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## **COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)**

### ***Intangible assets and tax depreciation***

**Meeting to be held on Thursday 10 March 2005**

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**WORKING DOCUMENT**

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## **I. Purpose of the paper**

1. The discussion on the tax depreciation of assets was opened at the first meeting of the CCCTB WG on 23 November 2004. The Commission working document CCCTB\WP\004\doc 'Assets and Tax Depreciation' outlined the basic principles and concentrated on solutions mainly for tangible assets (hereafter 'the original WD'). The discussion on tax depreciation of tangible assets was then referred to the subgroup (hereafter 'SG1') for more detailed work. Members of the CCCTB WG (hereafter 'members of the group') agreed that a discussion on intangible assets should follow at the next CCCTB WG plenary.
2. This document complements the original WD and has to be read in conjunction with it. This document identifies common aspects for both types of assets and the areas where the treatment for intangible assets needs to be different or more detailed. Although the term 'amortisation' is used in connection with intangible assets, it has broadly the same meaning as 'depreciation'.
3. The nature of intangible property makes the determination, recognition and measuring of intangible assets more difficult than it is in case of tangible assets. Most intangible assets are unique. Thus the assessment of their value to the business and the period over which they may be expected to be available for use (their useful life) are rather problematic. The specific character of intangible assets leads to special accounting and tax rules in many jurisdictions. Some MS rely on the accounting treatment for intangible assets also in taxation; but national accounting rules vary among MS. Tax treatments actually applied therefore vary as well. Some details on currently applied rules in MS are summarised in the Annex 1.
4. Primarily it should be closely analysed whether tax solutions for intangible assets have to be different from those for tangible assets. The purpose of the paper and the subsequent discussion is to identify what issues may need a specific solution in the CCCTB and should therefore be analysed further (possibly by SG1).
5. The main principles for the tax treatment of tangible and intangible assets should be the same. It may be practical for special arrangements for intangibles to work as a 'lex specialis' in relation to the rules on tax depreciation of (tangible) assets. This is a different approach from the one taken by IAS 16 (Property, Plant and Equipment) and 38 (Intangible Assets). Each of the two IAS exists relatively independently of the other. From the CCCTB point of view, it seems more practical not to repeat the issues that are common for both categories of assets. IAS 38 is used in this document as 'a working tool' in a similar way to how IAS 16 was used for tangible assets. The potential structure of the future CCCTB rules is illustrated in the Annex 2.
6. The difference between the purposes of tax and accounting treatment have to be taken into account when testing how useful accounting solutions adopted in IAS

38 may be for taxation. IAS treatments are primarily designed to ensure that balance sheets are not overstated by inflated or even non existing assets which should be expensed, whereas tax tests are essentially based on the opposite. They are designed to ensure that capital costs are not unreasonably expensed as incurred, with the effect of lowering the tax base.

7. The discussion should concentrate on the general treatment of intangible assets. Specific issues such as the disposal of intangibles, impairment of assets and business combinations will be discussed at later stages. The issue of the alienation (eg. sale) of intangible assets should be dealt with in line with solutions for capital gains. Business combinations are currently planned as a separate topic.

► *Given the number of elements which are common to both tangible and intangible assets do members of the group agree that this issue should be dealt within more detail by SGI?*

## **II. Definition of depreciable intangible assets**

8. The IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance<sup>1</sup>. The '*identifiability*' criterion is especially important and it is met if an asset is separable, ie. it is capable of being separated or divided from the entity and sold, transferred or otherwise disposed either individually or together with a related contract, asset or liability or if the asset arises from contractual or other legal rights regardless of whether those rights are transferable or separable from the entity or from other rights and obligations<sup>2</sup>. For the sake of certainty the definition of an intangible asset used for tax (CCCTB) purposes could be supported by a demonstrative list. However the task of creating a common EU set of examples or a demonstrative list may in itself be an extremely difficult task. Double Taxation Treaties may be helpful as regards a suitable definition for tax although it is not an intangible asset but the payment connected with it that is defined<sup>3</sup>.
9. Intangible assets also have to meet the '*control*' and '*future economic benefits that can be measured reliably*'<sup>4</sup> criteria in order to be able to be recognised in the balance sheet, just as tangible assets. These conditions are important in the tax area and they are common for all types of depreciable assets. Making a connection between the asset and the activity of an enterprise (making a business) through a 'business purpose test' is as important for intangible assets as for tangible assets.

