreciation and the computation of capital gains or losses concerning the replacement asset are based on its cost of acquisition minus the amount of the untaxed gain.

3. Computation of taxable gains and losses

In computing the taxable capital gain or loss no distinction is made between depreciable and non-depreciable assets.

The amount of the gain or loss is equal to the difference between consideration received and book value at the time of disposal. In case of a revaluation of assets to a going concern value ("Teilwert", see part B, para. 1, above) which is lower than book value, the capital loss is equal to the difference between going concern value and prior book value.

All gains are taxed at normal corporate or individual income tax rates, and capital losses are deductible in computing taxable business profits.

4. Relief on disposal of business by individual

In case of disposal of an individual's business or part of it, any capital gain is taxed at a reduced rate, namely at half the average rate applicable to total taxable income (para. 34 EStG). In addition, the first 30,000 DM of any gains realised on the disposal of the entire business, or a proportionate part of 30,000 DM in case of a part disposal of the business, is wholly exempt from tax, if the total gain does not exceed 100,000 DM (or a proportionate part of 100,000 DM in case of a part disposal). If the total gain exceeds 100,000 DM (or a proportionate part thereof in case of a part disposal), the exemption is reduced by the amount by which the total gain exceeds 100,000 DM (or a proportionate part thereof), so that no relief is available if the gain realized on disposal of the entire business amounts to 130,000 DM or more, or a corresponding amount in case of a part disposal.

The above amounts of 30,000 DM and 100,000 DM are doubled to 60,000 DM and 200,000 DM, respectively, if the taxpayer has reached the age of 55 or over, or is permanently disabled at the time of disposal.

In case of disposal of an entire agricultural or forestry business, or on disposal of part of the land belonging to such business, the taxpayer may, subject to certain circumstances, only be taxable on that part of the gain which exceeds 60,000 DM, provided the disposal has taken place prior to January 1, 1977.

5. Mergers

Because of the introduction of the new corporate income tax system (see the preliminary remarks) the Tax Conversion Law 1969 had to be changed. Only the provisions of the 1977 law will be dealt with in the survey below.

As mentioned earlier, each capital gain on disposal of business assets is, in principle, taxable with the exception of the cases mentioned in para. 2, above, where tax deferral is granted. The Tax Conversion Law however also grants favourable tax treatment in case of: a merger or conversion of a German resident company by a transfer of its net assets to a resident partnership or sole proprietorship; a merger or conversion of a German resident company into another; and, thirdly, a transfer of a business, an independent division thereof, a partner's share in a partnership, or a 100% participation in a German resident company to another German resident company, in exchange for shares in the latter.

The consequences of such a merger or conversion can be summarized as follows:

a. If net assets of a company are transferred to a partnership or sole proprietorship by way of universal succession (rather than on an individual basis, to which the general provisions concerning disposal of assets apply, see para. 3, above), the Tax Conversion Law provides that the transferor company's "hidden reserves" are released, but that they are not subjected to corporate income tax. The capital gains resulting from releasing the "hidden reserves" are fully subject to individual income tax for the partners of the transferee partnership or for the owner of the sole proprietorship.

Also, as a consequence of the new corporate income tax system regarding distributed profits, part of the value transferred from the company to the new owners will be treated as a profit distribution which implies that the new owners will be subject to income tax for the amount of such distribution increased by the underlying corporate income tax attributable to the distribution, the underlying corporate income tax then being credited against the income tax due. If the creditable corporate income tax exceeds the income tax due by the transferees, such excess is refunded. If, on the other hand, the income tax due exceeds the creditable corporate income tax, payment of such excess may be deferred for a maximum period of 10 years.

- b. If the net assets of a company are transferred by way of universal succession to another company, the "hidden reserves" are not released, subject to the condition that the transferee company takes over the assets and liabilities at their book values as recorded by the transferor either in exchange for shares in the transferee company, or without any consideration; no corporate income tax is levied, and no underlying corporate income tax attributable to the deemed distribution in the transfer can be credited. Only in case of subsequent distributions, corporate income tax on distributed profits will be levied, which in turn will be creditable against the shareholder's personal income tax.
- c. If an enterprise, an independent division thereof, a partner's share in a partnership or a 100% participation in a German resident company is transferred to another German resident company, in exchange for shares in the latter, the transferee company may carry on the bookvalues of the transferor, and no tax is due, neither at transferor's, or at transferee's level.

6. Transfer of assets to developing and other countries

A tax deferral, or even exemption from tax is granted, under the Developing Countries Tax Law, for capital gains on depreciable assets, realized through the transfer of these assets to foreign enterprises in a developing country as a contribution in kind in order to acquire a qualified investment (see part D, para. 5, below). If depreciable assets are transferred to a company, the book value of the transferred assets may constitute the book value of the participation. If depreciable assets are transferred to a partnership, or to a permanent establishment, the capital gain realized is totally exempt from tax if the assets remain within the foreign business enterprise for at least three years after their transfer.

Under the same law, a tax deferral is granted, if due to the circumstances in the developing country, the legal form of an enterprise has to be changed. Besides, if due to circumstances in the developing country, the foreign investment has to be disposed of, tax is deferred according to the provisions of para. 6 b of the EStG, as mentioned earlier (see para. 2, above), with the exception that only movable depreciable assets qualify as replacement assets.

Other relief provisions are contained in the Foreign Investment Law. This law grants the possibility of a reserve to be set up equal to the amount of gain normally realized through the transfer of depreciable assets to qualifying foreign enterprises. The amount of the reserve must be added back and included in taxable income at a minimum of 20% per annum over a period of five years beginning in the fifth year following the year in which it was created. Qualifying foreign enterprises are enterprises engaged in: the production and sale of merchandise, the extraction of natural resources, commercial services, excluding, however, leasing and granting of patent-rights, know-how, etc.

If the taxpayer has applied the exemption or deferral of tax as granted under the Developing Countries Tax Law no reserve may be set up under the present law. The Foreign Investment Law grants also a possibility of tax deferral with respect to capital gains realized at a disposal of shares, under the condition of para. 6 b EStG as mentioned in para. 2, above, if the gains are reinvested in shares of a foreign company.

D.

RESERVES
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Apart from the replacement reserves considered in part C, para. 2, above, the following reserves and provisions are allowed for tax purposes:

- (i) A reserve for price increases according to para. 74 of the EStR.

This reserve is limited to the amount by which the replacement cost of fungible goods which are part of the stock-in-trade has increased by more than 10% in the course of a financial year; the reserve must be added back to taxable income not later than the sixth year following the end of the financial year of creation;

- (ii) A valuation reserve according to para. 80 of the EStR.

This valuation reserve represents, in fact a 20% deduction from the cost of acquisition or lower replacement value at date of balance sheet of certain listed imported tangible goods which are part of the stock-in-trade and which are subject to wide price fluctuations on the world market; the amount of the reserve fluctuates as qualifying goods are sold and purchased;

- (iii) A reserve for qualifying investments in developing countries.

Under the Developing Countries Tax Law 1974 a reserve amounting to 100% of qualifying investments in the least developed countries (mainly those in Africa) may be created while a reserve of 40% applies to qualifying investments in the other developing countries (e.g. Argentina, Egypt, Greece, India, Mexico, Portugal, Spain, Turkey, Venezuela). In both cases, the reserve must be released and added back to taxable income over a maximum period of 6 years (i.e. at 16 2/3% per annum) beginning in the sixth year following the year of creation. In the case of investments which are particularly effective in reducing unemployment, the period of release is extended from six to twelve years; investments which do not qualify for the reserve include: production, sale and/or trading in weapons, investments in the field of tourism and in the field of leasing of tangible and intangible assets; the creation of the reserve may not result in a loss, or increase an existing loss in any year.

(iv) Reserve for losses of foreign subsidiaries.

Under the Foreign Investment Law 1969 a reserve may be created in respect of losses incurred by a foreign subsidiary, provided the German parent company owns at least 50% of the share capital of the foreign subsidiary, or at least 25%, if the subsidiary is located in a developing country. The reserve must be added back to income within five years; the amount of the reserve is limited to the value of the relevant investment for tax purposes in the parent company's tax balance sheet.

(v) Provisions for liabilities, including pensions.

Provisions for certain liabilities or anticipated losses may be set up as a liability item in the balance sheet and thus reduce taxable income in the year of creation. Where required by the rules governing commercial accounts, such provisions must also be set up for tax purposes. Although at the time the provision is set up the taxpayer must seriously expect to be held liable in future, the expected claims may be uncertain as to the amount. Consideration must therefore be given to the taxpayer's estimates which should be based on objective facts and business experience in the particular industry, transaction, etc. Provisions may not, however, exceed the going concern value of the otherwise estimated liability. Furthermore, the provision must be reflected in the commercial balance sheet and should not exceed the latter in total.

The following are examples of typical reserves: liabilities on surety obligations, warranties, damage claims, litigation expenses, currently deductible taxes and tax obligations, and future pension payments to employees. Self-insurance and deferred repair and maintenance reserves are normally disallowed. The latter type will be allowed if substantial repair or maintenance actually is done in the first quarter after the balance sheet date.

In December 1974, important changes were made in the rules which regulate pension reserves and their tax treatment. Under both the old and the new rules, a taxpayer may set up a reserve for future pensions (under Section 6(a) EStG) if he has entered into a firm obligation to pay old age pensions. Under the old rules, the reserve could only reduce the taxable profit in any one year to the extent to which a charge would fall on that year if the future pension obligations, as actuarially computed, were spread in equal instalments over the period from the date the pension promises were given to the time the benefits became due under the agreement. The new rules have introduced non-forfeiture provisions which come into effect where the employee in question is 35 years of age and either (a) the pension plan has been in existence for ten years or (b) the pension promise has been in existence for at least twelve years. The non-forfeiture provisions mean that adequate provisions under the old rules could not have been created where an employee with non-forfeiture rights terminated his employment prematurely. The new rules therefore permit the reserve to be spread from the date on which the employment relationship commenced, rather than the date on which the pension promise was given, provided that the employee has reached the age of 30. Service prior to the age of 30 is therefore amortized over the period from the age of 30 to the expected retirement. Increases in future pension benefits resulting from salary increases or plan amendments may be provided for in full in the year in which they occur to the extent that they have been "earned" from the age of 30 or later entry in the plan to the date in question. Reserves for pensions or future pensions need not be invested outside the business to qualify for taxation relief. As a result of the recent changes, however, insolvency insurance has been introduced to provide protection for business pension benefits against the risk of a deterioration in the financial position of the employer; the latter is obliged to contribute the necessary premiums.

E.

OTHER INVESTMENT INCENTIVES

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1. The Investment Credit

The Federal Government has authority (EStG art. 51(1) 2(s) to grant a temporary investment credit of 7.5% in times of recession. It used this power during the recessions of 1967, 1970 and 1973.

2. West-Berlin

Under the Berlin Aid Law, a taxpayer with a permanent establishment in West Berlin may claim a tax-free premium of 10% of the cost of new depreciable fixed assets. The premium is increased to 25% of the cost of new movable fixed assets which are used for production by a manufacturing business, with the exception of the building industry, however, including investment in the energy sector to improve energy and heating needs for West Berlin, and to 30% of the cost of new movable fixed assets which are used for research and development purposes. Automobiles and items costing individually up to 800 DM are generally excluded. The movable fixed assets must belong to a business establishment in West Berlin and must be used in West Berlin for a period of at least three years. Premiums can be claimed for payments on account or for partial construction costs. This period is eight years for ships acquired or constructed after May 15, 1973. Applications must be made within three months of the end of the calendar year in which the fiscal year ended in which the investment was made. The premium does not constitute taxable income and does not reduce the cost of the assets for tax purposes.

3. Investment premiums

The Investment Premium Law provides for premiums equal to 7.5% of the cost of investment in new depreciable fixed assets:

- (a) Used to establish or expand a business in a so-called development area;
- (b) Used for research and development purposes;
- (c) Used for production and distribution of energy; and

- (d) Used for any purpose where either the assets were ordered or production commenced after November 30, 1974 and before June 30, 1975, and in the case of movable fixed assets, delivery was received prior to July 1, 1976 (July 1, 1977 for immovable fixed assets). If qualifying investments are delivered or completed during a transitional period (between July 1, 1976 and June 30, 1977 in the case of movable fixed assets and between July 1, 1977 and June 30, 1978 in the case of buildings), the investment allowance will be made only in respect of payments on account or manufacturing costs incurred prior to July 1, 1976 (July 1, 1977 in the case of buildings).

The Development areas referred to above are:

- (a) town and urban districts bordering East-Germany - the so-called Zonenrandgebiete;
- (b) the Saar coal-mining district (Steinkohlenbergbaugesbiet Saar);
- (c) districts whose economic structure is, or is likely to become, lower than the federal average; and
- (d) districts in which the industries peculiar to that area are threatened with structural changes which will have an unfavorable influence on the districts;

Premiums are granted for investments in these areas in assets used to establish or expand a business in one of these areas only where the Federal Minister of Commerce confirms that the investment will be economically beneficial. The premium under this heading is not, however, granted to enterprises with a consistently favorable financial position. The financial position of group companies must also be taken into account. To qualify for the premium, the asset must be used in the development areas for three years.

The same time limit of three years applies to investments in fixed assets used for research and development purposes. In the case of immovable fixed assets in a development area or Zonenrandgebiet, these must be used to an extent of more than 90% for the purposes of the business, while immovable fixed assets qualifying for the research and development premium must be used at least two thirds for this purpose.

The premium for investments under the first two headings above may not be claimed in respect of the same asset. This does not apply, however, to the premiums for investments in fixed assets for the production and distribution of energy or to the temporary premium for assets ordered or produced between November 30, 1974 and before June 30, 1975. The latter premiums can be claimed in addition to other premiums under this general heading if the necessary other conditions are fulfilled. It should be noted that the above premiums are not granted for items costing individually less than 800 DM.

The premiums may be claimed for partial payments or construction costs. The claim must be filed within three months after the end of the calendar year in which the fiscal year ended in which the asset was acquired. The premiums do not constitute taxable income nor do they reduce the depreciable basis of the assets.

4. Investment subsidies in certain areas

Also, investment subsidies from 5 and 15% may be granted under the Regulations to the application of Federal budget funds to the district incentives program of the Federal Government, applicable as of August 1, 1969, and under the basic plan: Improvement of the district economical structure, for the period 1972-1975.

They are intended to encourage investments in the development areas bordering East-Germany and in other development districts and local places.

5. State grants

State governments, such as North-Rhine-Westphalia, provide investment grants or contributions towards interest costs on economically favorable investments (e.g., in former coal mining areas). The grants, which range from 10% to 25%, are contingent on the creation of a reasonable amount of additional employment and premiums received reduce the grants which may be claimed under this heading. The grants differ from premiums in that they have either to be treated as income or as a reduction in the cost of the investment.

6. General incentives in favour of West-Berlin

Apart from the incentive for certain investments in West-Berlin, considered in para. 2, above, there are two other incentives to further the economic development of West-Berlin, viz.:

(i) tax credit for loan capital invested:

resident taxpayers, but not banks, making loans to the Berliner Industriebank AG or to the Deutsche Industriebank (Berlin) for the purpose of investment in Berlin, may credit an amount equal to 12% of the loan against corporate income tax payable. Loans made directly to a business in West-Berlin (e.g., a subsidiary) may also benefit provided

- they are immediately and directly invested in depreciable fixed assets in West-Berlin, and
- both parties agree that one of the above mentioned investment banks is authorized to control the correct investment of the amount involved.

Qualifying loans must have been granted after December 31, 1969 and run for a period of at least 8 years. The repayment of capital must not start before the end of the fourth year and the annual instalments should not exceed 20% of the total loan. Financing of these loans by taking up credits is not allowed, but current liabilities are permitted for financing purposes. On loans made for the financing of dwellings in West-Berlin, this investment credit is increased to 20%. These loans must run over a period of at least 10 years if no interest is charged, or 25 years if interest is paid.

A 10,000 DM maximum per dwelling is imposed on interest-free loans in addition to other requirements. Interest-free loans made out of business funds may be set up in the lender's balance sheet at their discounted amount taking an annual interest rate of not more than 5½%;

(ii) West-Berlin TVA preferences:

West-Berlin enterprises are subject to TVA in the same manner as those in West-Germany. However, in order to encourage trade in and with the city, West-Berlin enterprises receive a preference on deliveries to and special services for a West-German customer. The rate of the preference is based on the "value added" (Wertschöpfung) by the Berlin enterprise two years prior to the year in which the delivery took place. The minimum rate is 4.5% but this is increased to 5% if the value added in Berlin was more than 50% and to 6% if the value added was more than 65%. Special definitions are given with regard to what is considered as the "value added" in Berlin. The preference is paid by permitting the West-Berlin enterprise to deduct the appropriate amount from the tax payable by it. In addition to the preference received by the West-Berlin enterprise, a West-German customer is permitted to reduce his TVA payable by 4.2% of the price (net of TVA) payable to West-Berlin enterprises. The credits are limited to goods actually manufactured in West-Berlin. This means that only substantial transformations of a product's identity, and not merely insubstantial processing, handling or improvement, qualify. Processing leases of tangible assets and of films to West-German enterprises also qualify if bookkeeping and invoice requirements are met.

7. Deductibility of certain losses incurred abroad

Lastly, under the Foreign Investment Law, foreign losses derived from a permanent establishment in a tax treaty country may be deducted from German-source income if under the treaty said losses are disregarded in computing taxable income in the Federal Republic. The losses must be added back to income in later years if and to the extent that the foreign permanent establishment earns profits. The add-back does not have to take place if there is no provision for loss carry-overs in the foreign country. It should be observed that the deductibility of foreign losses is also available in other countries, e.g., in the Netherlands and the United Kingdom, both in these countries the deductibility derives from the general income tax system rather than from express provisions in the law.

F.

VALUATION OF STOCK-IN-TRADE
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Stock-in-trade must be valued at cost of acquisition or production (including incidental costs such as import duties, insurance, freight etc., or at lower going concern value. Contrary to fixed assets, current assets, including stock-in-trade, may produce a "valuation profit" due to subsequent revaluation in the balance sheet, though the new book value may never exceed original cost.

Normally actual cost is used, but fungible goods which in economic life are determined according to size, number or weight may be estimated by the weighted average cost method. Neither LIFO, nor FIFO method is allowed, unless it is the taxpayer's actual practice.

Reference is made to the reserve for price increases and the valuation reserve as described in part D, above.

G.

SET OFF OF LOSSES
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Both the individual and the corporate income tax are annual taxes on the total amount of income from all seven sources mentioned in EStG(2) 1. Thus negative income from a source must first of all be deducted from positive income from other sources, obtained in the same year (Verlustausgleich). There are some exceptions to the general rule; these cases are specifically mentioned in the EStG and generally only a deduction of negative income from positive income from the same source is permitted in such cases. (e.g. income from speculation). However, a business loss may always be set off against positive income from other sources (with the exception of a loss from commercial breeding and keeping of animals, which may only be deducted from positive income from the same source, and of losses originating from the German Democratic Republic).

To companies the abovementioned rules do not apply, since all their income is deemed to be business-income (the income of foreign corporate income taxpayers, however is treated according to the so-called "isolierende Betrachtungsweise", i.e., only the source of income is considered, not the nature of the taxpayer).

If, after application of the abovementioned rules, total income results in a loss, this loss must first of all be set-off as a special expenditure (Sonderausgabe) up to a ceiling of 5,000,000 DM against the positive income of the preceding year ("Verlustrücktrag", entered into force on April 20, 1976 and applicable to losses incurred in the assessment period 1975 and subsequent years). If the amount of the loss exceeds 5,000,000 DM or the positive income of the preceding year, the remainder is carried forward during a period of 5 year, but must be set-off at the first possible time ("Verlustvortrag"). Normal depreciation is mandatory, and may not be postponed in a loss year.

See D, 6 and E, 7 for special treatment of losses of a foreign subsidiary, or of a permanent establishment in a treaty country under the Foreign Investment Law 1969, part D, under (iv), and part E, para. 7, above.

IRELAND

A.

INTRODUCTION

Before the Republic of Ireland became an independent state in 1922 British law (including tax law) applied in Ireland and the British Income Tax Act of 1918, as amended through the annual Finance Acts, continued to apply to the independent Republic.

As a matter of fact, through the Irish Finance Acts of 1923 and subsequent years Irish income tax law has gradually taken its own course so that there are now numerous differences in the field of taxation between the two countries. However, many provisions as well as the basic principles of income taxation are still very similar, to such an extent that, e.g., the decisions of United Kingdom case law will usually be followed in Ireland, unless the provisions of Irish law differ from those of the United Kingdom.

Thus, what is said in the Introduction to the Chapter on the United Kingdom concerning the basic distinction between income and capital gains is equally valid in Ireland. It will also be seen in the following parts of this Chapter that the Irish tax law still closely resembles that of the United Kingdom sometimes even in minute detail, and, in fact, new developments in the field of taxation which have taken place in the United Kingdom in recent years (such as the imputation system of taxation regarding distributed corporate profits and the capital gains tax) have been followed closely by Ireland. However, the reverse may also be true. As part of the sweeping tax reform carried out in the past few years, an annual wealth tax was introduced in Ireland recently through the Wealth Tax Act, 1975, whereas the introduction of such a tax in the United Kingdom is still pending.

Another important feature in Irish tax law are the tax exemptions granted with respect to export profits and profits from qualifying trading activities in the Shannon Airport area. These will be discussed in part E, below.