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<sup>1</sup> IAS 38 Para 8

<sup>2</sup> IAS 38 Para 12

<sup>3</sup> OECD Model Tax Convention on Income and on Capital, Art. 12 Para 2: 'The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.'

<sup>4</sup> IAS 38 Paras 8 and 18

10. If the intangible does not meet the conditions for recognition as an asset, it should not be amortised. Such an item can in principle be expensed as incurred in the year of acquisition (the same as the tangible asset) or its costs may only be taken into consideration if the asset is eventually sold. How expenditure which is not classified as for tangible or intangible asset is relieved (ie. whether it should be tax deductible/ non deductible) will be discussed and elaborated at a later stage when profit and loss items and expenses in general are dealt with.
11. Intangible assets of a minor value and/or a very short useful life (cf. tangible assets of minor value and/or a very short life) should probably be expensed as incurred. It would be practical to have the same rule for all assets.
12. The different legal treatment applicable to intangible property and the definitions of various types of intangibles contained in MS national legislations other than tax may bring some confusion in this area. Without a clear determination of what is an intangible asset for CCCTB purposes it may be difficult to avoid the situation when the same item is an intangible asset according to the interpretation of one MS, or not an asset at all according to others. For taxation purposes the distinction between the following two groups of intangible assets is important:
13. The first group of intangibles represents the property without physical presence which is subject to special legal protection such as transferable and non transferable copyrights, patents, models, trademarks, know-how, etc. The protection is formalised by fixed procedures in some cases (eg. patents, trademarks). These intangibles and/or rights to use them can be acquired or sold or transferred or otherwise disposed by means of special contractual arrangements such as licensing or other agreements. As already mentioned different legal concepts are present in MS and different definitions and general terms and conditions apply to them. For tax it is more important to test the character of the asset, than its name and formal classification. The tax treatment should not be therefore attached to the name of each particular intangible, but more to its substance.
14. Intangibles created during the research and development phase create a sub set of the first group which has a special position in taxation (see also Para 22 and following of this document).
15. Goodwill represents the second group of intangible assets. This category is particularly relevant for the tax and accounting area if arising on acquisition. It is described as any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction. Goodwill arising on acquisition represents a payment made by the acquirer in anticipation of future economic benefits<sup>5</sup>.
16. Different approaches to amortisation of acquired goodwill can be identified. Some MS treat it the same way as other intangible assets, some have fixed a special

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<sup>5</sup> IAS 22 Paras 41 and 42

- length of useful life for it (most often 15 years) and others do not allow capitalisation of it at all. The selected solution should be discussed in conjunction with business combinations.
17. Intangible assets can be internally generated or externally acquired. The latter are in principle subject to amortisation. The assessment of whether recognition criteria are fulfilled is less complicated for such purchased assets than for the former internally generated assets.
  18. Internally generated intangibles may need more guidance. It is difficult to assess whether an internally generated intangible asset qualifies for the recognition in the balance sheet. On the other hand, it can easily happen that a large amount of resources is spent with the intention to create a valuable intangible asset, but at the end it does not materialise. In some cases the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running the day to day operations<sup>6</sup>.
  19. Internally generated goodwill is not recognised as an asset in accounting, because it is not an identifiable resource controlled by an entity that can be measured reliably at cost<sup>7</sup>. This definition seems to be useful for tax as well, because it is almost impossible to determine and measure goodwill objectively before the related business is sold contrary to acquired goodwill which can be measured at cost, or more precisely a certain part of acquisition costs can be allocated to it.
  20. Internally generated brands, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets in accounting (similar to the treatment of internally generated goodwill), because they cannot be distinguished from the cost of developing the business as a whole. The accounting treatment of start-up costs is similar. It is worth considering whether in taxation these internally generated intangibles or start up costs should be recognised as intangible assets in some circumstances especially if they can be clearly determined and it is possible to measure them at cost.
  21. The accounting solution makes a clear distinction between intangibles generated in the research phase and intangibles generated in the development phase. Only the latter one can be recognised in the balance sheet. Expenditure on research is recognised as an expense when it is incurred<sup>8</sup>.
  22. Existing tax regimes contain various elements in respect of research and development (hereafter R&D). In contrast to the accounting solution, tax systems tend to test the relation between the activity performed by an enterprise and the research and development. However beneficial schemes of incentive character are available for both types of activities in most MS.