Companies are normally subject to the Corporation Tax, imposed at a rate of 50%, which has replaced the former dual system of income tax and corporation profits tax. A lower effective rate of 26% applies to taxable capital gains realized by companies.

Individuals are subject to a progressive income tax currently imposed at rates ranging from 26% to 77% with respect to income from all sources, whereas capital gains realized by individuals are normally subject to capital gains tax at the rate of 26%.

B. DEPRECIATION OF BUSINESS ASSETS

1. General outline

The provisions regarding depreciation allowances with respect to qualifying capital expenditure are laid down in secs. 241 through 304 of the Income Tax Act, 1967, a consolidating act incorporating all previous enactments regarding income taxation. The Income Tax Act, 1967 (hereinafter referred to as I.T.A. 1967) is amended from time to time by the annual Finance Acts and other legislation.

The various categories of capital expenditure which are eligible for depreciation allowances under I.T.A. 1967 are as follows:

- (i) industrial buildings and structures;
- (ii) machinery and plant;
- (iii) patents;
- (iv) dredging;
- (v) scientific research.

In addition, the Finance Act, 1974 contains provisions regarding depreciation of capital expenditure on the construction of certain farm buildings and works and the Finance (Taxation of Profits of Certain Mines) Act, 1974 similar provisions regarding expenditure incurred with respect to mines.

The allowable depreciation for tax purposes may be taken into account irrespective of whether the same depreciation is taken in the commercial accounts of the trade.

As the methods and rates of depreciation (both accelerated depreciation ("initial allowances") and normal (annual) depreciation) vary between the different categories of assets, the following survey will be arranged according to the types of assets and major emphasis will be on the two main categories, viz. industrial buildings and machinery and plant.

2. Depreciation of Industrial Buildings and Structures

2.1. Main principles

Accelerated depreciation ("industrial building allowance") and normal (annual) depreciation ("annual allowances") are available with respect to "capital expenditure" incurred on the "construction of a building or structure which is to be an industrial building or structure occupied for the purposes of a trade" carried on by the person who incurred the expenditure or by a lessee. The "industrial building allowance" is governed by I.T.A. 1967, sec. 254 et seq. and the "annual allowances" by I.T.A. 1967, sec. 263 et seq.

As in the United Kingdom, depreciation under this heading is limited to "industrial buildings and structures", as defined in the law, and also only capital expenditure incurred on the construction of such buildings qualifies for depreciation allowances. These two limitations and their implications are further considered in paras. 2.3. and 2.4.2.

It also follows from the above outline that the building must be used for the purpose of a trade and that, in principle, the person who incurred the expenditure may claim the allowances.

2.2. Basis and rates of depreciation

2.2.1. Depreciable basis

As indicated in para. 2.1., above, the basis for depreciation of industrial buildings is the cost of construction, i.e. "capital expenditure incurred on the construction of a building". The law does not contain a comprehensive definition of "capital expenditure incurred on the construction". However, it is expressly provided by I.T.A. 1967, sec. 256 that the term does not include expenditure incurred on the acquisition of, or of rights in or over, any land; expenditure on the provision of machinery or plant; or any expenditure eligible for depreciation allowances for expenditure on scientific research or mining development. On the other hand, expenditure incurred on preparing, cutting, tunnelling or levelling land for the purpose of preparing the land as a site for the installation of machinery or plant, such expenditure will be treated as part of the cost of construction of an industrial building (I.T.A. 1967, sec. 257).

Also, the term "capital expenditure" shall not include any expenditure deductible in computing the income from the trade (I.T.A. 1967, sec. 260). Thus, expenses which are deductible current business expenses are excluded.

Finally, no depreciation allowance can be claimed insofar as the expenditure is met directly or indirectly by the state, by any board established by statute or by any public or local authority (I.T.A. 1967, sec. 254(4)).

2.2.2. Rates of depreciation

2.2.2.1. Accelerated depreciation

Accelerated depreciation (termed "industrial building allowance") is currently, i.e. with respect to expenditure incurred between January 16, 1975 and March 31, 1977 (both dates included), granted at a rate of 50% ("one-half") of the expenditure. Originally, i.e., as of September 30, 1956 the rate was 10%, increased to 20% for expenditure incurred on or after December 14, 1961 (I.T.A. 1967, sec. 254 as amended).

The 50% rate applies only to industrial buildings specified in paragraphs (a) and (b) of I.T.A. 1967, sec. 255(1) (i.e., buildings or structures in use for the purposes of a trade carried on in a mill, factory or other similar premises or for the purposes of a dock undertaking).

For industrial buildings in use for the purpose of growing fruit, vegetables or other produce in the course of a trade of market gardening or for the intensive production of livestock the rate is 20% and for hotels, holiday camps and qualifying holiday cottages the rate is 10%. See para. 2.3., below, for further details concerning the various categories of "industrial buildings and structures".

2.2.2.2. Normal depreciation

The rate of the normal depreciation allowance (termed "annual allowance") is currently granted at a rate of 4% ("one-twentyfifth") of the expenditure with respect to industrial buildings specified in I.T.A. 1969, sec. 255(1)(a) and 255(1)(b) which qualify for the 50% rate of accelerated depreciation (see para. 2.2.2.1., above).

The rate of 4% applies to capital expenditure on qualifying industrial buildings, which is incurred between January 16, 1975 and March 31, 1977 (both dates included). For expenditure incurred prior to January 16, 1975, the former rate of 2% continues to apply.

With respect to the other categories of "industrial buildings" (hotels, holiday camps, qualifying holiday cottages and buildings for market gardening and the intensive production of livestock) the rate of the "annual allowance" is 10% of the expenditure.

In each year the full allowance is granted, irrespective of whether the expenditure is incurred during the year; decisive is the situation at the end of the basis period (accounting period), i.e. the taxpayer should have a "relevant interest" in the building, and the building must be in use for qualifying purposes at that time.

It should also be noted that for the year in which the expenditure is incurred, the taxpayer is entitled to both accelerated and normal depreciation.

2.3. Definition of "industrial building or structure"

As indicated earlier, the above rules regarding depreciation of buildings etc. are applicable only with respect to "industrial buildings and structures". The definition of "industrial building or structure" is given in I.T.A. 1967, sec. 255, which reads as follows:

255. - (1) In this Chapter, "industrial building or structure" means a building or structure in use -

- (a) for the purposes of a trade carried on in a mill, factory or other similar premises, or
- (b) for the purposes of a dock undertaking, or
- (c) for the purposes of growing fruit, vegetables or other produce in the course of a trade of market gardening within the meaning of section 54, or
- (cc) for the intensive production of cattle, sheep, pigs, poultry or eggs in the course of a trade other than the trade of farming within the meaning of section 13 of the Finance Act, 1974, or
- (d) for the purposes of the trade of hotel-keeping

and, in particular, the said expression includes any building or structure provided by the person carrying on such a trade or undertaking for the recreation or welfare of workers employed in that trade or undertaking and in use for that purpose:

Provided that a building or structure in use as a holiday camp or a building or structure in use as a holiday cottage and comprised in premises registered in any register of holiday cottages established by Bord Fáilte Éireann under the provisions of any Act of the Oireachtas passed after the passing of the Finance Act, 1969 shall be deemed to be a building or structure in use for the purposes of the trade of hotel-keeping.

(2) In this section, "dock" includes any harbour, wharf, pier or jetty or other works in or at which vessels can ship or unship merchandise or passengers, not being a pier or jetty primarily used for recreation, and "dock undertaking" shall be construed accordingly.

(3) Subsection (1) shall apply in relation to a part of a trade as it applies in relation to a trade, but where part only of a trade complies with the conditions set out in that subsection, a building or structure shall not, by virtue of this subsection be an industrial building or structure unless it is in use for the purposes of that part of that trade.

(4) (a) Notwithstanding anything in subsection (1) or (3), but subject to subsection (5), in this Chapter "industrial building or structure" does not include any building or structure in use as, or as part of, a dwelling-house, (other than a holiday cottage referred to in the proviso to subsection (1)) retail shop, showroom or office or for any purpose ancillary to the purposes of a dwelling-house (other than a holiday cottage referred to in the proviso to subsection (1)), retail shop, showroom or office.

(b) In this subsection "retail shop" includes any premises of a similar character where retail trade or business (including repair work) is carried on.

(5) Where part of the whole of a building or structure is, and part thereof is not, an industrial building or structure, and the capital expenditure which has been incurred on the construction of the second-mentioned part is not more than one-tenth of the total capital expenditure which has been incurred on the construction of the whole building or structure, the whole building or structure and every part thereof shall be treated as an industrial building or structure.

(6) Any reference in this Chapter to a building or structure shall be construed as including a reference to a part of a building or structure except where the reference is comprised in a reference to the whole of a building or structure.

The main categories of buildings which, subject to certain exceptions, are excluded from depreciation allowances are listed in subsection (4): dwelling-houses (other than qualifying holiday cottages), retail shops, showrooms and offices. However, if one-tenth or less of a building or structure does not qualify, the whole building or structure qualifies for the allowances pursuant to subsection (5).

The main distinction between this definition and the definition in United Kingdom law is that in Ireland hotels, holiday camps and holiday cottages are included in the definition.

2.4. Sale or other disposal of an "industrial building or structure"

2.4.1. Consequences for the seller: balancing allowances and charges

If capital expenditure was incurred on or after September 30, 1956 on the construction of an industrial building or structure and the relevant interest in the building or structure is sold, or the interest comes to an end or the building or structure is demolished or destroyed, an additional depreciation allowance ("balancing allowance") is granted if the proceeds of sale (or insurance, salvage or compensation moneys received) are less than the written-down value at the time of the event. Conversely, if the proceeds of sale etc. exceed the written-down value, a "balancing charge" is imposed on the taxpayer, so as to recoup that portion of capital allowances granted which, in fact, has been excessive. Any "balancing charge" may not exceed the amount of the previous depreciation allowances.

However, no "balancing charge" is made and no "balancing allowance" granted, if the sale or other event occurs more than fifty years (ten years in the case of hotels, holiday camps, holiday cottages, market garden buildings and buildings for the intensive production of livestock) after the building or structure was first used.

In addition, the sale or other disposal of the building may give rise to taxable capital gains (see Part C, below), but only if and to the extent that the proceeds of sale or other disposal exceed the expenditure incurred on the building or structure. Similarly, a capital loss may arise to the extent that such loss is not covered by depreciation allowances (including the "balancing allowance").

If in a certain year, a building did not qualify for the "annual allowance", e.g., because it was not used for the purpose of the trade, any "balancing allowance" or "balancing charge" on the occasion of a subsequent disposal is computed as if the "annual allowances" were granted every year.

For an example of the procedure regarding the disposal of an "industrial building", see the corresponding paragraph 2.4.1. of the Chapter on the United Kingdom.

2.4.2. Consequences for the purchaser

As indicated above, depreciation allowances with respect to "industrial buildings or structures" are granted only for the cost of construction. The computation of the "annual allowance" to which a subsequent owner may be entitled is made in such manner that that part of his purchase price as does not exceed the cost of construction of the building may be depreciated over the years of the remaining life of the building, being either ten years (in the case of hotels, holiday camps, holiday cottages, market garden buildings and buildings for the intensive production of livestock), 25 years (for other buildings, the expenditure on which is incurred between January 16, 1975 and March 31, 1977) or 50 years (for other buildings, the expenditure on which is incurred prior to January 16, 1975) from the year of construction.

Thus, the purchaser may depreciate his purchase price (or the allowable part thereof) over the years up to the moment the building is 10 years, 25 years or 50 years old, as the case may be.

For an example of this procedure, see Example II in the corresponding paragraph 2.4.2. of the Chapter on the United Kingdom.

3. Depreciation of Machinery and Plant

3.1. Main principles; definition

Depreciation allowances with respect to "machinery and plant" are granted in several ways.

For the year the expenditure on the acquisition of the item of "machinery or plant" is incurred, accelerated depreciation ("initial allowance") may be claimed which currently amounts to 100% of the expenditure. If the above "initial allowance" is claimed there is, naturally, no room for further depreciation allowances.

As an alternative to the "initial allowance", the taxpayer may also claim increased "annual allowances" up to an amount as specified by him, which implies "free depreciation", i.e. depreciation at any rate (which may vary from year to year) chosen by him, provided that it must exceed the normal rate of the annual allowance.

Both the "initial allowance" and "free depreciation" are available only with respect to "machinery and plant" which are acquired unused and not second-hand. Also, all kinds of motor vehicles are excluded from these two depreciation allowances.

Finally, the normal depreciation allowances ("annual allowances") are granted at varying rates which, originally, reflected the estimated useful life of the asset concerned, although the system has been simplified in 1968, so that at the present time only four different rates exist.

There is no definition of the expression "machinery and plant" in Irish law, which situation also exists in the United Kingdom. In case of doubt, the leading cases of United Kingdom courts will usually be followed. For further details, see part B, para. 3.1.2. of the Chapter on the United Kingdom.

3.2. Accelerated depreciation

3.2.1. The "initial allowance"

The "initial allowance" was introduced at the rate of 20% ("one-fifth") for qualifying expenditure incurred on or after April 6, 1956. The rate is currently (i.e., for qualifying expenditure incurred between April 1, 1971 and March 31, 1977 - both dates included) 100% of the expenditure.

The "initial allowance" applies to capital expenditure incurred on the provision, for the purposes of the trade, of new machinery or new plant, other than vehicles suitable for the conveyance by road of persons or goods or the haulage by road of other vehicles (I.T.A. 1967, sec. 251(1)). However, ships shall always be deemed to be new, so that the "initial allowance" does apply to second-hand ships (ibid, sec. 251(6)).

It is also provided that if the profits of the trade, before the initial (and annual) allowances, are insufficient to give full effect to the allowances, the excess may be carried forward to subsequent years, but it must be taken into account as soon as possible, i.e. as soon as the profits of the trade are sufficient to cover the outstanding allowances of previous years.

3.2.2. "Free depreciation"

Free depreciation, i.e. legally the normal depreciation allowance ("annual allowance") "increased by such amount as is specified by the person to whom the deduction is to be allowed" (F.A. 1971, sec. 26) was first introduced in 1967 for new machinery and new plant provided for use in any "undeveloped area", but as of April 1, 1971 until April 1, 1977 free depreciation is extended to the entire country.

As in the case of the initial allowance free depreciation is granted only with respect to plant and machinery purchased new (and not second hand), motor vehicles again being excluded. Unlike the "initial allowance" it does not apply to second hand ships.

Free depreciation and the "initial allowance" are mutually exclusive, i.e., if free depreciation is claimed, no initial allowance will be available.

A major distinction between the "initial allowance" and free depreciation is that the "initial allowance" is granted in addition to the "annual allowances", although with the "initial allowance" at 100% there will currently be no room for annual allowances, as initial allowance and annual allowances may together not exceed the expenditure incurred.

Free depreciation on the other hand consists, in principle, of increased annual allowances, which implies that no annual allowances can be claimed for any asset in addition to free depreciation.

Another distinction is that the initial allowance must be taken immediately, i.e., for the year in which the expenditure is incurred (although a carry forward is allowed in case of insufficient profits) whereas with free depreciation the taxpayer is free to spread the expenditure over the years as he thinks fit, provided that it seems that the depreciation in any year should not be less than the ordinary "annual allowance".

3.3. Normal depreciation; wear and tear allowances

3.3.1. Main provisions

Normal (annual) depreciation allowances (usually referred to as "wear and tear allowances") are based, in principle, on the estimated useful life of the asset concerned. The rate of the allowance is determined in such manner that the cost of the asset is written off over the estimated useful life, using the declining balance method.

The rate is determined without regard to any "initial allowance" granted, but as the aggregate of initial and wear and tear allowances may not exceed 100% of cost, there will be no room for annual depreciation allowances for assets which qualify for the 100% initial allowance.

With respect to assets acquired in the course of the year, the full allowance is granted.

The normal rate of the wear and tear allowance may be increased as the taxpayer elects under the system of "free depreciation", discussed in para. 3.2.2., above.

3.3.2. Rates of wear and tear allowances

As indicated in para. 3.3.1., above, the rates of depreciation are determined for the various types of assets on the basis of estimated useful life, and the actual amount allowed is the amount "considered by the Appeal Commissioners to be just and reasonable" (I.T.A. 1967, sec. 241(1)).

However, since 1958, the allowance was determined at five-fourths (125%) of the amount considered just and reasonable, except for motor vehicles, which implies a measure of accelerated depreciation quite apart from the "initial allowance".

A further change occurred in 1968, pursuant to sec. 4 of the Finance Act, 1968, for expenditure on new assets provided for use in the trade on or after April 1, 1968. Under this provision there are three "standard" rates of depreciation, viz.

- 10% if the amount considered "just and reasonable" does not exceed 8.75%;
- 12.5% if the amount considered "just and reasonable" is between 8.75% and 15%;
- 25% if the amount considered "just and reasonable" exceeds 15%.

The latter rates do not apply to motor vehicles (both vehicles for the transportation of persons and vehicles for the transportation of goods); they are subject to annual depreciation ("wear and tear") allowances of 20% (declining balance method). For passenger cars (i.e., "mechanically propelled road vehicles constructed or adapted for the carriage of passengers, other than vehicles of a type not commonly used as a private vehicle and unsuitable to be so used" - F.A. 1973, sec. 30) depreciation allowances are further restricted in that no depreciation is granted for such part of the retail sales price as exceeds £2,500 (ibid, sec. 25), this limit being increased to £3,500 for expenditure incurred on this kind of motor vehicles on or after January 29, 1976 (F.A. 1976, sec. 31).

Special provisions also apply to plant and machinery used in a trade which consists of or includes the working of a mine or quarry or the smelting of ore. In that case, the taxpayer may elect that the expenditure less any residual value is written off over the years during which the mine or quarry is likely to be worked or the smelting of ore is likely to continue (the annual deduction to be "such sum as is considered just and reasonable having regard to the period at the expiration of which the mine or quarry is likely to cease to be worked or the smelting of ore is likely to be discontinued" - I.T.A. 1967, sec. 241(1)).

Thus, the various rates currently in force can be summarized as follows:

- motor vehicles : 20% (depreciation restricted to retail price of £3,500 for passenger cars)
- plant and machinery : depreciation spread over the years the mine or quarry used in mining or quarrying or the smelting of ore will be worked or the smelting of ore is continued
- other assets:
 - a) acquired unused on or after April 1, 1968 : 10%, 12.5% or 25%
 - b) acquired prior to April 1, 1968 (unused or second-hand) or after that date (used) : 125% of the rate which is considered "just and reasonable".

3.4. Assets used partly for non-business purposes

Although there is no explicit provision in the law to that effect, it must be assumed that if an item of plant or machinery is used partly for non-business (e.g., private purposes) the allowable depreciation (both accelerated and annual depreciation) is reduced accordingly.

3.5. Sale or disposal of plant and machinery: balancing allowances and charges

3.5.1. General rule

If an item of plant or machinery for which an initial allowance or wear and tear allowances have been granted subsequently ceases to belong to the taxpayer (either through a sale or otherwise), or if the asset is no longer used for the purposes of the trade, or if the trade is discontinued, an additional depreciation allowance (termed "balancing allowance") is granted if the proceeds of sale or insurance or compensation moneys received (or open-market value if there is no sale or a sale not at arm's length) are less than the written-down value of the asset. Conversely, if the proceeds of sale etc. exceed the written-down value a "balancing charge" equal to such excess is added to taxable income (I.T.A. 1067, sec. 272 et seq.). The "balancing charge", however, may not exceed the amount of depreciation allowances taken or deemed to have been taken in the past.

Any excess of the proceeds of sale etc. over the original cost price of the asset may give rise to a chargeable capital gain (see part C, below).

3.5.2. Assets used partly for non-business purposes

In computing the written-down value of assets not used exclusively for business purposes, both depreciation allowances actually granted with respect to the use for business purposes and depreciation referable to the non-business use are taken into account, and the balancing allowance or charge is adjusted accordingly (I.T.A. 1967, sec. 276).

Example

An asset which was purchased for £1,000 was used as to 20% for private or other non-business purposes.

Initial and annual allowances granted for tax purposes amount to £600 (with respect to 80% of total use) and the notional depreciation referable to non-business use thus amounts to £150. The adjusted written-down value is thus £1,000 - £750 = £250.

If the asset is subsequently sold for £600, the total cost of the asset during the entire period of ownership is £1,000 - £600 = £400, of which 80% or £320 is referable to the business use of the asset. However, actual allowances granted for tax purposes amounted to £600 and there is thus a "balancing charge" of £600 - £320 = £280.

3.5.3. Replacement of plant or machinery

If an item of plant or machinery is sold or otherwise disposed of or destroyed, and such event would give rise to a "balancing charge", but the asset is replaced by another asset, the taxpayer may elect that the "balancing charge" shall not be made, but that the cost of the new asset will, for the purpose of depreciation allowances, be reduced by an amount equal to the "balancing charge" not imposed on him (I.T.A. 1967, sec. 273).

3.5.4. Sales not at arm's length: open-market value; "silent transfer"

As indicated in para. 3.5.1., above, if the taxpayer disposes of an item of plant or machinery, otherwise than by an arm's length transaction, or if he keeps the asset for other than business purposes, the asset in question is, in principle, considered to be sold at the open-market price in determining the amount of any balancing allowance or charge.

The same open-market price will be the basis for depreciation allowances (annual allowances only, the initial allowance being restricted to assets purchased unused) for the subsequent owner.

However, if the transfer takes place on the occasion of the permanent discontinuance of the transferor's trade or if the transfer takes place by way of a gift, and the transferee is going to use the relevant asset for the purposes of his trade, then the transferor and the transferee may jointly elect that the transfer is made at the written-down value at the date of transfer and any subsequent balancing allowances and balancing charges on the transferee will be computed as if he owned the asset since the time of acquisition by the transferor (I.T.A. 1967, sec. 277(5)).

A similar "silent transfer" is granted to the person succeeding to a trade under the will or intestacy of the person previously carrying on the trade (ibid, sec. 278).

3.6. Subsidies

Unlike the situation as regards depreciation of industrial buildings, there is no provision in the law according to which subsidies must be deducted in computing the depreciable basis of plant and machinery.

However, in computing any balancing allowance or balancing charge on the sale or other disposal of an asset for which a subsidy has been received, it is assumed that an additional depreciation allowance equal to the amount of the subsidy has been granted.

4. Depreciation of Patents

Capital expenditure incurred on the purchase of patent rights may be written off in equal annual instalments over a period of seventeen years, or over the remaining life of the patent if less than 17 years, or over the years of any specified period of less than 17 years for which the patent rights are purchased (I.T.A. 1967, sec. 285).

A balancing allowance will be granted (or a balancing charge made) if the patent rights are subsequently sold or come to an end and the proceeds, if any, are less than (or exceed) the written-down value of the patent.

To the extent that the proceeds of sale of a patent exceed any capital expenditure previously incurred, a capital gain arises. Contrary to the normal situation regarding capital gains (discussed in part C, below), capital gains on the sale of patents are taxed as ordinary income, spread over a period of six years, unless the taxpayer elects to be taxed on the entire gain in the year of sale.

Like in the United Kingdom, the liability to ordinary income taxation in this case is a deviation from the normal concept of "income", as opposed to "capital gains".

5. Depreciation of Capital Expenditure on Dredging

Capital expenditure incurred on dredging is subject to depreciation allowances when the expenditure is incurred for the purposes of a trade which consists of the maintenance or improvement of the navigation of a harbour, estuary or waterway or when the dredging is for the benefit of vessels coming to, leaving or using any dock or other premises occupied by the taxpayer for the purposes of the trade.

The depreciation allowances ("capital allowances") in this case consist of an "initial allowance" equal to 10% of the expenditure and "annual allowances" equal to 2% of the expenditure (I.T.A. 1967, sec. 294).

If the trade is permanently discontinued an allowance will be granted for any part of the expenditure remaining after the depreciation allowances granted in previous years.

A person contributing a capital sum to expenditure on dredging shall be treated as incurring capital expenditure on dredging equal to the amount of the contribution and the expenditure of the person to whom the contribution is made is deemed to be reduced accordingly (ibid, sec. 294(9)).

6. Depreciation of Capital Expenditure on Scientific Research

Capital Expenditure on Scientific Research incurred by a person who is carrying on a trade or who commences a trade after the expenditure is incurred, may be written off completely in one year. Thus, the rate of depreciation amounts to 100%. For expenditure incurred prior to April 6, 1965, the rate was 20%, i.e. the expenditure was depreciable in five annual instalments. The expression "scientific research" is defined as "any activities in the fields of natural or applied science for the extension of knowledge" (I.T.A. 1967, sec. 244).

Appropriate adjustments are made if an asset, representing capital expenditure on scientific research subsequently ceases to be used for such research. The value of such an asset will then be added back to taxable income, and if it remains in use in the trade, depreciation allowances may be claimed under the appropriate heading (e.g., for plant and machinery).

7. Depreciation of Farm Buildings and Works

From April 6, 1969 until April 6, 1974 profits from farming, from the occupation of woodlands and a few similar types of income were not subject to income taxation. Prior to 1969 income tax was imposed normally under Schedule B on the "annual value" of the land occupied for farming purposes, unless the taxpayer elected to be taxed under Schedule D, i.e. the Schedule applying, inter alia, to trading income.

The exemption granted in 1969 (F.A. 1969, sec. 18(2)(a)) was abolished by the Finance Act 1974, and under the provisions of the latter Act, farming profits are now taxed under Schedule D in basically the same way as other trades, subject to certain exceptions.

The relevant section of the Finance Act, 1974 (sec. 22) provides for depreciation allowances with respect to capital expenditure on the construction of farmhouses, farm buildings, cottages, fences or other works.

The depreciation allowances consist of an "initial allowance" of 20% ("one-fifth") of the expenditure in the first year, and "annual allowances" for the first and subsequent years amounting to 10% ("one-tenth") of the expenditure. Thus, in the first year both the initial and the annual allowance may be claimed.

However, the "initial allowance" applies only to expenditure incurred on or after April 6, 1974, whereas the "annual allowance" applies to expenditure incurred on or after April 6, 1971.

With respect to expenditure on farmhouses, only one-third of the expenditure is taken into account or an even smaller proportion "if the accommodation and amenities of the farmhouse are out of due relation to the nature and extent of the farm".

If the taxpayer transfers his interest in the farm land to another person, that other person shall normally be entitled to the annual allowances for the years following the transfer.

8. Depreciation with respect to Mines

Up to April 5, 1974 significant tax exemptions existed with respect to mining operations carried out in Ireland.

However, as of April 6, 1974 these exemptions were terminated pursuant to the Finance (Taxation of Profits of Certain Mines) Act, 1974 (not applicable to coal mining), and this act contains, inter alia, provisions regarding depreciation allowances with respect to qualifying capital expenditure. These provisions are rather generous, apparently to smoothen the change-over from tax-exempt status to tax liability.

Depreciation allowances currently available include the following:

a) mine development allowance (I.T.A. 1967, sec. 245)

With respect to capital expenditure incurred (i) on the development of a mine on searching for or on discovering and testing mineral deposits or winning access thereto, or (ii) on the construction of any works which are of such a nature that when the mine has ceased to be operated they are likely to have so diminished in value that their value will be little or nothing, an annual allowance is granted computed in such manner that the expenditure (less any estimated residual value) is spread evenly over the estimated life of the deposit, subject to a maximum of 20 years.

This allowance applies only to mines operated for the purpose of obtaining "scheduled minerals", being barytes, felspar, serpentinous marble, quartz rock, soapstone, ores of copper, ores of golds, ores of iron, ores of lead, ores of manganese, ores of molybdenum, ores of silver, ores of sulphur and ores of zinc.

Moreover, the allowance does not apply to expenditure incurred on the acquisition of the site or on the acquisition of, or of rights over, the deposits, nor to expenditure on works constructed for subjecting the raw product of the mine to any process.

Under sec. 2 of the Finance (Taxation of Profits of Certain Mines) Act, 1974, capital expenditure eligible for the above allowance incurred before April 6, 1974 could be written off completely in the year 1974-75 to the extent it was still unallowed at that date.

b) abortive exploration allowance

Any abortive exploration expenditure incurred between April 6, 1967 and April 5, 1974 by a person carrying on a trade of working a "qualifying mine" on April 6, 1974 is allowed in full for the year of assessment 1974-75 (F(TPCM)A, 1974, sec. 3).

c) exploration investment allowance

For exploration expenditure incurred on or after April 6, 1974, by a person carrying on the trade of working a "qualifying mine", a 20% investment allowance is granted over and above the mine development allowance discussed under a), above (F(TPCM)A, 1974, sec. 6).

d) investment allowance for plant and machinery

A 20% investment allowance is also granted for expenditure on new plant and new machinery (except motor vehicles) provided for use for the purposes of the trade of working a "qualifying mine" (ibid, sec. 7).

The plant and machinery qualifying for the investment allowance will also qualify for "free depreciation" as discussed in para. 3.2.2., above.

Also, the written-down value of any plant or machinery purchased prior to April 6, 1974 is written off completely for the year of assessment 1974-75 (ibid, sec. 7(2)).

e) annual depletion allowance

Capital expenditure incurred after March 31, 1974 or the acquisition of a "scheduled mineral asset" (as defined) by a person carrying on the trade of working a "qualifying mine" is eligible for annual allowances similar to the mine development allowance (ibid, sec. 8).

C. TAXATION OF CAPITAL GAINS AND LOSSES

1. General outline

Like in the United Kingdom, capital gains and losses, whether realised or not, are not normally taken into account in computing the income of a trade.

The basic distinction between (ordinary) trading income and capital gains in Ireland is the same as in the United Kingdom. For more detailed information on this subject, reference is made to the corresponding paragraph 1 of part C of the Chapter on the United Kingdom.

Capital gains taxation was introduced in Ireland by the Capital Gains Tax Act, 1975, applying to all disposals of assets taking place on or after April 6, 1974, several years after the introduction of similar legislation in the United Kingdom.

It should also be emphasized that capital gains tax applies only to realised capital gains. Non-realised capital gains (e.g., resulting from a revaluation of fixed capital assets belonging to a trade) are not taxable. This implies, inter alia, that a mere revaluation of fixed business assets in the balance sheet is irrelevant for tax purposes.

In the following paragraphs a short general description of the Capital Gains Tax is given, followed by a survey of the various exemptions and other special provisions which are of particular relevance for taxpayers engaged in a trade.

2. The Capital Gains Tax

2.1. Main charging provisions

Residents of Ireland are subject to Capital Gains Tax with respect to all disposals of assets irrespective of their location, whereas non-residents are subject to Capital Gains Tax only with respect to certain assets located in Ireland, viz.

- (i) land located in Ireland;
- (ii) minerals located in Ireland, and any rights or other assets in relation to mining or minerals or the searching for minerals; and
- (iii) assets located in Ireland which are used in or for the purposes of a trade carried on by the taxpayer in Ireland through a branch or agency, or which were used or held or acquired for use by or for the purposes of the branch or agency (Capital Gains Tax Act, 1975 - hereinafter referred to as C.G.T.A. 1975 -, sec. 4);

Subject to a number of exceptions, chargeable assets are, in principle, all forms of property, specifically including:

- (i) options, debts and incorporeal property generally;
- (ii) any currency, other than Irish currency and sterling; and
- (iii) any form of property created by the person disposing of it, or otherwise becoming owned without being acquired (C.G.T.A. 1975, sec. 7).

There is no comprehensive definition of "disposal" in the Act. Besides sales and gifts, there is a disposal in the terms of the Act "where any capital sum is derived from assets notwithstanding that no asset is acquired by the person paying the capital sum", e.g. capital sums received by way of compensation for damage or injury to assets, capital sums received under a policy of insurance of the risk of any kind of damage or injury to assets, capital sums received in return for forfeiture or surrender of rights, and capital sums received as consideration for use or exploitation of assets. Also, the granting of an interest or right in or over an asset is a taxable "part disposal" of the asset (ibid, sec. 8).

The capital gain (or loss) is basically computed as the difference between consideration received at the disposal (or market value in the case of gifts and certain other transactions which are not at arm's length) and cost of acquisition. However, the Capital Gains Tax Act has no retroactive effect, which implies that with respect to assets owned at the time the Act became effective (April 6, 1974) only that part of the total gain which has accrued or is deemed to have accrued after April 6, 1974 is taxed at a subsequent disposal.

Also, with respect to "wasting assets" (i.e., assets with a predictable life not exceeding fifty years) the gain is not computed as the difference between consideration received and cost of acquisition, but as the difference between consideration received and the depreciated value of the asset concerned, assuming a straight-line depreciation over the years of the predictable life of the asset.

However, this depreciation with respect to wasting assets for capital gains tax purposes does not apply to business assets for which depreciation allowances (capital allowances) have been or could have been claimed: in that case, any excess of consideration received over the cost of acquisition is normally fully subject to capital gains tax, quite apart from the imposition of a "balancing charge" as discussed in part B of this Chapter.

As to "wasting assets" it should also be noted that gains on the disposal of "wasting assets" which are tangible movable property are completely exempt, except for business assets which have been subject to depreciation allowances (C.G.T.A. 1975, sec. 18).

Thus, in practice, the rules concerning "wasting assets" apply only to intangible property other than business property which has been subject to depreciation allowances, for which full capital gains tax liability is maintained, subject to specific exceptions as outlined in the following paragraphs.

2.2. Special rules concerning businesses and business assets

2.2.1. Depreciable assets

As already indicated in para. 2.1., above, and in part B (Depreciation of Business Assets), the sale or other disposal of business assets which have been subject to depreciation allowances does not normally give rise to a capital gain or loss.

Sale or other disposal for a price (or other compensation received) below the written-down value will normally result in a "balancing allowance" equal to the difference.

Sale or other disposal for a consideration exceeding the written-down value will normally result in a "balancing charge" equal to the difference, except for the replacement provisions regarding plant and machinery (see part B, para. 3.5.3., above).

However, any "balancing charge" made may not exceed the amount of depreciation allowances taken in the past, so no "balancing charge" is made for any excess of the sales proceeds over the original cost of acquisition. Such excess will constitute a taxable capital gain, subject to various relief provisions as outlined below.

2.2.2. Restoration and replacement of business assets

There is no general provision in the Capital Gains Tax Act regarding relief or postponement of tax in case a business asset is replaced by another asset. However, relief is available in a limited number of cases. These provisions can be summarized as follows:

a) compensation received in case of damage

If a capital sum is derived from an asset which is not lost or destroyed (being such capital sums as are taxable disposals under sec. 8(2)(a) of the Act - see para. 2.1., above) and that capital sum is wholly (or almost wholly) applied in restoring the asset, then the recipient may claim that the receipt of the sum is not treated as a disposal, but the sum received is deducted in computing the cost of acquisition of the asset on a subsequent disposal of the asset (C.G.T.A. 1975, sec. 29(1)).

This relief applies to both business and private assets, except that so-called "wasting assets" do not qualify for the relief.

b) compensation received in case of loss or destruction

If a capital sum is derived upon the loss or destruction of an asset, and the capital sum is within one year of receipt, or such longer period as the inspector of taxes may allow, applied in acquiring a replacement asset then the owner of the asset may claim that the compensation received (if otherwise of a greater amount) is deemed to be of such amount as would secure that no gain or loss accrues on the disposal, and as if the cost of acquisition of the new asset were reduced (for capital gains tax purposes) by the excess of actual compensation received plus any residual or scrap value of the old asset over the amount deemed to be received by him (ibid, sec. 29(2)).

Limited relief is available, under certain conditions, if not the entire capital sum received is used for the acquisition of the new asset.

Like the relief under a) above, this relief applies to both business and private assets, "wasting assets" again being excluded.

c) replacement of business assets

A relief similar to the relief outlined in b), above, applies to all disposals of business assets or of an interest in such assets (i.e., assets used, and used only, for the purposes of the trade throughout the period of ownership), followed by an acquisition of replacement assets (ibid, sec. 28).

The relief is continued if the new assets are themselves replaced at a later date.

Partial relief may be claimed if the assets are used exclusively for business purposes during part of the period of ownership only, and with respect to buildings used partly for business and partly for other purposes.

However, this relief applies only to three categories of business assets, viz.:

(i) plant and machinery;

- (ii) except where the trade is a trade of dealing in or developing land, or of providing services for the occupier of land in which the person carrying on the trade has an estate or interest -
- any building or part of a building and any permanent or semi-permanent structure in the nature of a building, occupied (as well as used) only for the purposes of the trade,
 - any land occupied (as well as used) only for the purposes of the trade, provided that where the trade is a trade of dealing in or developing land, but a profit on the sale of any land held for the purposes of the trade would not form part of the trading profits, the trade shall be treated for the purposes of this subsection as if it were not a trade of dealing in or developing land;
- (iii) goodwill. (ibid, sec. 28(5)).

The above relief applies to trades, as well as to professions, offices or employments; farming; woodlands managed on a commercial basis; public authorities; non-profit making bodies; trade associations; and athletic and amateur sports bodies.

2.2.3. Termination of a business

There are no general relief provisions with respect to the termination of a business. However, some measure of relief is granted upon retirement of individual taxpayers who dispose of "qualifying assets", i.e., broadly speaking, the individual's chargeable business assets which, apart from tangible movable property, he has owned for a period of not less than 10 years, and shares in a "family company" which he has owned for not less than 10 years.

The available reliefs can be summarized as follows:

- a) if an individual who has attained the age of 55 years disposes of the whole or part of his qualifying assets and the consideration received does not exceed £50,000, any capital gain is fully exempt. If the consideration exceeds £50,000 the amount of capital gains tax shall not exceed half the difference between the actual amount of the consideration and £50,000 (ibid, sec. 26);

b) if an individual who has attained the age of 55 years disposes of the whole of his qualifying assets to one or more of his children and the amount or value of the consideration does not exceed £150,000, any capital gain is fully exempt. If the consideration exceeds £150,000 the amount of capital gains tax shall not exceed half the difference between the amount of the consideration and £150,000. (ibid, sec. 27).

The reliefs under a) and b), above, are mutually exclusive, i.e., if the relief under b) is claimed, the relief under a) is not available.

The term "family company" used in the definition of "qualifying assets" means, broadly, a company the voting rights in which are as to not less than 25% exercised by the individual, or as to not less than 75% exercisable by the individual, or a member of his family, and, as to not less than 10% exercisable by the individual himself.

In determining whether assets are owned for a period of not less than 10 years, ownership by the spouse of the transferor and the transferor personally, and ownership of shares in a family company preceded by direct ownership of the assets by the individual, are added together, subject to certain conditions.

2.2.4. Transactions between groups of companies

Special relief provisions apply to transactions between members of a group of companies, i.e., generally speaking, a company resident in Ireland together with its resident subsidiaries in which it owns directly or indirectly not less than 75% of share capital.

The disposal of assets from one member of such a group of companies to another member of the group will be deemed for capital gains tax purposes to be made for a consideration of such amount as would secure that no capital gain or loss arises for the transferor.

Capital gains tax liability will arise at the moment the asset in question leaves the group (Corporation Tax Act, 1976, sec. 130).

2.2.5. Company reorganizations; mergers

Under a "scheme of reconstruction or amalgamation" involving the transfer of the whole or part of a resident company's business to another resident company, any assets included in the transfer are deemed to be acquired by the second company for a consideration of such amount as would secure that no capital gain or loss accrues to the transferor company (Corporation Tax Act, 1976, sec. 127). Thus, capital gains tax liability is postponed until the assets are disposed of by the transferee company. In such case the transferee company shall be treated as if the acquisition of the assets involved by the transferor company had been the acquisition by the transferee company.

The expression "scheme of reconstruction or amalgamation" is defined as "a scheme for the reconstruction of any company or the amalgamation of any two or more companies".

Also for shareholders there will not normally be any immediate capital gains tax liability in case of a reorganisation or reduction of a company's share capital, or if he receives shares in another company in exchange for his existing holding in the company. These provisions are laid down in Schedule 2 to the Capital Gains Tax Act, 1975.

In the first event (reorganisation or reduction of share capital) there will be no disposal for capital gains tax purposes, and the "new holding" (i.e., the shares in and debentures of the company which as a result of the reorganisation or reduction represent the original shares including any original shares remaining) shall be treated as the same asset acquired as the original shares were acquired. Any consideration given by the shareholder shall be treated as having been given for the original holding, and if any consideration is received other than the new holding the shareholder will be treated as having disposed of an interest in the original shares, and be subject to capital gains tax accordingly.

In the second event (exchange of share in a company for shares in another company) the same rules apply, mutatis mutandis, subject to the condition that the company issuing the new shares has, or in consequence of the exchange will have control of the other company, or that the shares are issued as the result of a general offer made to the shareholders of the other company if such offer was made in the first instance on condition that the company making the offer would gain control of the other company.

D.

RESERVES

Like in the United Kingdom, the creation of reserves is not acceptable for the purposes of income tax and corporation tax. This applies to both "true" reserves as well as to provisions for future expenses.

These strict rules emerge from the basic concepts regarding business income applying in Ireland as they do in the United Kingdom.

To give one example, no general reserve e.g., expressed as a percentage of outstanding debts receivable, may be created although it is allowed to deduct the amount of any debts proved to be bad, or to make a provision for specific debts to the extent that they are estimated to be bad.

There are also no investment incentives in the form of investment reserves etc.

E. OTHER INVESTMENT INCENTIVES

1. General outline

Besides accelerated and normal depreciation allowances set out in part B, there are various other investment incentives available for tax purposes in Ireland.

In the first place, investment allowances are granted with respect to certain qualifying investments, in order to stimulate certain business activities in particular industries or in particular parts of the country.

Investment allowances are granted in the form of a deduction which is expressed as a percentage of qualifying investments; the deduction is given over and above depreciation allowances covering the entire expenditure over the years, so that where an investment allowance applies more than 100% of qualifying expenditure is in fact deductible.

Secondly, tax exemptions are granted to companies engaged in export trade and to companies established in the Shannon Airport Area which are engaged in qualifying business activities.

The above incentives will be considered in the following paragraphs.

2. Investment allowances

2.1. Allowance for machinery and plant in "designated areas"

Capital expenditure incurred between April 1, 1971 and March 31, 1977 by a person carrying on a trade or profession, on the provision of "qualifying machinery or plant" for the purposes of the trade or profession is eligible for an "investment allowance" equal to 20% of the expenditure (F.A. 1971, sec. 22)

The term "qualifying machinery or plant" is defined as machinery and plant (other than road vehicles) provided for use in any "designated area" and bought unused and not second-hand.

The expression "designated area" is fully defined in the Industrial Development Act, 1969; these "designated areas" are economically underdeveloped and are situated, broadly speaking, in the western part of the country.

The "investment allowance" is granted for the year in which the expenditure is incurred (i.e., "for the year of assessment in the basis period for which the expenditure is incurred"). The investment allowance does not apply to that part of expenditure which is met directly or indirectly by Government grants (ibid).

If an investment allowance is made, it will be withdrawn (with corresponding adjustment in the tax assessments) if the assets are sold without being used for the trade in a designated area, or if they are sold within two years from the day they began to be used (ibid, sec. 25).

2.2. Investment allowance for new ships

An "investment allowance" equal to 40% of the expenditure applied to capital expenditure incurred on the purchase of a new ship for the purposes of a trade between April 6, 1957 and July 23, 1973, (I.T.A. 1967, sec. 246). The allowance is suspended for expenditure incurred between July 24, 1973 and March 31, 1977, however.

As in the case of the investment allowance for machinery and plant used in designated (development) areas, the shipping investment allowance did not apply to any part of the expenditure met by Government grants.

The allowance was withdrawn (with corresponding adjustments in tax assessments) if the ship was sold without being used in the trade, or if the ship was sold within 5 years from the day it was first used (ibid, sec. 250).

2.3. Investment allowance for the mining industry

An investment allowance equal to 20% of expenditure is granted with respect to exploration expenditure incurred on or after April 6, 1974 on the mining of "scheduled minerals" and for expenditure on new plant and machinery. For further details, see part B, para. 8, sub c) and d), above.

3. Exemption for Export Profits

3.1. General outline

The provisions regarding the exemption for export profits are currently laid down in secs. 53 through 68 of the Corporation Tax Act, 1976, replacing the earlier provisions of the Income Tax Act, 1967.

Only companies (whether resident or not resident in Ireland) are eligible for the relief.

Basically, an exemption is granted during 15 years (followed by five years of tapering relief) in respect of increases in export sales as compared with a standard period, the standard period being a period of one year ending on September 30, 1956, or, at the company's election, the one-year period ending on September 30, 1955. However, companies which did not exist in 1956, or which did not export at all during that year, are exempt for their entire profits attributable to export sales.

As stated earlier, the relief is granted in full during a maximum period of 15 years, followed by another 5 years of "tapering relief", during which the tax on qualifying export profits is reduced by 80%, 65%, 50%, 35% and 15%, respectively. However, as the law now stands, no relief will be granted for accounting periods or parts of accounting periods falling after April 5, 1990. Thus, for companies established after April 5, 1970 the period of full or partial relief will be less than the statutory 20 years.

Dividends paid wholly or partially out of exempt profits are also exempt from Irish income tax in the hands of shareholders, irrespective of whether the shareholders are resident in Ireland or not.

3.2. Definition of "exports"

In principle, the exemption is granted for export of "goods", the word "goods" meaning, basically, goods manufactured within Ireland by the person who exports them, including the case where there are two related companies (one company holding, directly or indirectly, more than 90% of the shares in the other company, or persons having a controlling interest in one company holding more than 90% of the shares in the other company) and the goods are manufactured by one of the companies and exported by the other. In the latter case, the relief is granted to the company which exports the goods (C.T.A. 1976, sec. 54).

Relief is also granted if the company exporting the goods acts as a wholesaler and the goods are manufactured by another person (ibid).

Through the years, the definitions of "goods" and "exports" have been extended for purposes of the relief, e.g., to certain goods which are not manufactured, and to certain services rendered to non-residents.

These extensions include:

- fish produced in Ireland on a fish farm;
- cultivated mushrooms, cultivated in Ireland;
- books and greeting cards printed in Ireland, but exported by the publisher are regarded as manufactured by the publisher;
- repairs carried out in Ireland to a ship, is regarded as manufacture of goods, and, to the extent that the ship is wholly owned by persons not ordinarily resident in Ireland, as exports;
- a company carrying on the trade of building or repairing ships, may also elect that all ships built and all ship repairs are treated as goods exported by the company, and that all payments received with respect to such building or repairing are treated as amounts received from the sale of goods exported;

- milk products and pigmeat products, as defined, sold to the "An Bord Baine Co-operative Limited" and the "Pigs and Bacon Commission", respectively, and subsequently exported by those bodies, are treated as exported by the company which produced the goods;
- if a company carries on the trade of rendering services to another person by way of subjecting commodities or materials belonging to that person to any process of manufacturing, and all or some of the services are rendered to a non-resident in relation to commodities or materials imported, and the commodities or materials, or the products into which they have been converted, are subsequently exported while still belonging to that other person, the company may elect that the rendering of such services shall be regarded as manufacture of goods, and to the extent that the services are rendered to non-residents they shall be regarded as exports;
- a company carrying on a trade which consists of or includes the rendering of engineering services (being design and planning services carried out in Ireland in connection with chemical, civil, electrical or mechanical engineering works executed outside Ireland), the company may elect that the rendering of such services shall be regarded as manufacture of goods, and to the extent that the services are rendered to non-residents they shall be regarded as exports.

3.3. Calculation of the exemption

The corporation tax is reduced to nil to the extent that it is referable to the income from the sale of goods exported (or to the income from the increase in export sales, if the standard period applies - see para. 3.1., above).

In determining which part of total income is attributable to export sales (or to the increase in export sales) the total income is split on the basis of turnover, i.e., in the same proportion as the amount receivable from the sale of goods exported bears to the total amount receivable from the sale of goods.

As indicated in para. 3.1., above, the exemption is granted for a maximum period of 15 years, followed by tapering relief during 5 more years, but subject to the limitation that the relief ends on April 5, 1990.

4. Exemption for Shannon Airport Area

4.1. General outline

The exemption for qualifying activities in the Shannon Airport Area are laid down in secs. 69 through 77 of the Corporation Tax Act, 1976.

The exemption was originally introduced at the time when the activities on the airport diminished due to the entry into service of long-range jet propelled aircraft which no longer needed to re-fuel at Shannon on their journeys from the European Continent to the United States and vice-versa.

Like the exemption for export trade, discussed in para. 3, above, this relief applies only to companies.

The relief is available for certain activities carried on in the airport and a certificate issued by the Minister for Finance is needed before the exemption can be applied.

In principle, the exemption is granted without limitation in time, subject to ministerial powers to revoke the company's certificate, but as the law now stands the exemption will be terminated on April 5, 1990.

4.2. Qualifying activities

As stated above, any company wishing to operate in the Shannon Airport Area and to benefit from the tax exemption, needs a certificate certifying that the company's trading operations are exempt trading operations.

No certificate can be issued unless the trading operations fall within one or more of the following classes:

- the sale of goods exported, or to be exported, out of Ireland by the qualified company, being goods produced, manufactured or processed within the airport by the qualified company;
- the sale of goods exported, or to be exported, out of Ireland by the qualified company, being goods imported into Ireland, and packaged or handled within the airport by the qualified company;

- the repair or maintenance of aircraft within the airport;
- the rendering of services within the airport or outside of Ireland, entailing the use of aircraft or air transport;
- other trading operations which contribute to the use or development of the airport;
- trading operations ancillary to the above activities.

There is also a list of activities which are specifically disqualified, such as the sale of goods from the airport to the rest of the country; the rendering of services in Ireland but outside the airport to residents of Ireland; and the retail sale of goods.

If part of a company's trade consists of exempt trading operations, and another part of other (taxable) trading operations, the company is deemed to carry on two distinct trades.

The income from exempt trading operations is fully exempt from corporation tax, until April 5, 1990. However, the exemption may be terminated earlier in that the Minister for Finance can revoke the certificate, e.g., when the company has failed to comply with any conditions, or when the company's trade ceases, or becomes carried on wholly outside the airport.

As in the case of exempt export profits, the exemption extends to dividends paid out of income from exempt trading operations.

F.

VALUATION OF STOCK-IN-TRADE1. Main provisions

There are no explicit provisions in the Irish taxing acts regarding the valuation of stock-in-trade, but in practice, valuation is normally done at the lower of cost or market value, which practice is based on general accounting principles.

United Kingdom case law is often referred to for further details of the system. For example, like in the United Kingdom the taxpayer may value certain goods or classes of goods at cost and other goods or classes of goods at market value at the same time. In determining the cost of goods which cannot easily be identified the first in-first out (F.I.F.O.) method should be used, the last in-first out method not being permitted.

Other methods, like the "base-stock method" are not acceptable for tax purposes.

Also with respect to the valuation of work in progress the rules of United Kingdom case law will generally be followed: both the direct cost method (cost of materials and labour) and the on-cost method (materials, labour increased by an appropriated amount for general and overhead expenses) may be used.

2. Relief for increases in value of stock-in-trade and work in progress

Temporary relief for increases in values of stock-in-trade, similar to that granted in the United Kingdom, is enacted in the Finance Act, 1975, sec. 31 and Schedule 3. Originally the relief applied only to companies for accounting periods ending in the tax years 1973-74 and 1974-75. By sec. 12 of the Finance Act, 1976, the relief was extended to individual taxpayers and the period for which relief can be claimed was extended by another year by sec. 26 of the 1976 Finance Act.

The relief is available for taxpayers carrying on a trade in Ireland which consists wholly or mainly of the manufacture of goods; the carrying out of construction operations; farming; and/or the sale of machinery and plant (excluding road vehicles) or goods to persons engaged in one of the above activities.

For each of the three accounting periods the relief is given in the form of a deduction from taxable income which is equal to the increase in value of trading stock and work in progress over the year (i.e., the difference between opening stock value and closing stock value) less 20% of the trading profits for that same period, trading profits being computed before deduction of capital (depreciation) allowances.

Where the above deduction is claimed for the final year, i.e. the accounting period 1975-76, the opening value of stock-in-trade for the next accounting period must be reduced by the amount of the deduction, which implies that the relief is recouped in that following accounting period, unless the relief is extended by subsequent legislation.

It should be noted that the relief is granted irrespective of whether the increase in value is caused by rising prices or by an increase in the quantity of the stock.

G. COMPENSATION OF LOSSES1. Normal system

Relief for losses sustained in carrying on a trade is granted in various ways according to a system very similar to the system in the United Kingdom, although there are a number of differences.

Firstly, for any loss sustained in any year of assessment in any trade (other than farming), profession or employment the taxpayer may claim such repayment of tax as is necessary to secure that the aggregate amount of tax ultimately borne corresponds with his income as reduced by the loss. This relief (laid down in I.T.A. 1976, sec. 307) in effect implies a carry back of one year to the extent that the loss is offset against trading income, since trading income is taxed on a preceding year basis, so that the trading income taxed in a year of assessment is earned in the preceding year. The corresponding relief for companies is laid down in the Corporation Tax Act, 1976, sec. 16 (2)(3).

Secondly, an individual carrying on two distinct trades may set off a loss incurred in one of the trades against the income of the other trade (I.T.A. 1967, sec. 308). A company may set off such loss against profits of whatever description of the same accounting period (C.T.A., 1976, sec. 16(2)).

Thirdly, any remaining loss of a trade may be carried forward indefinitely and set off against profits of the same trade in subsequent years, provided that the losses must be set off at the earliest opportunity, so that the taxpayer is not free to set off the loss against profits of any future year as he thinks fit. These carry-forward provisions are laid down in I.T.A. 1967, sec. 309 for individuals and in C.T.A. 1976, sec. 16(1) for corporate taxpayers.

Due to the limitation that the carry-forward is only granted with respect to profits of the same trade, no further carry-forward is allowed if the taxpayer's trade is discontinued and replaced by another trade, or if the nature of his trade is so radically changed that it can no longer be considered as the same trade.

Like in the United Kingdom there are provisions to counteract "loss buying", i.e., trading in so-called "tax loss companies".

Sec. 27 of the Corporation Tax Act, 1976 provides that:

- (i) if within any period of three years there is both a change in the ownership of the company and a major change in the nature or conduct of a trade carried on by the company; or
- (ii) if at any time after the scale of the activities in a trade carried on by a company has become small or negligible, and before any considerable revival of the trade, there is a change in ownership of the company there will be no relief for pre-change of ownership losses against post-change of ownership profits. The provision includes an extensive definition of the term "major change in the nature or conduct of a trade". The term "change in the ownership of a company" is laid down in Schedule 5 to the Finance Act, 1973, by which act the provision was first introduced.

On the other hand, there are provisions according to which the carry forward of losses may be continued in case of "company reconstruction without change of ownership", i.e., broadly speaking, if the trade of a company which ceases to carry on a trade is continued by another company and an interest of not less than a three-fourths share in the trade belongs to the same persons at any time within two years after as at some time within a year before the reconstruction (C.T.A. 1976, sec. 20).

2. Terminal losses

The carry back of trading losses is extended to the profits of three preceding years with respect to losses incurred in the final year of the business (C.T.A. 1976, sec. 18 and I.T.A. 1967, sec. 311).

3. Capital losses

Capital losses may be set off only against capital gains realized in the same or subsequent years. They may not be carried back and they may not be set off against ordinary income (C.G.T.A. 1975, sec. 12).

ITALY

A.

GENERAL CONCEPT - Introductory remarks

After the general tax reform of 1973 (effective January 1, 1974) business enterprises are subject to two income taxes: the corporate income tax (imposta sul reddito delle persone giuridiche) or, if the business is privately owned, the individual income tax (imposta sul reddito delle persone fisiche) and the local income tax (Imposta locale sui redditi), which latter tax applies to both corporations and individuals.

The profits of a business enterprise constitute, in principle, all net income earned during a financial period and is based on the results shown by the profit and loss account. Net income comprises total world-wide income, after deduction of allowable charges and expenses, exempt income and losses, and including capital gains.

Any foreign income is subject to the normal income taxes, but foreign taxes paid abroad as a final tax thereon are creditable within certain limits against the Italian Corporate or individual income tax. The credit granted is not necessarily the full amount of foreign tax paid, but is based on whether the foreign state grants a tax credit for income of the same nature arising in Italy or not.

If the foreign state from which the income is derived grants a similar relief for Italian tax on Italian source income, Italy will grant a credit for foreign taxes to an amount not greater than 66 2/3% of the Italian corporate or individual income tax, as the case may be, attributable to the income derived from that particular state and not less than 25% of the attributable Italian income tax.

If the other state does not grant a similar relief, the credit granted shall not exceed 25% of the pro-rate share of the Italian income tax. The total credit will be limited to the amount of foreign tax paid.

The rate of the corporate income tax is 25%; the individual income tax is levied at progressive rates up to 72%.

ITALY

In addition to either the corporate or individual income tax, profits are subject to the local income tax.

The local income tax is, in general, levied on the same base as the corporate or individual income tax, subject, however, to some adjustments. In principle, the income tax is levied only on income derived from Italian sources, but business income earned abroad is also subject to the local income tax, unless such profits are derived through a permanent establishment located in the foreign country, and the management and accounts of this permanent establishment are separate from those of the Italian head office.

The local income tax is also not applicable to income (including dividends) arising from participations in resident or non-resident companies and partnerships of any type.

Individuals do not pay the local income tax on salaries, wages and pensions. In case the business income is derived by an individual, the profits, subject to the local income tax, are reduced by an amount fixed by law, which represents the remuneration for the personal work he has done for the enterprise. This reduction amounts to half the business income, with a minimum of 6 million lire and a maximum of 12 million lire. The deduction is only granted if the taxpayer is actively engaged in the activities of the business.

The rates of the local income tax may vary between the following minimum and maximum:

	minimum	maximum
- in favor of municipalities	6 %	8.5 %
- in favor of provinces	1.5 %	2.5 %
- in favor of regions	1 %	2 %
- in favor of Chambers of Commerce	0.4 %	1.2 %
- in favor of Spas and holiday resorts (when applicable)		0.5 %

The effective rate, therefore, may vary from a minimum of 8.9 % to a maximum of 14.7 %. However, in practice, the maximum rates will apply until at least December 31, 1977, viz. 14.7 % in municipalities which are holiday resorts and 14.2 % in the other municipalities.

For corporations the corporate income tax and the local income tax are fully cumulative, but for individuals the local income tax may be deducted in computing income subject to the individual income tax.

Losses may be carried forward and set off against the profits of the next 5 years, but only for purposes of the corporate or individual income tax, not for the local income tax.

Non-resident companies and individuals carrying out business activities in Italy through a permanent establishment there are subject to the same taxes and the same rates as residents.

A special tax is levied on capital gains derived from the alienation of real property located in Italy. For corporations and individual enterprises, such gains are subject to this special tax and to the other income taxes.

Private individuals realising such capital gains not in the scope of a business are subject to this tax only, unless the gains are considered to be derived from speculation, in which case the individual and local income taxes are also due.

Certain immovable property companies are subject to this tax not only on disposal of the real property, but also after each ten-year ownership, on the capital appreciation of the property during this period of time (see C 1.5).

The above tax is deductible from profits for purposes of the computation of the corporate, individual and local income taxes.

B.

DEPRECIATION OF BUSINESS ASSETS1. Introduction

According to Presidential Decree no. 597 of September 29, 1973, depreciation allowances on business assets may be deducted from gross income as business expenses. The depreciation may not exceed the rates laid down in the law or in a special table approved by decree by the Minister of Finance. The maximum amount of depreciation may be increased in any year if an asset is more intensely used than is normal in that sector of business, and then the increase must be in proportion to the more intense use.

Only the straight-line method of depreciation is allowed.

An accelerated depreciation for tangible assets exists.

2. Depreciable assets

Decree no. 597 lists all the business assets which may be depreciated, but the result of the listing is that, for all practical purposes, all tangible and most intangible assets used in the conduct of a business are depreciable. Assets whose value do not diminish during their use, e.g. land, may not be depreciated.

Depreciable tangible assets include plant and machinery, immovable property, and any other movable property.

Intangible assets comprise industrial patents and other rights and trade names, processes, formulae and the like and also information concerned industrial, commercial or scientific experience (know-how) and goodwill.

Special provisions exist for expenses relating to studies and research directed at obtaining the intangible rights mentioned above, advertising expenses, formation expenses, expenses for repair and other costs attributable to more than one year (see below).

3. System of depreciation

3.1. Normal depreciation

Only the straight-line depreciation method is allowed, whereby annually a fixed percentage of the purchase price or manufacturing cost is deducted as depreciation allowance.

3.2. Accelerated depreciation

Only tangible assets may be written off at an accelerated rate. This accelerated depreciation amounts to 15 percent of the original cost for each of the first three years of the asset's useful life. The entrepreneur is allowed to deduct this extra depreciation allowance in those three years at 15% or so much less as he elects, but any difference between the maximum allowable accelerated depreciation, and the actually applied depreciation may not be recouped in later years by way of accelerated depreciation.

3.3. Basis of depreciation

Depreciation is based on the original cost of the assets, i.e. the price actually paid or the cost of production, including any directly attributable accessory expenses.

Depreciation of an asset may be continued without taking into account the salvage value.

The costs of repairs, maintenance, modernization and alterations to business assets are not added to the depreciable basis of the relevant assets, but such costs may be deducted in the year in which they were incurred, up to an amount equal to 5% of the cost of acquisition less depreciation of depreciable assets held at the beginning of that year. Any excess over 5% is allowable as a deduction in equal portions over the next 5 years.

Interest paid on loans concluded for the purchase of the construction of business assets relating to the period of time prior to the moment in which the assets begin or could begin to be used, is added to the initial cost price for purposes of depreciation.

Any grant received with respect to the acquisition of a business asset need not be deducted from the depreciable base of the business asset. Such grant, however, is included in taxable profits, unless the amount of the grant is placed in a special reserve fund to be utilized to cover losses incurred.

In case of tax free mergers and similar reorganisations under the income tax law, the depreciable base of the assets remains the same (carry over of book values).

3.4. Percentages and duration

3.4.1. Tangible assets

The maximum rates of depreciation of tangible assets are fixed by decree issued by the Minister of Finance. The rates vary according to the industry using the assets. A few examples follow as an illustration:

Textile industry

Industrial buildings	3.5 %
Light buildings, sheds, etc.	10 %
Plant and machinery	10 %
Tools and other small outfittings	25 %
Office furniture and ordinary office machines	12 %
Electronic office machines	18 %
Motor vehicles	20 %

For some sections of the textile industry slightly different percentages may apply.

ITALYMetallurgical industry (in general)

Industrial buildings	4	%
Light buildings, sheds, etc.	10	%
Non-automatic plant and machinery	10	%
Automatic plant and machinery	17.5	%
Ovens	12.5	%
Tools and other small outfittings	25	%
Office furniture and ordinary office machines	12	%
Electronic office machines	18	%
Motor vehicles	20	%

Metallurgical industry (excluding iron and steel industry)

Industrial buildings	5.5	%
Light buildings, sheds, etc.	10	%
General plant and non-automatic specific plant and machinery	10	%
Automatic specific plant and machinery	17.5	%
Electric cells	17.5	%
Ovens	14	%
Tools and other small outfittings	25	%
Office furniture and ordinary office machines	12	%
Electronic office machines	18	%
Motor vehicles	20	%

Transport industry (persons and goods)

Industrial buildings	4	%
Light buildings, sheds, etc.	10	%
Autobusses used for public transportation between towns	25	%
Trucks and trailers	20	%
Autovehicles in general (public transport)	25	%
Delivery vans	25	%
Tractors, electronic cars	20	%
Cattle trucks	10	%
Machine shops, lifting-gear	10	%
Various and small equipment	20	%
Office furniture and ordinary office machines	12	%
Electronic office machines	18	%
Metal or plastic containers	15	%

In addition to the above percentages, an accelerated depreciation may be taken of not more than 45% of the initial cost to be spread over three years (to a maximum of 15% per year).

3.4.2. Intangible assets

Industrial patents and similar rights relating to the use of inventive works, including directly attributable accessory costs, rights to use trademarks and tradenames, processes, formulae and similar rights, and information concerning industrial, commercial or scientific experience may be depreciated in equal instalments over the period of use foreseen by law or by contract.

Should the period of use not be determinable, then the rate of deductible depreciation may not exceed one fifth of the cost.

Goodwill may be depreciated at a rate not exceeding one fifth of the original value.

3.4.3. Assets of small value

Any asset whose cost of acquisition does not exceed 50,000 lire may be fully depreciated in the tax year in which the asset was purchased or manufactured.

3.4.4. Minimum depreciation rates

Business assets may be depreciated at a rate that is less than the above mentioned maximum allowable rates determined by Ministerial decree. Where, however, the depreciation taken in any tax year is less than half the maximum allowable depreciation (not including the accelerated depreciation allowed for tangible assets) than any amount under this half of the maximum amount is no longer depreciable (unless it is due to lower than normal use of the asset).

3.5. Commencement of depreciation

Depreciation of business assets is first permitted in the first tax year that the assets are or can be utilized. The law does not provide for a pro rate depreciation if during the first year the asset was only used during the last part of that year.

Newly established business enterprises may start depreciation of business assets in the first tax year in which gross income is received.

3.6. Special arrangements

Newly established enterprises which incur expenses, including incorporation expenses, in tax periods prior to that in which the first gross income is received may deduct such expenses in the first year in which gross income is derived and the four subsequent years, or up to 50% of such expenses in any one year.

Expenses relating to studies and research directed at obtaining intangible rights such as patents and other rights relating to the use of inventive works, trademarks, processes, formulae and similar rights, and know-how, may be deducted in that tax year in which those expenses were incurred, limited to a maximum of 50%. The remaining part is depreciable according to the normal rules of depreciation, provided that the expenses have resulted in a useful right. Otherwise the excess may be deducted either in the following year in its entirety or in equal instalments in that year and subsequent years, but not after the fourth year.

Advertising costs are deductible in its entirety in the year sustained or in equal instalments in that year and the next two years.

Other costs attributable to more than one year shall be deductible to the extent of the amount attributable to each tax period.

Where assets have to be transferred at the end of a concession, without charge, the rate of deductible depreciation shall be determined by dividing the original cost of the assets (less any contribution paid for by the grantor of the concession) by the number of years from the year the asset was put into use until the year in which the concession ended.

4. Deferral and recovery

If depreciation is taken on tangible assets in an amount less than the rates mentioned in the law or in the Ministerial decree, the difference shall be depreciable in the tax periods following the close of the normal term of depreciation. However, if the depreciation taken in any financial year is less than 50% of the permitted depreciation, the difference is no longer allowable as a deduction (also not in later years, unless it can be proved that the asset was put to less than normal use during that period).

Depreciation of intangible assets must be taken under the above rules and any deferral in excess of the possibilities the law grants cannot be recovered in later years.

5. Balance sheet; commercial and fiscal depreciation

In general, a business asset is valued on the balance sheet at its cost of acquisition as long as the asset remains in the enterprise.

The depreciation taken on such assets must be contributed to a depreciation fund on the liability side of the balance sheet.

Business enterprises are required to keep a register of taxable business assets, in which the cost of acquisition, the usual useful life and the depreciation applied to it and any other information required is registered.

The depreciation taken on business assets for purposes of the commercial balance sheet may differ from the depreciation for purposes of the fiscal balance sheet, but in practice it seems that the same depreciation rates are taken for both balance sheets.

According to the Civil Code, the valuation of business assets may not exceed the actual value.

C. TAXATION OF CAPITAL GAINS AND LOSSES AND THE REVALUATION OFBUSINESS ASSETS1. Capital gains in general1.1. Introduction

Generally, all capital gains realised within the scope of a business enterprise are included in taxable income as profits and taxed at the ordinary rates of the corporate or individual income tax and the local tax. In this context, the term "assets" means business assets, including goods manufactured or dealt in as part of the enterprise's activity, raw materials, semi-finished products, auxiliary materials, goods acquired for use or consumption in production, and stocks, bonds or similar securities, if the enterprise's activity is entirely or partly devoted to the trading in such securities.

Individuals realising capital gains outside the scope of a business are not subject to income taxes, unless the income is deemed to be derived from speculative transactions. The law gives a few specific cases in which speculative intention is assumed, without possibility to prove the contrary, in particular with respect to immovable property and artistic or antique objects or collections (see below).

1.2. Non-realised capital gains

Non-realised capital gains not entered in the accounts are not taxable. Non-realised capital gains, entered in the accounts through grossing-up of the book value of the assets, are deemed to be taxable income of the period in which the increase in value is recorded in the accounts. However, Law no. 576 of December 21, 1975 provided for a tax free revaluation of business assets acquired before 1973 (see below).

1.3. Realised capital gains

Sales of business assets are considered for tax purposes as transactions of a normal business nature; gains thereon are assessable to income taxes as part of the business profits, while losses are treated as admissible deductions. In the case of assets acquired before 1947 and revalued not later than 1953 under the relevant legislation and assets acquired before the end of 1973 and revalued under the law of December 21, 1975, any profits or losses on disposal of the business assets are computed by reference to the revalued book values.

2. Re-invested capital gains

Capital gains realised through the sale, exchange or contribution of assets are not included in the taxable income of the enterprise, if the gains are credited to a special reserve fund and the gains are re-invested in depreciable assets within two tax periods after the disposal of the assets. Any portion of the gain which has not been re-invested within the period of time described above will be included in the taxable income of the second tax period after that in which the gain was realised.

On re-investment, the re-invested gain must be transferred to the depreciation fund. For the purposes of calculating the depreciation of assets acquired by utilisation of the capital gain fund, only that part of the asset's cost which exceeds the re-invested amount from the capital gain fund is depreciable.

This tax-free realisation of capital gains is not available if such gains are realised by capital appreciation of the business assets in the accounts.

3. Unrealised capital gain through the revaluing of business assets

3.1. Eligible assets

Law no. 576 of December 21, 1975 allows business enterprises to revalue free from tax their business assets acquired before December 31, 1973.

The following assets may be revalued:

1. immovable property
2. plant and machinery
3. personal property
4. patent rights, rights to inventions, rights to concessions and to trademarks;
5. stock in corporations and shares in partnerships.

Inventory, raw material, semi-finished products may not be revalued.

3.2. Corporations

Resident corporations, partnerships limited by shares, limited liability companies, cooperative societies, mutual insurance companies and other public or private entities which have as their exclusive or principal activity the carrying out of business activities may choose between two methods of revaluation:

Under the first method, each business asset acquired before 1974 may be revalued by increasing its initial cost by

40%, if acquired before 1972;

30%, if acquired in 1972; and

20%, if acquired in 1973.

Similarly, any depreciation allowances applied to such asset must be revalued with the above mentioned percentages;

The above mentioned percentages are maximum percentages, and the corporation may revalue with lower percentages; in any case the value of the assets after revaluation and taking into account the depreciation applied, may not exceed the value effectively attributable to the asset, considering its productive capacity, its economic use for the enterprise, or, as the case may be, the current value or the quotation at the stock exchange.

Under the second method the assets may be revalued more freely, but the total amount of the revaluation may not exceed an amount equal to 50 percent of the corporation's net worth (contributed capital plus reserves) at the end of the financial year 1971, or, if lower, at the end of the year during which the revaluation is effected.

Also under this method the value of each asset after revaluation may not exceed the effective value.

The revaluation may be effected in 1975, 1976 and 1977. If the first method is chosen, the revaluation may be effected in the course of these three years, but if the second method is chosen, the whole revaluation must be effected in one year.

The balance resulting from the revaluation must be contributed to a special reserve fund. This fund may be capitalised by issuing bonus shares or by increasing the par value of the outstanding stocks or shares, but may not be distributed as dividends in cash.

The balance resulting from the revaluation of assets is tax free for the company and the receipt of bonus shares or the increase of the par value of the stock is not taxable in the hands of the shareholder. If, however, the stock or shares are owned by an enterprise, the receipt of the stock or shares is not subject to tax, but on a later disposal of the shares or stock any gain is subject to tax under the normal rules.

3. Individuals, partnerships and other entities

Individuals owning an enterprise and all associations and partnerships not mentioned above under 4.1. and all corporate and non-corporate non-resident enterprises which have a permanent establishment in Italy may revalue business assets under the first method, provided that they comply with certain accounting methods.

3.4. Distribution of the special revaluation fund

If the fund is distributed to shareholders other than in the form of bonus shares or increase of the par value of the outstanding stock or shares, the amount distributed is first taxed as business income for the company and thereafter as a dividend distribution for the shareholder.

4. Sales at the liquidation or transfer of a business (branch or private business)

Capital gains realised by a corporate or other entity subject to the corporate income tax, on gains realised upon the transfer of part of the business or upon liquidation is included in taxable income. Distributions to shareholders upon liquidation of the company are subject to tax to the extent they exceed the par value of the shares or capital contributed, in the same manner as ordinary dividends or distributions of profits.

Capital gains realised upon transfer or liquidation of a private business shall not be included in the business income of the year the gain is realised but the gain shall be taxed separately; the rate applicable to this gain shall be the rate which would apply to half the aggregate income of the two years prior to the transfer or liquidation.

5. Speculative sales by individuals

Gains derived from speculative transactions, not being business transactions are subject to the individual income tax. The law does not give precise indications what must be considered to be a speculative transaction, other than that the transaction is undertaken for speculative purposes, but it mentions a few transactions which are conclusively considered speculative transactions, i.e. no proof to the contrary is allowed.

These transactions are:

- the sale of land or part thereof, if the land is subdivided or preparatory work is done with respect to land to make it suitable to build upon if the land is included in an urbanisation plan;
- the acquisition and sale of immovable property which is not destined for personal use or for the use of the family of the purchaser if the period of time between acquisition and sale is 5 years or less; The same provision applies if gains are made on the acquisition and subsequent sale of stocks or shares in an immovable property company whose stock is not quoted at the stock exchange within five years of ownership;
- the acquisition and sale of art objects, antiques and collector's objects, if the period of time between the acquisition and sale is two years or less;

6. Mergers

On the merger of two or more companies (either a "true" merger or absorption of one or more companies by another company) the newly created or absorbing company takes over all rights and obligations of the merged companies, and may thus take over all the assets and liabilities at the value they had in the books of the merged or absorbed companies. Therefore, capital gains or capital losses will not necessarily be realized in such a transaction. Even if the assets are valued at a higher amount than the original book value in the appraisal report (which report is required by the Civil Code to be deposited at the Registration office when the decision for a merger or absorption is taken) these values need not be adopted in the accounts of the "new" company.

Only in one instance may the assets taken over be entered in the books at a higher value without capital gains being realised: any amount of gain equal to the difference between the cost of the shares of the absorbed company and the net value of the assets transferred by the absorbed company is not included in taxable gains.

The law does not contain any specific provision with regard to the consequences for shareholders of a merger.

7. Special tax on gains (realised or not realised) with respect to immovable property

Gains, realised on the transfer of immovable property located in Italy, are subject to a special "tax on capital appreciation in value of real property" (imposta comunale sull'incremento di valore degli immobili), irrespective of whether the immovable property is a business asset or not.

In general, the liability for this tax arises only at the time of disposal of the property for a consideration or as a gift, but immovable property management companies have to revalue their immovable property every ten years in their accounts and have to pay the tax on the amount of the increase in book value.

The capital gain is determined by the difference between cost of acquisition plus expenses incurred and the cost of later improvements, and the value realised at the date of transfer. This gain is, however, reduced by an amount of 4 percent per year since the year of acquisition, computed on the acquisition cost. A similar reduction is granted for the cost of later improvements.

The rates vary from municipality to municipality, with minimum and maximum rates determined by law:

on the part of the gain between	Min. rate	Max. rate
0% and 10% of the initial value	3%	5%
10% and 50% of the initial value	5%	10%
50% and 100% of the initial value	10%	15%
100% and 150% of the initial value	15%	20%
150% and 200% of the initial value	20%	25%
on the gain exceeding 200% of the initial value	25%	30%

This tax may be deducted as an expense for the computation of the corporate or individual income tax.

Example:

Corporation A bought a building on January 1, 1973 for 1 million lire and sold it after four years for 2,400,000 lire. No improvements were made during these four years.

The building is situated in a municipality which applies the maximum rates. Assume that the depreciation allowed on that building was 3 percent per year, and that no accelerated depreciation was applied.

Profit, for purposes of the imposta comunale sull'incremento di valore degli immobili is 1,400,000 less 4 times 4% of 1,000,000 = 1,240,000 lire.

Computation of the "imposta comunale sull'incremento di valore degli immobili":

on the first	100,000 (i.e. 10% of the initial value)	:	5% =	5,000 lire
on the next	400,000 (40% of the initial value)	:	10% =	40,000 lire
on the next	500,000 (50% of the initial value)	:	15% =	75,000 lire
on the next	240,000 (remaining part of the profit)	:	20% =	48,000 lire
	<u>1,240,000</u>			<u>168,000</u> lire
Tax on	1,240,000 amounts to			168,000 lire

Taxable under the corporation tax:

initial cost of acquisition	1,000,000 lire
less: depreciation 4 times 3%	<u>120,000 lire</u>
	880,000 lire

Net profit: 2,400,000 less 880,000 = 1,520,000 lire

Taxable profit 1,520,000 less the above tax of 168,000 = 1,352,000 lire

Corporation tax 25% of 1,352,000 =	338,000 lire
Local income tax 14.2% of 1,352,000 =	<u>191,984 lire</u>
Total amount of tax	<u>697.984 lire</u> =====

D.

RESERVES1. General rule

Generally, contributions to "true" reserves, including the compulsory contribution to the legal reserve, are not deductible for the computation of the income tax. Exceptions to this general rule are the tax free temporary reservation of capital gains realised on the disposal of business assets and the tax free revaluation of business assets, discussed above.

Contributions to so-called "reserves", which constitute in fact amounts set aside to meet future liabilities, estimated expenses and other contingencies are not recognised as deductible expenses, unless the law explicitly allows such a deduction.

2. Allocation of business expenses to proper year

Business expenses which are attributable to more than one tax year may only be deducted to the extent that they can be attributed to each tax year. No provisions for expenses which must be met in future years is allowed, except in the case of ships and aircraft, with respect to their periodic maintenance and overhauling. In this case a provision may be created at the beginning of such a period, and each year an amount equal to 5 percent of the initial cost of the ship or aircraft less depreciation may be contributed to this provision. At the end of such period (i.e. when the maintenance is actually performed), any balance of the provision over the effectively paid expenses for maintenance and overhaul is added to the taxable profit.

3. Reserves for bad debts

Enterprises are allowed to create a provision for bad debts, and they may allocate to this provision, at the end of each tax year, an amount equal to 0.5 percent of total debt claims receivable at the end of that year, until the provision reaches 3 percent of the outstanding debt claims. Thereafter, the provision can be increased each year by 0.25% of total debt claims receivable, until the provision reaches 5 percent of outstanding debt claims.

4. Reserves for social purposes

Enterprises may create reserves for the purpose of social security or for the providing of old age, widow and orphan's pensions for their employees. The contributions to these reserves may not exceed the sums due under legal provisions or under specific contracts concluded with the employee. When a modification of the law or of a contract increases the rights of such an employee, necessary adjustments to the reserve must be made (e.g. backservice), but such an adjustment may not be spread over more than three years.

OTHER INVESTMENT INCENTIVES

1. General

Apart from the above mentioned incentives, viz. the 45 percent accelerated depreciation allowance, the temporary reservation of capital gains on business assets under the condition of reinvestment, and the revaluation of business assets under the condition that the revaluation fund may not be distributed in cash, no general investment incentives are available. There are, however, several incentives created to further the economic development of certain regions or to promote certain kinds of business activity. These incentives are laid down in Presidential Decree no. 601 of September 29, 1973.

The tax relief granted to agricultural enterprises, certain cooperative societies and certain credit institutions and to owners, including immovable property companies, exploiting low-cost dwellings will not be discussed here.

2. Mezzogiorno

To further the industrial development of Italy south of Rome, including Sardinia, Sicily and some other small islands, tax relief is granted to new industrial enterprises and to existing industrial enterprises which expand their activities. In addition to subventions and low-interest loans, and some relief with respect to indirect taxes, profits derived from newly established industrial activities are exempt from local income tax for a period of 10 years, beginning with the year that the new activities result for the first time in a profit. A ten-year relief for the corporate income tax is granted to companies newly established in the "Mezzogiorno" whose activities are limited to this area. The relief is granted in the form of a reduction of 50 percent of the corporate income tax. The ten year period starts at the date of formation of the company

3. Depressed areas in Central and Northern Italy

Newly established handicraft enterprises and small and mediumsized manufacturing enterprises are exempt from the local income tax during the first ten years from the start of their activities.

F.

VALUATION OF STOCK-IN-TRADE

Raw materials, supplies, semi-finished products, and finished products and merchandise intended for sale or use in production are in principle, valued at cost. This cost includes all additional expenses, but any interest or general expenses are not included. According to the Civil Code, the value may not be higher than the lower of cost or current market value.

The tax code allows a system of valuation of stock-in-trade which is basically a last-in first-out (LIFO) method.

For this purpose, goods of the same kind and the same quality are grouped together; goods of the same kind, but slightly different in quality, and goods of different kind but of equal unit value may also be grouped together.

In the first tax period that an enterprise has a specific product in stock, each item of this product in stock must be valued by dividing the total cost of production or purchase of that product, by the number of items of that product. If, in a following year, the quantity of that product increases, the excess must be valued separately, according to the method mentioned above.

If, however, the quantity is less than in the preceding year, the decrease must be charged against increases which occurred in prior tax years, beginning with the most recent.

If, under this system of valuation, the value per item is higher than the market value in the last three months of the tax year, then valuation of the goods within this category may be effected by multiplying the entire quantity, independent of the period of origin, by this market value.

If the total inventory of a group of similar goods is valued higher than the market value during the last three months of the preceding year, or higher than the cost, as determined under the method explained above, then each item shall be valued by dividing the market value, or the cost, by the number of items.

Other methods are, in practice, allowed by the tax administration. If an entrepreneur wants to change his method of valuation of the inventory, he must inform the tax administration, and if no objection is made, he can use the new method in the next following year.

However, the base stock method is not allowed.

G.

SET OFF OF BUSINESS LOSSES

A loss incurred in one taxable year is deductible from the profits of the same year.

Losses may be set off against profits of the next following five years, but only for purposes of the corporate income tax. No carry-forward of losses is allowed for the computation of the local income tax.

No carry back of losses is permitted.

LUXEMBOURG

A.

INTRODUCTION

Business income is taxable in Luxembourg under the Income Tax Act (Loi du 4 décembre 1967 concernant l'impôt sur le revenu (hereinafter referred to as L.I.R.)) on the national level, and under the Business Tax Act (Gewerbesteuer-gesetz vom 1. Dezember 1936) on the municipal level.

The L.I.R. is divided into three parts:

part one contains the sections on individual income tax (section 1-157) including a subpart on withholding tax on salaries (section 136-145) and on investment income (section 146-157);

part two contains provision on corporate income tax (sections 158-174); and part three contains transitional and additional provisions (sections 175-188).

Section 10 of the L.I.R. mentions three types of business profits:

commercial business profits, agricultural and forestry profits, and profits from professions.

The term "commercial business profits" is defined as income from commercial, industrial, mining or handicraft enterprises (section 14).

Commercial business profits are determined, in principle, in a given accounting period as the difference between the enterprise's net worth at the beginning of the period and net worth at the end of that period (section 18).

Computation of profits according to a cash basis method is allowed, subject to certain conditions, for entrepreneurs who are not obliged to keep proper accounting records, and who actually do not keep such records.

In computing agricultural and forestry profits and profits from professions specific rules apply.

The computation of commercial profits earned by entities subject to the corporate income tax is subject to the same basic rules as apply to the computation of profit earned by private business entrepreneurs.

A general capital gains tax does not exist in Luxembourg, although under certain circumstances capital gain may be taxed as speculative income, or as profits from a substantial participation.

Capital gains concerning business assets, however, are basically included in business income, and as such taxable at normal tax rates (see however, part C, below). Thus, it is of great importance whether an asset is a business asset, or whether it belongs to the entrepreneur's private property. The L.I.R. determines that assets which are destined by their nature to serve the enterprise must be treated as business assets; that assets which are destined by their nature not to serve an enterprise, may not be included in business assets, and that an entrepreneur, who keeps regular books, may at his choice, include in his business assets assets which in general are not destined to serve an enterprise, but which are actually used in his enterprise.

The problem of whether an asset constitutes a business asset or not does not occur in case of companies, since all their income is deemed to be commercial business income and all their assets are deemed to be business assets.

The L.I.R. has replaced former legislation which was based on German laws. German case law and interpretation is still an important factor, however.

B. DEPRECIATION OF BUSINESS ASSETS

1. General remarks; depreciable basis

Business assets are divided into fixed assets (immobilisations), current assets (biens du réalisable et du disponible) and liabilities.

Fixed assets are defined as goods which are destined to serve the enterprise permanently.

Fixed assets which decrease in value in the course of time or by use, or by a decrease of deposits of minerals or fossils embedded in or attached to the earth, qualify for depreciation.

Land, participations, goodwill and current assets are specifically mentioned as non-depreciable assets.

Depreciation may be carried out for technical as well as for economical decrease of value, but may never exceed cost less any residual value.

The base for depreciation is constituted by the acquisition price of the asset increased by all amounts paid by the entrepreneur to install the asset in the way it was done at the moment of valuation less any subsidies received.

In case of self construction the base for depreciation of an asset consists of all expenses related to the construction of the asset including the costs of materials, wages for the instruction, the special production costs as well an appropriate part of the general production costs including depreciation of assets used by the construction. However, sales costs, interest on loans and costs which do not represent exploitation costs are excluded.

In case an asset is received without paying a consideration e.g., by way of a gift, the asset has to be valued at the going concern value at the time of acquisition.

Where an enterprise or an independent part of an enterprise is acquired against consideration the assets acquired have to be entered into the accounts at the going concern value of such assets. Any amount paid in excess of the total amount of the going concern value of all the acquired assets represents the acquisition price of goodwill which is not depreciable.

2. Computation of allowable depreciation

Depreciation must be computed for the relevant accounting period by dividing the cost of acquisition or construction less residual value and depreciation of previous years at the beginning of the financial period over the remaining normal period of use in such manner that depreciation is spread evenly over the period of use (straight line).

The normal period of use must be expressed in a number of years and must be determined with a view to the circumstances under which the asset is used.

The administration may approve other appropriate systems, e.g. on an utilization basis if the annual use of the asset fluctuates widely.

A special rule applies to depreciable assets with a useful life not exceeding one year and to assets the cost of acquisition of which does not exceed 15,000 Lfrs.: such assets may be written off at once.

With the exclusion of buildings, tangible fixed assets may also be depreciated in declining annual amounts (declining balance method). In that case, a fixed percentage of depreciation must be taken from the remaining book value at the beginning of each year. This percentage may not exceed twice the percentage under the straight line method, and is subject to a maximum of 20%.

A change-over from declining-balance method to straight-line method is permitted, but the reverse is not.

3. Additional depreciation

A special additional depreciation allowance is granted in case of extraordinary technical or economical obsolescence. Once this special depreciation has been taken, any further normal depreciation must be computed according to the straight-line method.

If assets are used during more than one daily work-shift, this should be recognized already under normal depreciation, since the period of use must be determined with a view to the circumstances under which the asset is used (see para. 2, above).

4. Depletion of mineral assets

The normal annual depreciation of fixed assets which decrease in value by depletion of deposits of minerals or fossils incorporated in the asset has to be computed in accordance with the ratio between the part of the deposits extracted and the entire deposit of minerals at the beginning of the financial period. If for example the deposit consisted of 100 units at the beginning of a financial period and during that period 5 units are extracted then the annual depreciation is $\frac{5}{100}$ times the value of the asset at the beginning of the financial period.

5. Miscellaneous provisions

5.1. Commencement of depreciation

Depreciation is allowed as of the moment the asset is acquired or taken into use. This implies that for the first year depreciation is granted pro rata temporis.

5.2. Postponement of depreciation

If allowable depreciation is not fully taken in any accounting period it is not allowed to recoup such depreciation in a subsequent accounting period.

5.3. Relationship between depreciation for tax purposes and commercial purposes

Depreciation computed for tax purposes on the basis of estimated useful life must be equal to the depreciation taken in the commercial accounts.

C. TAXATION OF CAPITAL GAINS AND LOSSES1. Main provisions

Business profits are determined, in principle, as the difference between the net worth of an enterprise at the beginning of a financial period and the net worth at the end of the same period. This difference is taxable at the normal rate and no distinction is made between trading profits and capital gains and losses. Thus, the general rule is that capital gains entered in the accounts for tax purposes, either as a result of an alienation or of a (re)valuation of assets constitute business profits. Therefore, the valuation rules for assets are very important (see for depreciable fixed assets part B, above and for stock-in-trade part F, below). It is not permitted to include unrealised gains on assets in the accounts for tax purposes. However, if the going concern value (Teilwert) of assets is lower than the bookvalue according to the normal valuation rules, then this lower going concern value may be adopted, the unrealised capital loss being deductible in computing business profits (section 23(2) L.I.R.).

This implies that capital gains are included in business profits if realised, subject to two exceptions, however:

- (i) Capital gains realised when part of the enterprise's net worth (bien de l'actif net investi) is destroyed, expropriated or sold in order to avoid expropriation may be deducted from the acquisition price of the replacement provided a) the new asset is economically and technically similar to the old asset; b) the entrepreneur keeps proper accounts; and c) the new asset is acquired within two years after the year of destruction or expropriation.
- (ii) Capital gains realised at the alienation of buildings or non-depreciable assets which constitute part of the fixed assets (immobilisations), of the business may also be tax deferred subject to the following conditions:
 - a) the alienated buildings or non-depreciable assets will only be considered to form part of the fixed assets (immobilisations) if they are part of the assets of the business for at least 5 years (bien de l'actif net investi);

- b) the capital gains may only be deducted from the acquisition price of new replacing fixed assets if such assets form part of the net worth of a permanent establishment situated in Luxembourg;
- c) if the alienated fixed asset constitutes a "participation" then the capital gain can only be deducted from a replacing participation after approval of the Minister of Finance.

A participation in this context means a holding of at least 25 percent in the share capital of a corporation;

- d) the entrepreneur must have the intention of reinvesting the proceeds received at alienation; and
- e) reinvestment must be completed by the end of the second accounting period following the accounting period of alienation.

2. Mergers

Capital gains realized at a special type of enterprise merger may be tax deferred. The general rule with respect to enterprise mergers, i.e. the situation where the net worth of a company is transferred to another company, is that all capital gains realized at the alienation are taxable as normal profits. However, if the net worth of a company which is resident in Luxembourg as a whole is transferred to another company so resident, both companies being subject to the normal rules of taxation (i.e. not having a tax exempt status) the capital gain realized will be tax exempt if the following conditions are met:

- a) the consideration for the transfer must consist of newly issued shares of the purchasing company, to be issued to the shareholders of the transferor company;
- b) should the purchasing company have a participation in the transferor company then this participation has to be annihilated, i.e. the purchasing company may not issue new shares in its own capital with respect to the participation the company holds in the transferor company;
- c) if the purchasing company has a participation in the transferor company, then the transfer of the net worth has to be justified by sound commercial reasons, especially from the point of view of the purchasing company;
- d) the purchasing company has to adopt in its financial accounts the same book values of the transferred assets as accounted for by the transferor company.

D.

RESERVES

Generally speaking, the creation of reserves and provisions for tax purposes is allowed in a limited number of cases only.

Apart from the "tax deferral" provisions discussed in part C, above, which, in fact, imply the creation of a replacement reserve to the extent that there is no immediate purchase of replacing assets, it is only allowed to create provisions for uncertain liabilities or anticipated losses by way of liabilities in the balance sheet for tax purposes. The provision may not exceed the going concern value of the otherwise estimated liability, must reflect a similar provision in the commercial balance sheet and may not exceed the latter. The following are examples of typical liability provisions: liability on surety obligations, warranties, damage claims, litigation expenses, currently deductible taxes and tax obligations, and future pension payments to employees. Self-insurance and deferred repair and maintenance provisions are not allowed.

E. OTHER INVESTMENT INCENTIVES1. Investment allowance

Luxembourg reinstated the investment allowance already permitted in previous laws, by the Law of April 9, 1973. The effect is as follows:

An enterprise may deduct from its income tax an amount equal to 9% of any "supplementary investment" in qualifying assets.

Supplementary investment is the difference between the value attributed to the qualifying assets at the end of the accounting year and the value attributed to the same category of assets at the end of a reference accounting year. The reference accounting year is the year (after December 31, 1961) in which the value of this category of assets taken at the end of the year was highest.

In determining the value of the qualifying assets at the end of the accounting year, the following assets are not taken into account:

- (1) assets acquired through the transfer, for consideration, of an enterprise or of an autonomous part of a subdivision of an enterprise;
- (2) second-hand assets;
- (3) isolated assets acquired gratuitously; and
- (4) supplementary investment less than L.frs. 75,000.

In addition enterprises may deduct from income tax an amount equal to 6% of investment in qualifying assets up to L.frs. 2 millions' worth and 3% of the value of the exceeding L.frs. 2 million.

Qualifying assets are tangible depreciable assets other than buildings, livestock and mineral and fossil deposits, heating plants and sanitation systems in hotel buildings, and certain buildings used for social purposes.

The credit is not granted for:

- (1) assets having a useful life of less than eight years (although, for financial years ending in calendar years 1972-1976 this period of time was reduced to four years);
- (2) assets acquired through the transfer of an enterprise or autonomous part or subdivision of an enterprise;
- (3) second-hand assets;
- (4) assets having a cost price of not more than L.frs. 15,000; and,
- (5) vehicles for transportation other than those used inside the enterprise.

Any credit granted must be taken against the income tax on the income of the year in which the investments were made. No refund of income tax is granted where the credit exceeds the income tax. There is, however, in such a case a carry-forward of the credit during the following four years.

This investment allowance is granted for the financial years ending in calendar years 1972-1976.

2. Partial tax holiday

One quarter of income earned through "new production" is exempt from corporate income tax. This partial tax holiday is granted if this "new production" particularly favours the growth or improves the structure of national economy. The partial tax holiday is granted for a period of 8 years, to new production started in the period from January 1, 1972 to January 1, 1982.

F.

VALUATION OF STOCK-IN-TRADE

Stock-in-trade must be valued at acquisition or production cost, or at lower going concern value. Where at the end of the preceding accounting period stock-in-trade was valued at going concern value and this value has increased at the end of the pertinent accounting period, this increased value may be adopted, but may never exceed cost of acquisition or production.

L.I.F.O. nor F.I.F.O. is permitted, unless it is actually carried out in practice.

The value of fungible goods may be estimated by way of the weighted average cost method.

G.

SET-OFF OF LOSSES

A loss from any category of income must first of all be deducted from positive income of another category derived within the same year (exceptions to this rule exist, e.g., in case of speculative income, where a speculation loss may only be deducted from a speculation gain, and a remaining loss may not be deducted from other positive income).

Only losses from business enterprise, agriculture and forestry and from a profession may be deducted as special expenditure (dépenses spéciales, sections 109 and 114 of the L.I.R.) from income in one of the following five years, if they could not be deducted from positive income from other categories in the year in which they were incurred.

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A. INTRODUCTION

One of the main characteristics of the United Kingdom tax system, as opposed to the systems of most Continental European countries, is that in determining the tax liability of taxpayers engaged in a trade or business, a distinction is made between "income" and "capital gains". Thus, for example, if an individual or corporate taxpayer who carries on a trade disposes of a fixed capital asset ^{in or} used for the purposes of his trade, any gain or loss realised at the disposal does not, as a matter of principle, constitute business income but a capital gain or loss. Similarly, the sale of investments such as shares or securities owned by a business will give rise to a capital gain or loss rather than to trading income, unless the taxpayer's trade is deemed to consist of (or to include) dealing in securities. If, on the other hand, assets are sold which constitute part of the trade's circulating capital (e.g. stock-in-trade) the amount received will be included in the computation of the taxpayer's trading income.

The distinction between "income" and "capital gains" is particularly relevant for both individual and corporate taxpayers, because different rules apply to the computation of taxable income versus the computation of capital gains, and because capital gains are taxed at a lower rate.

For corporate entities, the normal rate of the corporation tax is 52%, whereas capital gains - though also subject to corporation tax - are taxed at a lower effective rate of 30%, a certain proportion of the gain being deductible in computing the amount actually subject to corporation tax.

Individual taxpayers are subject to a progressive income tax, at rates ranging from 35% to 83%, but capital gains realised by individuals are subject to Capital Gains Tax at a rate of 30%.

B. DEPRECIATION OF BUSINESS ASSETS.

1. General Outline

Depreciation allowances, termed "capital allowances" in United Kingdom law, are governed by the Capital Allowances Act 1968, as amended from time to time by the annual Finance Acts.

The Capital Allowances Act 1968 (hereinafter referred to as C.A.A.) is, in effect, a consolidating act, in which all existing provisions concerning depreciation for tax purposes have been brought together, with the exception of the provisions regarding patents and know how. The rules regarding depreciation of patents and know how are laid down in Secs. 378 to 388 of the Income and Corporation Taxes Act 1970, hereinafter referred to as I.C.T.A.

According to the Capital Allowances Act 1968 and the relevant provisions of the Income and Corporation Taxes Act 1970, depreciation allowances are available with respect to expenditure ("capital expenditure") under the following headings:

- (i) industrial buildings and structures, etc.;
- (ii) plant and machinery;
- (iii) mines, oil wells, etc.;
- (iv) dredging;
- (v) agricultural land and buildings;
- (vi) scientific research;
- (vii) patent rights and know how.

The allowable depreciation for tax purposes may be taken into account irrespective of whether the same depreciation is taken in the commercial accounts of the trade.

As the methods and rates of depreciation applicable to the various types of qualifying expenditure vary widely, the following survey will be organized in such manner that the capital allowances (both normal depreciation and accelerated depreciation, where available) for the various assets will be considered separately, with major emphasis on industrial buildings and plant and machinery.

2. Depreciation of Industrial Buildings and Structures

2.1. main principles

According to C.A.A., sections 1 and 2, "initial allowances" (accelerated depreciation) and "writing-down allowances" (annual or normal depreciation) are available with respect to "capital expenditure" incurred "on the construction of a building or structure which is to be an industrial building or structure". Two significant limitations emerge from these provisions. First, only capital expenditure incurred on the construction of the building qualifies for depreciation allowances, which implies, inter alia, that not only for the first, but also for any subsequent owners, the allowances will be based on the cost of construction of the building or structure rather than on the price paid at a subsequent purchase. Secondly, depreciation allowances are available only with respect to "industrial buildings", as defined in the Act, and other buildings do not qualify for depreciation allowances under this heading. These two limitations are considered further in paras. 2.4.2. and 2.3, below.

The person who incurs the capital expenditure and his successors, are entitled to claim the depreciation allowances; in general, this will be the owner or the lessee of the property on which the building is erected.

A further condition for the granting of depreciation allowances is that the building is occupied for the purposes of a trade carried on either by the person who incurred the expenditure or by a lessee.

2.2. basis and rates of depreciation

2.2.1 depreciable basis

As indicated in para 2.1., above, the basis for depreciation of industrial buildings is the cost of construction. ("capital expenditure incurred on the construction of a building"). No definition of the term "capital expenditure incurred on the construction of a building" is given in the Capital Allowances Act. However, it is expressly provided that such expenditure does not include "any expenditure incurred on the acquisition of, or of rights in or over, any land" (C.A.A., sec. 17) but expenditure incurred on preparing, cutting, tunnelling or levelling land is eligible (C.A.A., sec. 8)

It is further provided that any investment grants or subsidies received in connection with the expenditure have to be deducted in computing the expenditure eligible for capital allowances (C.A.A., secs. 83 and 84). Also deducted is any expenditure which is allowed to be deducted in computing the profits or gains of a trade, profession, office, employment or vocation carried on or held by the taxpayer (C.A.A., sec. 82).

2.2.2. rates of depreciation

2.2.2.1. Accelerated depreciation

Accelerated depreciation (termed "initial allowance" in the Capital Allowances Act) is currently granted at a rate of 50% ("one-half") of qualifying expenditure.

This rate of 50% applies to qualifying expenditure incurred in or after November 13, 1974. The rate has been changed from time to time, in connection with, inter alia, the economic situation, and also because of the interaction between the initial allowance and other investment incentives available, such as investment allowances (abolished in 1966) and investment grants (subsidies) (abolished in 1970, except for certain areas of the country).

2.2.2.2. normal depreciation

The normal (annual) depreciation allowance (termed "writing-down allowance" in the Capital Allowances Act) is currently, i.e. for qualifying expenditure incurred on or after November 6, 1962, 4% of cost ("one-twenty-fifth of the expenditure"). For qualifying expenditure incurred before that date the rate is still 2% (one-fiftieth) annually.

For qualifying expenditure incurred during the year, the full allowance is granted: decisive is whether the taxpayer is entitled to a relevant interest in the qualifying building or structure at the end of the accounting period (for companies) or at the end of the basic period for the year of assessment (for individuals). The annual allowance is reduced only if the taxpayer's accounting period is less than 12 months.

It should further be noted that in the year the expenditure is incurred both the "initial allowance" and the normal "writing-down allowance" are granted.

2.3. definition of "industrial building or structure"

As indicated earlier, depreciation allowances are available only with respect to "industrial buildings or structures", as defined in the Capital Allowances Act. The main definition is given in C.A.A., sec. 7. which reads as follows:

" 7. Definition of "industrial building or structure"

- (1) Subject to the provisions of this section, in this Chapter "industrial building or structure" means a building or structure in use-
- a) for the purposes of a trade carried on in a mill, factory or other similar premises, or
 - b) for the purposes of a transport, dock, inland navigation, water, electricity or hydraulic power undertaking, or
 - c) subject to subsection (7) below, for the purposes of a tunnel undertaking, or
 - d) subject to subsection (8) below, for the purposes of a bridge undertaking, or
 - e) for the purposes of a trade which consists in the manufacture of goods or materials or the subjection of goods or materials to any process, or
 - f) for the purposes of a trade which consists in the storage-
 - i) of goods or materials which are to be used in the manufacture of other goods or materials, or
 - ii) of goods or materials which are to be subjected, in the course of a trade, to any process, or
 - iii) of goods or materials which, having been manufactured or produced or subjected, in the course of a trade, to any process, have not yet been delivered to any purchaser, or
 - iv) of goods or materials on their arrival by sea or air into any part of the United Kingdom, or
 - g) for the purposes of a trade which consists in the working of any mine, oil well or other source of mineral deposits, or of a foreign plantation, or
 - h) for the purposes of a trade consisting in all or any following activities, that is to say, ploughing or cultivating land (other than land in the occupation of the person carrying on the trade) or doing any other agricultural operation on such land, or threshing the crops of another person, or
 - i) for the purposes of a trade which consists in the catching or taking of fish or shellfish,

and, in particular, the said expression includes any building or structure provided by the person carrying on such a trade or undertaking for the welfare of workers employed in that trade or undertaking and in use for that purpose.

- (2) The provisions of subsection (1) of this section shall apply in relation to a part of a trade or undertaking as they apply in relation to a trade or undertaking:

Provided that where part only of a trade or undertaking complies with the conditions set out in the said provisions, a building or structure shall not, by virtue of this subsection, be an industrial building or structure unless it is in use for the purposes of that part of that trade or undertaking.

- (3) Notwithstanding anything in subsection (1) or subsection (2) of this section, but subject to the provisions of subsection (4) of this section, "industrial building or structure" does not include any building or structure in use as, or as part of, a dwelling-house, retail shop, showroom, hotel or office or for any purpose ancillary to the purposes of a dwelling-house, retail shop, showroom, hotel or office:

Provided that this subsection shall not apply to, or to part of, a building or structure which was constructed for occupation by, or for the welfare of, persons employed at, or in connection with the working of, a mine, oil well or other source of mineral deposits, or for occupation by, or for the welfare of, persons employed on, or in connection with the growing and harvesting of the crops on, a foreign plantation, if the building or structure is likely to have little or no value to the person carrying on the trade when the mine, oil well or other source or the plantation is no longer worked, or will cease to belong to such person on the coming to an end of a foreign concession under which the mine, oil well or other source, or the plantation, is worked.

- (4) Where part of the whole of a building or structure is, and part thereof is not, an industrial building or structure, and the capital expenditure which has been incurred on the construction of the second mentioned part is not more than one-tenth of the total capital expenditure which has been incurred on the construction of the whole building or structure, the whole building or structure and every part thereof shall be treated as an industrial building or structure.

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- (5) In this section - "retail shop" includes any premises of a similar character where retail trade or business (including repair work) is carried on;
- "dock" includes any harbour, wharf, pier or jetty or other work in or at which vessels can ship or unship merchandise or passengers, not being a pier or jetty primarily used for recreation, and "dock undertaking" shall be construed accordingly;
- "water undertaking" means an undertaking for the supply of water for public consumption;
- "electricity undertaking" means an undertaking for the generation, transformation, conversion, transmission or distribution of electrical energy;
- "hydraulic power undertaking" means an undertaking for the supply of hydraulic power;
- "undertaking" does not include an undertaking not carried on by way of trade;
- "foreign plantation" means, subject to subsection (6) below, any land outside the United Kingdom used for the growing and harvesting of crops;
- "crops" includes any form of vegetable produce and "harvesting" includes the collection thereof, however effected.
- (6) In this section the expression "foreign plantation" shall (without prejudice to the generality of the definition in subsection (5) above) be extended so as to include any land outside the United Kingdom used for husbandry or forestry, and the reference in subsection (3) above to the growing and harvesting of crops shall correspondingly ^{be} extended.
- (7) Subsection (1) (c) above shall not affect any allowance or charge which would have been made under this Part of this Act if this Act had been enacted without that paragraph and if section 25 of the Finance Act 1952 (which is the corresponding provision repealed by this Act) had not been passed, and where by virtue of the said paragraph (c) a balancing charge is made on a person in respect of any expenditure, the amount on which it is made to him in respect of that expenditure by virtue of the said paragraph (c) (and the said section 25).
- (8) Subsection (1) (d) above shall effect only in relation to expenditure which is to be treated for the purposes of this Chapter as incurred after the end of the year 1956-57.

(9) For the purposes of this Chapter references to use as an industrial building or structure do not apply, in the case of a building or structure outside the United Kingdom, to use for the purposes of a trade at a time when the profits or gains of the trade are not assessable in accordance with the rules applicable to Case I of Schedule D."

The main categories of buildings which, subject to certain exceptions, are excluded from depreciation allowances are listed in subsection 3: dwelling-houses, retail shops, showrooms, hotels and offices. However, according to subsection 4, if part of a building does not qualify as an industrial building, depreciation is still allowed on the entire building, provided that not more than one-tenth of the total capital expenditure was incurred on the construction of the non-qualifying part.

Also, buildings provided for the welfare of employees, such as canteens, qualify as industrial buildings (see subsection 1, in fine), as well as sports pavilions used for the welfare of all or any of the workers employed in the taxpayer's trade (C.A.A., sec. 10).

2.4. Sale or other disposal of an "industrial building or structure".

2.4.1 consequences for the seller : balancing allowances and charges.

If a taxpayer who incurred capital expenditure on the construction of an industrial building or structure, and became entitled to capital allowances in respect of such building or structure, subsequently sell his interest in such building or structure, or if the building is demolished or destroyed, or if his interest comes to an end, an additional depreciation allowance (termed "balancing allowance") is granted if the proceeds of sale (or insurance, salvage or compensation moneys received) are less than the written-down value at the time of the event. Conversely, if the proceeds of sale (or insurance, salvage or compensation moneys received) exceed the written-down value, a "balancing charge" is imposed on the taxpayer, so as to recoup that portion of total capital allowances granted which, in fact, has been excessive. Any "balancing charge" may not exceed the amount of capital allowances granted in the past.

However, as an important exception to the general rule set out above, no "balancing allowance" is granted and no "balancing charge" made, if the sale or other event occurs more than 25 years (or, where the expenditure was incurred before November 6, 1962, 50 years) after the building or structure was first used.

The sale or other disposal of the building or structure may also give rise to a chargeable capital gain (see chapter C, below), but only if and to the extent that the proceeds of sale or other disposal exceed the expenditure incurred on the building. Similarly, a capital loss is only recognised for capital gains tax purposes, to the extent that the loss is not covered by capital allowances (including any balancing allowance).

Example I : The cost of construction of an "industrial building" was £20,000 and the first owner has taken depreciation allowances totalling £12,000 over the years, so that the written-down value at the time of sale is £8,000.

Case a): The proceeds of sale amount to £7,000; in that case the seller will be entitled to a "balancing allowance" of £8,000 - £7,000 = £1,000, provided that the sale takes place within the 25 or 50 years period referred to above.

Case b): The proceeds of sale amount to £15,000; in that case, a "balancing charge" of £7,000 (£15,000 - £8,000) is added to the taxpayer's profits, again provided that the sale takes place within the stated period.

Case c): The proceeds of sale amount to £25,000; in that case, there will be a "balancing charge" of £12,000 (equal to the total depreciation allowances taken), being the difference between £20,000 (cost price) and £8,000 (written-down value), as well as a capital gain of £5,000, being the excess of proceeds of sale over cost price.

The taxation of capital gains is considered in Chapter C, below.

2.4.2. Consequences for the purchaser.

As indicated earlier, depreciation allowances with respect to "industrial buildings and structures" are granted only with respect to the cost of construction of such buildings and structures, which implies that also for subsequent owners the depreciable basis is, in principle, the original cost of construction.

In computing the annual (writing-down) allowance to which a subsequent owner may be entitled, it is further assumed that the qualifying building should be completely written off in 50 years (when the expenditure on the construction of the buildings was incurred before November 6, 1962) or in 25 years (when such expenditure was incurred on or after November 6, 1962) from the time the building was first used. As a result, the subsequent owner may depreciate his purchase price (or the allowable portion thereof) over the years up to the moment the qualifying building is 50 or 25 years old.

Example II: taking the same figures as in Example I, and assuming that the expenditure on the construction of the building was incurred in 1965, that the building was first used in that same year, and that sale has taken place in 1975, the position of the purchaser in each of the three cases mentioned is as follows:

Case a) (purchase price : £7,000) : the total purchase price qualifies for depreciation allowances, and the amount of £7,000 must be divided over the years 1975 through 1989, and the annual allowance thus amounts to one-fifteenth of £7,000 or approximately £466.

Case b) (purchase price : £15,000) : the total purchase price, being less than the cost of construction, qualifies for depreciation allowances, and the annual allowance amounts to one-fifteenth of £15,000 or £1,000.

Case c) (purchase price : £ 25,000) : the amount qualifying for depreciation allowances for the purchaser is limited to £20,000, the cost of construction. The annual allowance for the years 1975 through 1989 thus amounts to one-fifteenth of £20,000 or approximately £1,333.

Note 1: for the sake of simplicity, the total depreciation allowances for the original owner have been fixed at £12,000 throughout this example, and they do not reflect the statutory rates of initial and annual allowances in force during the period taken in the example.

Note 2: it is emphasised that the initial allowance is available only to the person who incurs the capital expenditure on the construction of the buildings, and first uses that building, and is not granted to subsequent owners.

3. Depreciation of Plant and Machinery

3.1. general

3.1.1. Outline of the system

The system of depreciation allowances with respect to plant and machinery has been thoroughly revised by sec. 40 et seq. of the Finance Act, 1971 applying to capital expenditure on the provision of machinery and plant incurred on or after 27 October 1970.

As of that date, capital expenditure on plant and machinery is eligible for a "first-year allowance" of currently 100% of the expenditure, subject to certain exceptions, so that the entire expenditure can be written off in the year of purchase. Any remaining book-value after the "first-year allowance" has been taken, is written down on an aggregate basis (the so-called "pool of expenditure") at a rate of 25% per annum. Under this new system, the sale or other disposal of items of plant and machinery does not normally give rise to a "balancing allowance" or "balancing charge", as in the case of industrial buildings, but the proceeds of sale or other disposal merely reduce the aggregate depreciable basis of plant and machinery. See para. 3.3.1. for further details.

3.1.2. definition of "machinery and plant"

There is no general definition of the concept "machinery and plant" in the Capital Allowances Act 1968 or in any other taxing act. In practice, it includes all assets employed for permanent use in the business, whether movable or immovable, with the exception of buildings or parts of buildings. In particular, in many cases fixtures and fittings of a permanent and durable nature have been held in the Courts ^{to} be machinery and plant, e.g., heating equipment and sprinkler installations, telephone and alarm systems, wash basins, baths and canteen equipment, and mobile office partitioning. But a new shop front was considered as part of a building and thus not as plant.

In certain cases, capital expenditure is deemed to be incurred on machinery and plant by express provision in the law. Examples are expenditure incurred after 12 November 1974 for insulating against loss of heat industrial buildings or structures (F.A. 1975, sec. 14) and fire escapes for hotels under the Fire Precautions Act 1971, although such fire escapes will normally be part of the building.

3.2. the "first-year allowance".

3.2.1. main provisions.

A person carrying on a trade who incurs capital expenditure on the provision of machinery and plant for the purposes of the trade is entitled to a first-year allowance, except that no "first-year allowance" is available if the expenditure is incurred during the chargeable period in which the trade is permanently discontinued and, also, that the "first-year allowance" does not apply if the machinery or plant ceases to belong to the person who incurred the expenditure without having been brought into use for the purposes of the trade (F.A. 1971, sec. 41).

The "first-year allowance" applies to machinery and plant irrespective of whether the assets are acquired new or second-hand.

However, the "first-year allowance" does not apply to ordinary (passenger) motorcars, as "mechanically propelled road vehicles" are excluded, except "vehicles of a construction primarily suited for the conveyance of goods or burden of any description; vehicles of a type not commonly used as private vehicles and unsuitable to be used; and vehicles provided wholly or mainly for hire to, or for the carriage of, members of the public in the ordinary course of a trade". (F.A. 1971, sec. 43).

3.2.2. assets used partly for other purposes

If items of machinery or plant are used not only for purposes of the trade but also for other purposes (e.g., private use) the "first-year allowance" will only be granted to the extent of the use for the trade, "as may just and reasonable having regard to all relevant circumstances".

However, as indicated in para. 3.2.1. above, no first-year allowance at all applies to ordinary (passenger) motrcars, not being rent-a-cars or taxi-cabs.

3.2.3. rates of the "first-year allowance"

The rate of the "first-year allowance" is currently 100% of the expenditure on both new and second-hand assets. This rate applies to expenditure incurred on or after 22 March 1972 (F.A. 1972, sec.67). Originally, i.e. from 27 October 1970 to 19 July 1971, the rate was 60 %, increased to 80 % during the period from 20 July 1971 to 21 March 1972. In the latter periods, a 100% rate applied, however, to expenditure on new ships and to expenditure on new equipment (except for mobile equipment) for use in development areas.

3.2.4. disclaimer of "first-year allowance"

The taxpayer, whether individual or corporate body, is not obliged to take the full "first-year allowance" in that he may disclaim the allowance in whole or in part by notice in writing to the tax inspector not later than two years after the end of the chargeable period for which he is entitled to the allowance, and the assessments will eventually be corrected accordingly. (F.A. 1971, sec.41(3)) The part of the "first-year allowance" disclaimed only qualifies for the normal "writing down allowance", discussed below, in subsequent years. Only for new ships, the situation is different. In that case, the "first-year allowance" may in fact be spread over more than one year as the taxpayer elects (F.A. 1971, Schedule 8 para 8).

3.3. the "writing-down allowance".

3.3.1. main provisions.

The remaining book value of items of machinery and plant after the "first-year allowance" is subject to "writing-down allowances" in subsequent years.

However, under the new system in force since October 27, 1970, the "writing-down allowances" are not granted for each qualifying asset separately but on the aggregate book value of all qualifying assets, i.e. in principle all items of plant and machinery for which capital expenditure is incurred on or after 27 October 1970, except for certain motor cars and for assets used partly for non-business purposes

For expenditure on machinery and plant incurred prior to 27 October 1970, the annual depreciation allowances continued at the previous rates and for each asset separately.

These rates were normally 15%, 20% or 25% (declining balance method) or 6.25%, 8.5% or 11.25% (straight-line method), depending on the estimated useful life of the asset as usually determined by the Commissioners of Inland Revenue. However, pursuant to F.A. 1976, sec.39, the book value of these "old" assets may now be included in the collective basis applying to assets acquired after October 26, 1970, unless the taxpayer elects to continue depreciation for these "old" assets separately.

The collective basis for the existing "writing-down allowances" in any accounting period for assets acquired on or after 27 October 1970 is, basically, the aggregate depreciated book value of qualifying assets at the beginning of the previous accounting period less "writing-down allowances" for that previous period, plus the amount of capital expenditure incurred during that previous period as reduced by any "first-year allowance" taken, and minus the proceeds of sale (or other compensation received) of assets disposed of during the year. Thus, assets acquired during a certain accounting period qualify only for the "first-year allowance" for that period, and any remaining book value is not included in the depreciable basis for writing down allowances until the next accounting period.

Under the new system, a sale or other disposal of an item of plant and machinery does not normally give rise to a "balancing allowance" or "balancing charge" (as in the case of industrial buildings) but merely the aggregate depreciable basis. Only if the "disposal value" (i.e. sales price or other compensation received) in any year exceeds the aggregate depreciable basis, a "balancing charge" is made.

3.3.2. rate of "writing-down allowance"

The rate of the "writing-down allowance" is 25% of the aggregate depreciable basis. (F.A. 1971, sec. 44 (2)). However, individual taxpayers (not companies) may claim a reduced rate of the allowance. If the relevant accounting period is less than one year the "writing-down allowance" is reduced accordingly.

For the year in which the trade is discontinued, no "writing-down allowance" is available, but a "balancing allowance" is made equal to the remaining book value whereas any sales proceeds or other compensation received may lead to a "balancing charge" (F.A. 1971, sec. 44(3))

3.3.3. example of combined effect of depreciation allowances.

In order to illustrate the combined effect of the "first-year allowance" and "writing-down allowances" over a number of years, the following example may be given:

Example III

A company makes up its accounts for accounting periods which coincide with the calendar year. It starts trading operations in 1971 and incurs expenditure on plant and machinery during that year (before 20 July, 1971) equal to £ 100,000. Further expenditure is incurred in 1972 (before March 21, 1972) equal to £ 30,000 and that year part of the machinery purchased in 1971 is sold for £ 10,000. Depreciation allowances are available as follows:

Year 1971

expenditure	£ 100,000
first-year allowance : 60% (max.)	£ 60,000
	<hr/>
carried forward to 1972 (no writing down allowance)	£ 40,000

Year 1972

balance brought forward	£ 40,000
Less: proceeds of sale	£ 10,000
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balance	£ 30,000
writing-down allowance : 25%	£ 7,500
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balance carried forward	£ 22,500

new expenditure incurred in 1972:	£ 30,000
first-year allowance: 80% (max.)	£ 24,000
	<hr/>

balance carried forward	£ 6,000
	<hr/>
total balance carried forward to 1973	£ 28,500
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Summary:

Total expenditure : £ 100,000 + £ 30,000 - £ 10,000 = £ 120,000

Allowances 1971 : first-year allowance	: £ 60,000
Allowances 1972 : first-year allowance	: £ 24,000
	writing-down allowance: £ 7,500 £ 91,500
	<hr/>
book value carried forward to 1973.	£ 28,500
	<hr/> <hr/>

3.3.4. Assets used partly for private and other non-business purposes.

With respect to items of plant and machinery which are not used exclusively for the purposes of the trade it is provided that the expenditure on such items is not included in the aggregate depreciable basis (the "pool of expenditure") but is computed for each item separately, whereby only a proportion of the allowable "writing-down allowance", corresponding to the business use, is actually granted. Corresponding adjustments are made if the taxpayer subsequently disposes of the assets in question.

3.3.5. special provisions for motorcars

In principle all motor vehicles qualify for "writing-down allowances" including motorcars which are disqualified for the "first-year allowance" (see para, 3.2.1, above).

However, motorcars not eligible for the "first-year allowance" (i.e., basically, passenger cars) are not included in the aggregate book value of all other items of plant and machinery but are depreciated separately. Also, if the expenditure on motor cars not eligible for the "first-year allowance" exceeds £ 4,000 (increased to £ 5,000 for expenditure incurred on or after April 6, 1976 - F.A. 1976, sec. 43) the total depreciation allowed is limited to £ 4,000 or £ 5,000, respectively, with a maximum of £ 1,000 or £ 1,250, respectively per annum (F.A. 1971, Schedule 8, para 10). The allowable writing-down allowances are further reduced if the motor cars in question are used partly for other than business purposes. (see para. 3.3.4., above).

4. Depreciation of Mines, Oil wells, etc.

4.1. general provisions

Depreciation allowances are available under this heading with respect to "capital expenditure incurred in connection with the working of a mine, oil well, or other source of mineral deposits of a wasting nature -

- a) on searching for or on discovering and testing deposits, or winning access thereto, or
- b) on the construction of any works which are likely to be of little or no value when the source is no longer worked or, where the source is worked under a foreign concession, which are likely to become valueless when the concession comes to an end to the person working the source immediately before the concession comes to an end. (C.A.A. 1968, sec. 51 (2)).

However, expenditure on the acquisition of the site or of rights over such site on the acquisition of the deposit or of rights in or over the deposits and expenditure on works to process the raw materials are not eligible for depreciation allowances, except for expenditure on the acquisition of deposits outside the United Kingdom. But see the "depletion allowance", para 4.3., below with respect to certain expenditure in the United Kingdom. Also excluded is expenditure on buildings occupied by or for the welfare of workers (such buildings will usually qualify for the "industrial buildings allowance", see para 2.3., above) and expenditure on office buildings.

4.2. rates of depreciation allowances

4.2.1. initial allowance

An initial allowance of currently 40% (two-fifth) is granted only with respect to expenditure mentioned under (b) in para 4.1., above ("expenditure on the construction of any works which are likely to be of little or no value when the source is no longer worked") (C.A.A. 1968, sec. 56).

For qualifying expenditure on or after 27 October 1970 in so-called "development areas" and in Northern Ireland, the initial allowance is increased to 100%, but the taxpayer may disclaim this initial allowance in whole or in part (F.A. 1971, sec. 52).

4.2.2. writing down allowance.

The annual depreciation allowance ("writing down allowance") which is granted with respect to qualifying expenditure under both headings (a) and (b) given in para 4.1., above, is the greater of either 5% of the expenditure incurred or the fraction $\frac{A}{A+B}$ of the "residue of expenditure" (i.e. original expenditure less depreciation allowances), whereby A is the output from the source in the relevant accounting period and B the total potential future output of the source (C.A.A. 1968, sec. 57).

A different computation of the writing-down allowances applies to expenditure on land outside the United Kingdom.

4.3. depletion allowance

With respect to capital expenditure on the acquisition of a mineral asset the acquisition of which entitles the taxpayer to work a mine, oil well or other source of mineral deposits of a wasting nature in the United Kingdom, a special writing-down allowance (depletion allowance) is granted; such expenditure is not eligible for the normal initial and writing down allowances (see para. 4.1., above)

The depletion allowance amounts to a fraction of the "royalty value" of the output in the relevant accounting period, the fraction being one-half if less than 10 years have elapsed since the expenditure was incurred; one-quarter if between 10 and 20 years have elapsed; and in other cases one-tenth.

The term "royalty value" means, broadly speaking, the amount of royalties that would be payable on the output if the person working the mine were a lessee under a lease, for a term expiring immediately after that output was produced, granted at the date when the expenditure was incurred.

5. Expenditure on Dredging

Where a taxpayer incurs capital expenditure on dredging, and either his trade consists of the maintenance or improvement of the navigation of a harbour, estuary or waterway or the dredging is for the benefit of vessels coming to, or leaving or using any dock or other premises occupied by the taxpayer for the purposes of his trade, he is entitled to depreciation allowances ("capital allowances") as follows:

- an "initial allowance" for the accounting period in which the expenditure is incurred equal to 15 % of the expenditure;
- a "writing down allowance" equal to 4 % of the expenditure for the accounting period in which the expenditure is incurred, and each subsequent accounting period until the expenditure is written off completely (C.A.A. 1968, sec. 67)

For any part of the expenditure not written off at the time the taxpayer's trade is permanently discontinued, an allowance equal to the remaining expenditure is granted for the last accounting period.

A person contributing a capital sum to expenditure on dredging incurred by another person is treated as incurring capital expenditure on dredging equal to the amount of his contribution (ibid.)

No capital allowance under this heading is granted for capital expenditure for which allowances is or can be made under the provisions regarding "industrial buildings" or "machinery and plant" (C.A.A. 1968, sec. 67 (11)).

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6. Expenditure on Agricultural Land and Buildings

Under this heading depreciation allowances ("capital allowances") are granted to owners and tenants of any agricultural or forestry land located in the United Kingdom. (C.A.A. 1968, sec. 68)

The allowance applies to expenditure incurred for the purposes of husbandry or forestry on the construction of farmhouses, farm or forestry buildings, cottages, fences or other works, but with respect to farmhouses one-third only of the expenditure is taken into account (or, if the accommodation and amenities of the farmhouse are "out of due relation to the nature and extent of the farm", such smaller proportion as may be just), and with respect to other assets a just proportion only will be taken into account if such assets are used partly for other purposes than husbandry and forestry.

The qualifying expenditure may be written off in a period of 10 years, which implies a rate of 10 % per annum. If within the 10-year period the assets are transferred to another person, the transferee shall be entitled to the allowances for the part of the writing-down period falling after the date of the transfer (ibid, sec. 68 (4)).

7. Expenditure on Scientific Research

If a person carrying on a trade incurs capital expenditure on scientific research related to that trade and directly undertaken by him or on his behalf, or if such expenditure is incurred by a person who thereafter sets up and commences a trade, the whole of the expenditure may be written off for the accounting period in which the expenditure was incurred or, in case of expenditure incurred before commencement of the trade, for the first accounting period (C.A.A. 1968, sec. 91).

In this context "scientific research" means "any activities in the fields of natural or applied science for the extension of knowledge" and "scientific research expenditure" means "expenditure incurred on scientific research". However, the term does not include any expenditure incurred on the acquisition of rights in, or arising out of, scientific research (C.A.A. 1968, sec. 94).

If assets representing scientific research expenditure of a capital nature are subsequently sold or destroyed any sales price or insurance moneys or other compensation received is added to taxable profits (ibid., sec. 92).

8. Depreciation of Patents and Know-How

Depreciation of patent rights and know-how is not governed by the Capital Allowances Act 1968, but by sections 378 through 388 of the Income and Corporation Taxes Act 1970.

With respect to capital expenditure incurred on the purchase of patent rights or in obtaining a right to acquire patent rights in the future, writing-down allowances are granted during 17 years commencing in the accounting period during which the expenditure is incurred. If the patent rights are purchased for a period shorter than 17 years, the writing-down period is correspondingly reduced (ICTA 1970, sec. 378 and 388).

If the patent rights are sold or come to an end before the expiration of the writing-down period, a balancing allowance will be granted if the proceeds of sale or other compensation received, if any, are less than the written-down value.

If, on the other hand, the patent rights (or part of them) are sold for a capital sum exceeding the written-down value a "balancing charge" will be made equal to the difference between sales price and written-down value, but the "balancing charge" may not exceed the total writing-down allowances granted in previous years.

With respect to capital expenditure incurred on the acquisition of know-how, the writing-down period is six years.

C. Taxation of Capital Gains and Losses

1. General outline

As already indicated in the introduction (see part A, above), the United Kingdom tax system differs from that of most continental European countries, in that in computing the tax liability of taxpayers engaged in a trade a distinction is made between (ordinary) trading income and capital gains. Before the introduction of capital gains taxation in 1962, capital gains and losses were, in principle, tax exempt, irrespective of whether these gains and losses were realized with respect to assets of a business undertaking or "private" assets.

Thus, the basic distinction between income and capital transactions is whether the sale constitutes a "trading activity" or a mere realization of a "capital asset". This implies, basically, that if a taxpayer's "trade" consists of, or includes, dealing in the assets concerned any profit or loss will be included in the income of the trade, whereas other transactions result in a capital gain or loss.

The term "trade" is, defined as "every trade, manufacture, adventure or concern in the nature of a trade" (ICTA 1970, sec. 526).

Not only regular trading activities are covered by this definition; also isolated transactions have often been held by the Courts to constitute "an adventure or concern in the nature of a trade", depending on factual circumstances of each particular case. In evaluating these factual circumstances, there are a number of relevant factors to be taken into account, the "badges of trade", as outlined in a 1965 report of a Royal Commission on the Taxation of Profits and Income. These are:

- (i) the subject matter of the transaction: goods which do not yield an income or personal enjoyment to their owner are more likely to be acquired for the purpose of a trading activity than goods which can be, and frequently are held as an investment of for personal enjoyment;
- (ii) the length of the period of ownership: goods acquired for the purpose of a trading activity will normally be sold after a relatively short period, whereas investments will be held for a longer period;
- (iii) the frequency or number of similar transactions: the more similar transactions are carried out by the same person, the more likely is the existence of trading;

- (iv) the carrying out of work in connection with the goods: activities to bring the goods in a more marketable condition or to find purchasers may imply a trading transaction;
- (v) the circumstances responsible for the transaction: the presence of special circumstances (the sudden need for ready money or an emergency situation) may imply that trading was not the object of the transaction and vice versa;
- (vi) the motive behind the transaction: the motive (trading transaction or not) may be inferred from the circumstances of the case, even in the absence of direct evidence.

It will be evident that a given transaction, e.g., the sale of a house, may well be a capital transaction for one person, and a trading activity for another person, for instance if that person is regularly dealing in immovable property or if the circumstances are such that "an adventure or concern in the nature of a trade" must be assumed.

As a matter of fact, the Income Tax Laws contain several exceptions to the general rule that capital transactions do not result in (ordinary) income, one of these exceptions being the sale of patent rights. Since 1948, any capital sum received with respect to the sale of a patent is included in ordinary income, spread over a period of six years (ICTA 1970, sec. 380). Also, the sale or other disposal of assets for which depreciation allowances have been claimed may result in a "balancing charge" up to the amount of depreciation allowances claimed.

Capital gains taxation as such was not introduced in the United Kingdom until 1962, where certain short-term capital gains were made subject to income tax under a separate schedule, complemented by a long-term capital gains tax, normally imposed at a flat rate, introduced by the Finance Act of 1965. However, in 1971 the short-term capital gains tax provisions were repealed, and all capital gains are now subject to capital gains tax according to the provisions of the Finance Act, 1965, as amended from time to time.

2. The Capital Gains Tax

2.1. Main charging provisions

Residents of the United Kingdom are subject to capital gains tax with respect to disposals of assets, irrespective of where the assets are located, whereas non-residents are subject to capital gains tax only if they carry on a trade in the United Kingdom through a branch or agency and the assets are located in the United Kingdom and are either used in or for the purposes of the trade or used or held for the purposes of the branch or agency, or acquired for use by or for the purposes of the branch or agency (F.A. 1965, sec. 20).

Chargeable assets are, in principle, all forms of property, including:

- (a) options, debts and incorporeal property generally;
- (b) any currency other than sterling; and
- (c) any form of property created by the person disposing of it, or otherwise coming to be owned without being acquired. (F.A. 1965, sec. 22).

There is no comprehensive definition of the term "disposal" in the law, but there is a disposal of assets, inter alia, "where any capital sum is derived from assets notwithstanding that no asset is acquired by the person paying the capital sum", including capital sums received by way of compensation for any damage or injury to assets, capital sums received under an insurance policy covering the risk of damage to or loss of assets and capital sums received for the surrender of rights. (F.A. 1965, sec. 22). Furthermore, outright sales and gifts constitute disposals.

The capital gain or loss is basically computed as the difference between consideration received at the disposal (or market value in the case, inter alia, of gifts and transactions not at arm's length) and cost of acquisition. There is no provision to exclude inflationary gains caused by the fall in the value of money. Retroactive effect of the 1965 provisions however, is avoided, in that for assets owned at the time of introduction of the Act (April 6, 1965) the actual value at that time may generally be taken in lieu of actual cost of acquisition.

The capital gains tax legislation does take into account the diminishing value over the years of so-called "wasting assets", i.e., assets with a predictable useful life not exceeding fifty years. If such assets are disposed of, the depreciated value rather than original cost of acquisition is taken into account in computing the taxable capital gain. However, with respect to disposals after 19 March 1968, gains and losses with respect to tangible movable assets which are "wasting assets" are exempt from capital gains taxation, which implies that the rules concerning "wasting assets" currently apply mainly to intangible assets. The provisions regarding "wasting assets", moreover do not normally apply to business assets for which depreciation allowance could be claimed. In those cases, a capital gain will normally arise only where the proceeds of sale exceed the cost of acquisition. For further details see the next paragraph.

2.2. Special rules concerning businesses and business assets

2.2.1. Depreciable assets

As already indicated in paragraph 2.1., above and in chapter B on depreciation allowances, the sale or other disposal of business assets which have been subject to depreciation allowances does not normally give rise to a capital gain or loss.

Sale or other disposal for a price (or other compensation received) below the written down value (i.e. capital expenditure incurred less depreciation allowances taken) will normally result in a "balancing (depreciation) allowance" equal to the difference, except in case of items of plant and machinery written down on an aggregate basis, where the proceeds of sale merely reduce the aggregate depreciable basis for the future.

Sale or other disposal for a consideration exceeding the written-down value will normally result in a "balancing charge" equal to the difference, except again in the case of plant and machinery written down on an aggregate basis, where the proceeds of sale reduce the aggregate depreciable basis.

However, "balancing charges" made may not exceed the amount of depreciation allowances taken in the past, so normally no balancing charge is made for any excess of the sales proceeds over the original cost of acquisition. This also applies to plant and machinery as the "disposal value" which is deducted from the aggregate depreciable basis may also not exceed cost of acquisition.

To the extent that the consideration received on the sale or other disposal of depreciable assets exceeds the cost of acquisition, a taxable capital gain arises, however.

In this context it should be noted that the capital gains tax exemption regarding "wasting assets" which are tangible movable property does not apply to assets which have been eligible for depreciation allowances.

2.2.2. Restoration and replacement of business assets

Although there are no general provisions in the Capital Gains Tax legislation providing for relief in case of sale or loss of an asset there are certain provisions which grant an exemption or postponement of capital gains tax in a number of cases.

These provisions can be summarized as follows:

(a) Compensation received in case of damage

If a capital sum is derived from an asset which is not lost or destroyed (such capital sums are in principle subject to capital gains tax, see para. 2.1., above), and that capital sum is wholly or almost wholly applied in restoring the asset, then the recipient may claim that the receipt of the sum is not treated as a disposal for capital gains tax purposes, but the sum received is deducted in computing the cost of acquisition on a subsequent disposal of the asset (F.A. 1965, Schedule 6, para. 13).

However, "wasting assets" do not qualify for this relief.

(b) Compensation received in case of loss or destruction

If a capital sum is received by way of compensation (through insurance or otherwise) for an asset lost or destroyed, and the capital sum is used within one year, or such longer period as the Inspector of Taxes may allow, in acquiring a replacement asset then the owner of the asset may claim that the compensation received (if otherwise of a greater amount) is deemed to be of such amount as would secure that no gain or loss accrues to him on the disposal, and as if the cost of acquisition of the new asset were reduced by the excess of the actual compensation received plus any residual or scrap value of the old asset over the amount deemed to be received by him (ibid, para. 13(3)).

For example, if an asset with an original cost of acquisition of, say, £ 10,000 is destroyed and the compensation received is £ 12,000, and the cost of the new asset is £ 13,000, the taxpayer may claim that no capital gain arises with respect to the compensation, and the cost of acquisition of the new asset for capital gains tax purposes is reduced by £ 2,000, being the difference between actual compensation of £ 12,000 and the cost of the old asset of £ 10,000. Upon a subsequent disposal of the new asset, its cost of acquisition will thus be taken at £ 11,000.

It should be noted, that this relief, like the relief under (a) above, does not apply to "wasting assets".

(c) Replacement of business assets

A relief similar to the relief outlined in (b), above, applies to voluntary replacements of business assets, but application of this relief, usually termed "roll-over relief", is limited to five classes of assets (F.A. 1965, sec. 33), viz.

Class 1: A - a) any building or part of a building and any permanent or semi-permanent structure in the nature of a building, occupied (as well as used) only for the purposes of the trade; and
b) any land occupied (as well as used) only for the purposes of the trade.

Note: Assets under this heading do not qualify where the trade is a trade of dealing in or developing land, or of providing services for the occupier of land in which the person carrying on the trade has an estate or interest.

B - Fixed plant or machinery which does not form part of a building or of a permanent or semi-permanent structure in the nature of a building.

Class 2: ships;

Class 3: aircraft;

Class 4: goodwill;

Class 5: hovercraft.

Since the Finance Act 1971 (sec. 60), it is no longer necessary for this provision to apply that assets in one of the five classes are replaced by assets of the same class. Thus, for instance, the replacement relief may be applied if a ship is replaced by an aeroplane or hovercraft.

2.2.3. Termination of business

There are no general relief provisions with respect to the termination of a business. However, some measure of relief is granted upon retirement of individual taxpayers who dispose of their private business or of shares in their "family company".

The provisions of this relief can be summarized as follows:

An individual taxpayer who has attained the age of 60 years and who:

- a) disposes by way of sale or gift of the whole or part of a business which he had owned throughout the period of ten years ending with the disposal; or
- b) disposes by way of sale or gift of shares or securities of a company which has been a trading company and his family company during the period of ten years ending with the disposal, and of which he has been a full time working director throughout that period, is entitled to a capital gains tax exemption equal to £ 20,000 where the individual in question had reached the age of 65 years at the time of the disposal, and if he was between 60 and 65 years of age at that time, to an exemption of £ 4,000 for each year by which his age exceeds 60, plus a corresponding part of £ 4,000 for any remaining part of a year (F.A.1965, sec. 34, as amended).

The exemption also applies if condition a) was fulfilled during part of the ten-year period and condition b) during the remainder of that period.

The term "family company" is defined, in short, as a company in which either the individual owns not less than 25% of the voting rights, or the individual and a member of his family (being husband or wife, brothers and sisters, ancestors and lineal descendants) not less than 75% of the voting rights, at least 10% thereof being exercisable by the individual himself.

2.2.4. Transactions between groups of companies

Special relief provisions apply to transactions between members of a group of companies, i.e., generally speaking, a company resident in the United Kingdom together with its resident subsidiaries in which it owns directly or indirectly

not less than 75% of share capital.

The disposal of assets from one member of such a group of companies to another member of the group will be deemed for capital gains tax purposes to be made for a consideration of such amount that no capital gain or loss arises for the transferor. Thus, in principle, the taxation of any gain or loss is postponed until the assets in question leave the group (ICTA 1970, sec. 273).

2.2.5. Company reorganizations; mergers

Under a scheme of reconstruction or amalgamation involving the transfer of the whole or part of a resident company's business to another resident company, any assets included in the transfer are to be treated as disposed of by the transferor company for a consideration of such amount that no capital gain or loss arises for the transferor company, and the transferee company is deemed to have acquired the assets for the same amount (ICTA 1970, sec. 267). Thus, capital gains tax liability is actually postponed until the assets in question are disposed of by the transferee company.

Also for the shareholder there will not normally be a capital gains tax liability in case of any reorganization or reduction of a company's share capital, or if he receives shares in another company in exchange for his existing holding in a company.

In the first event (reorganization or reduction of a company's share capital, including the allotment of shares in respect of and in proportion to the shareholder's existing holding of shares in the company) there will be no disposal for capital gains tax purposes, and the "new holding" shall be treated as the same asset acquired as the original shares were acquired. Any consideration given by the shareholder will be added to the cost of acquisition of the original shares, whereas any consideration received by the shareholder other than "the new holding", will imply a "part disposal" of the original shareholding, and capital gains tax liability will arise for that part of the original shareholding which is deemed to be disposed of (F.A. 1965, Schedule 7, para. 4).

In the second event (exchange of shares for shares) the same rules apply, *mutatis mutandis*, provided that the company issuing the new shares has or in consequence of the exchange will have control of the other company, or if the exchange was a result of a general offer made to shareholders of the other company, the offer being made in the first instance on a condition such that if it were satisfied the company making the offer would have control of the other company. (F.A. 1965, Schedule 7, para. 6).

D. Reserves

The allocation to reserves is generally not acceptable for income tax or corporation tax purposes.

This applies to "true" reserves, as well as to reserves for future expenses.

This rather strict rule emerges, inter alia, from the basic concepts of United Kingdom tax law regarding the computation of business profits which, in principle, prohibit the deduction of expenses not actually incurred for the purposes of the trade.

In some cases the creation of reserves is forbidden by express provisions of the law, e.g., with respect to general reserves for bad debts (ICTA 1970, sec. 130(i), where it is provided that only "bad debts proved to be such", and "doubtful debts to the extent that they are respectively estimated to be bad" may be deducted, in addition to bad debts of debtors who are bankrupt or insolvent).

There are other examples in case law where the Courts have disallowed the creation of reserves, e.g., in the case of annual allocations to an "insurance fund" by the owner of a ship who did not insure the ship with an insurance company.

Also, no "average loss" beyond the "actual amount of loss" may be deducted (ICTA 1970, sec. 130(j)).

Reference should be made, however, to the "roll-over relief" provisions in Capital Gains Tax Law, summarized in chapter C, para. 2.2.2. under c).

Also, the United Kingdom tax law does not contain any provisions for the creation of "investment reserves" or similar tax incentives.

E. Other investment incentives

Apart from the rather generous provisions concerning the depreciation of business assets (initial allowances, first-year allowances and writing-down allowances), as outlined in chapter B, above, there are currently no other investment incentives in the field of taxation.

Investment allowances, being deductions with respect to qualifying capital expenditure over and above the initial and annual depreciation allowances covering the entire expenditure incurred with respect to the assets concerned, have been granted in the past, at varying rates according to the state of the national economy, in combination with an initial allowance the rate of which was also varied from time to time.

As of January 16, 1966, however, the investment allowances were replaced by a system of Government grants (subsidies) but these were again abolished on October 26, 1970, and at the present time investment grants are only available for qualifying investments in certain "development areas". More generous depreciation allowances were introduced when the general system of government grants was terminated on October 26, 1970.

F. Valuation of stock-in-trade

1. Main provisions

The general rule regarding the valuation of stock-in-trade is that valuation should be at the lower of cost or market value. This rule is based on general accountancy principles rather than on express provisions in the law.

The valuation at cost or market value may be applied to each item or each class of goods separately, so that it is permissible to value certain goods at cost (where market value is higher) and other goods at market value (where market value is below cost). Efforts by the Revenue to apply cost or market value to the entirety of a taxpayer's stock-in-trade (the "global" method) have failed in Court several times.

With respect to classes of goods which cannot be easily identified, the cost price is determined on the basis of the first in - first out (F.I.F.O.) method, the last in-first out (L.I.F.O.) system not being permitted.

The cost price of stock-in-trade consists not only of the purchase price but also of expenses on freight, insurance, etc.

As to work in progress, both the direct cost method (cost of materials and labour) and the on-cost method (materials, labour plus an appropriate amount for general and overhead expenses) have been held to be acceptable as being in accordance with general accountancy principles, but the taxpayer should use the same method through the years.

Other methods of valuation (e.g., the base-stock method or "average cost" or "standard cost" methods) are not allowed for tax purposes.

2. Relief for increases in value of stock-in-trade and work in progress

With a view to the rapid rise in the cost of raw materials due to inflation, some relief was introduced by a statement of the Chancellor of the Exchequer on 12 November 1974.

The original provisions have been changed several times and the relief is now governed by section 37 and Schedule 5 of the Finance Act 1976.

The main provisions of this relief may be summarized as follows:

An individual or corporate taxpayer engaged in a trade, whose "closing stock value" (being the value of his trading stock at the end of a period of account) exceeds his "opening stock value" (being the value of his trading stock at the beginning of that period) is entitled to relief (in the form of a deduction in computing his trading income) of an amount equal to the increase in stock value less 15% of the relevant trading income of that period.

Application of this relief can be claimed by the taxpayer within two years after the end of the year of assessment in which the accounting period ends.

If in a subsequent accounting period the closing stock value is less than the opening stock value, the relief is recouped by way of a charge (addition to taxable income) equal to the lesser of the actual reduction in stock value or the amount of unrecovered relief granted in previous years. A final charge is made if the taxpayer ceases to carry on the relevant trade.

It should be noted that this relief is available, irrespective of whether the increase in stock value is caused by a rise in prices or by an increase in the quantity of goods in stock.

G. Compensation of losses

1. General outline

Relief for losses sustained in carrying on a trade may, generally, be relieved in three different ways, which apply both to individual and corporate taxpayers.

Firstly, losses may be set off against other income of the same year; secondly, losses may be carried back for one year, and thirdly, any remaining loss may be carried forward indefinitely.

There is, however, an important distinction to make between the first two options on the one hand and the third option on the other, in that the unlimited carry forward applies only to losses incurred in a particular trade and ceases at the moment the trade is discontinued and eventually replaced by another trade carried on by the same taxpayer. This implies, inter alia, that if a taxpayer changes the nature of his trading activities after having incurred losses in his original activities, he will not be able to offset the losses incurred in the original trade against the profits of his new trade.

2. Carry back provisions

The provisions regarding the setting off of losses against income of the same or the preceding year are governed by ICTA 1970, sec. 168 for individuals and by ICTA 1970, sec. 177 (2) for corporate taxpayers.

Section 168 provides that where an individual sustains a loss in any trade, profession, employment or vocation may claim relief against his other income of the same year and the next succeeding year of assessment. However, since income from a trade earned in any accounting period is normally taxed in the next year of assessment (the so-called "preceding year basis"), the setting-off of losses against income of the year of assessment in which the loss is actually incurred means in fact, as far as trading income is concerned, that the loss sustained during an accounting period may be offset against the profits of the preceding accounting period. Thus, the carry-back is not explicitly laid down in the law, but derives from the fact that the assessment of trading profits is normally on a "preceding year basis", whereas trading losses are taken into account on a "current year basis".

It should also be noted that the loss relief provisions of sec. 168 cover not only trading losses, but also losses from a profession, employment or vocation.

Sec. 177(2) provides that where a company carrying on a trade incurs a loss in the trade, the company may require that the loss be set off against profits of that accounting period and the preceding accounting period, subject to certain adjustments if the various accounting periods are not equal in length.

3. Carry forward provisions

The carry forward provisions are laid down in ICTA 1970, sec. 171 for individuals and sec. 177(1) for corporate taxpayers.

As far as individuals are concerned this provision applies to income from any trade, profession or vocation (not to employment income) whereas for companies the relief is limited to trading income. In both cases it is required for the carry forward to apply that the taxpayer continues the same trade. Also, the taxpayer must set off the losses in the earliest possible accounting period in which profits are made and is not free to spread the losses over the years as he thinks fit.

The requirement of a continuing trade implies, inter alia, that the relief is granted primarily to the trade as such rather than to the taxpayer which is a clear distinction from the system of most Continental European countries. However, the identity of the owner of the trade is also an important factor, in that carry forward of losses is no longer granted if the ownership of the trade changes hands, and also if the majority ownership of shares in a company with accumulated losses changes hands. The latter event is governed by ICTA 1970, sec. 483, which provides that if within any three year period there is a change in the ownership of the company and a major change in the nature or conduct of a trade carried on by the company or if at any time after the scale of the activities of the company has become small or negligible and before any considerable revival of the company there is a change in ownership of the company, there will be no relief for pre-change of ownership losses against post-change of ownership profits. There are extensive definitions of the terms "change of ownership" (inter alia, where a single person acquires more than half of the company's share capital, or where two or more persons each acquire a holding of 5% or more and these holdings together amount to more than half the share capital) and "major change in the nature or conduct of the trade". This provision is mainly aimed at the sale of so-called "tax loss companies".

4. Terminal losses: three year carry back

The possibility of carrying back trading losses is extended to the three previous years with respect to losses incurred in the ultimate year when the trade is discontinued. The relevant provisions are laid down in ICTA 1970, sec. 174 for individuals and sec. 178 for companies.

5. Capital losses

Capital losses cannot be set off against (ordinary) income from a trade or any other source. They can only be set off against capital gains realized in the same or in any subsequent year.