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<sup>6</sup> IAS 38 Para 51

<sup>7</sup> IAS 38 Paras 48 and 49

<sup>8</sup> IAS 38 Para 54

23. Over a number of years, various European Councils have underlined the paramount importance of R&D for the economic prospects of the EU. Detailed work has been carried out at Commission level, at intergovernmental instances and at the OECD. Research and technological innovation are key drivers of economic growth and central to the EU's goals. The CCCTB WG should build on this work and not try to 'reinvent the wheel'. The following initiatives deserve particular attention in this respect: A fiscal sub-group to the 'Committee for Scientific and Technical Research' (CREST) has elaborated four tax recommendations on which measures MS could take in order to achieve the 3% Barcelona objective<sup>9</sup>. In parallel, the Commission Services have created four expert groups in order to advise on a variety of policy issues of importance for R&D. The report on fiscal measures of January 2003 presents 'principles of good design' of such fiscal measures. It also contains some useful sections on the effectiveness of fiscal incentives and the relevant evaluation techniques. In following up the existing reports and in order to obtain an even more detailed and accurate and up to date picture of the situation in MS the Commission Services commissioned a detailed survey on the 'tax treatment of research & development expenses' from the IBFD, covering the direct tax treatment of such expenses in the 25 MS as well as the USA and Japan<sup>10</sup>.
24. Taking into account the above, a favourable tax treatment of R&D expenditure should be considered in due course in the work on the CCCTB. It should be possible to find a coherent and well balanced solution (e.g. immediate deduction of such expenses, possibly combined with another incentive measure). However it should be discussed in line with other potential incentive measures.
25. Discussions on the need for more guidance on some specific groups of intangible assets have also been held. For example, the International Financial Reporting Interpretations Committee (IFRIC) of the IASB recently debated the recognition and valuation of the trading of emission rights<sup>11</sup>. The debate centred on whether or not emission trading rights should be recognised in the balance sheet of an enterprise as an intangible asset and whether they should be measured at fair value even if granted for less (eg. by government). Any agreed tax treatment of intangible assets will also have to be capable of adaptation or application to potentially new types of intangible assets

► *Members of the group are invited to comment on above paragraphs, especially on the proposed techniques for how depreciable intangible assets could be defined.*

► *Do members of the group agree that internally generated goodwill shall not be eligible for depreciation whereas other internally generated intangibles could be amortised if substantiated; or do they think that other categories of internally*

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<sup>9</sup> To increase the investment in EU R&D with the aim of approaching 3% of GDP by 2010

<sup>10</sup> The final report of the survey has recently been made available on official DG Taxation and Customs Union 's website.

<sup>11</sup> IFRIC 3 Emission Rights issued December 2004

*generated intangible assets should be subject to the same regime as internally developed goodwill?*

▶ *Do any MS allow/require tax depreciation of internally generated intangibles? If yes, could those MS elaborate on their experience in identification of cost of these intangibles and how they are distinguished from the cost of developing the business as a whole?*

▶ *Would members of the group prefer to discuss the regime for acquired goodwill in conjunction with business combinations or intangible assets or both?*

▶ *Do members of the group wish to comment on what they see as a suitable general approach to research and development? Do members of the group agree that any special R&D incentive regime should be discussed as a separate topic along with other potential incentive schemes?*

▶ *Do members of the group believe that special guidance is needed on some types of intangibles? If so, which types, and what type of guidance do they recommend?*

### **III. Depreciable basis and valuation**

26. The valuation of intangibles is a complex issue although the main principles are the same as for tangible assets. The intangible asset is measured initially at cost in accounting<sup>12</sup>, as for tangible assets. Besides that the accounting standards stress the importance of fair value accounting for intangible property. After the initial recognition the intangible can be carried either at its cost less any accumulated amortisation and any accumulated impairment losses (cost model) or at a revalued amount being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses (revaluation model). IAS 38 also provides for some more guidance on whether the increase of the value after the revaluation should be credited directly to equity or should be recognised in the profit or loss<sup>13</sup>.

27. Tax treatments tend to attach a much lower relevance to the revaluation to fair value than accounting does. As already mentioned above the main purpose of tax rules is not to ensure that assets recognised in the balance sheet are correctly stated with an emphasis on avoiding overstatement. The main tax purpose is to ensure that the taxable profit is properly determined. The potential recognition of revaluation to fair value in the tax area opens the question of unrealised profits and losses and to date this has been a relatively restricted area in taxation<sup>14</sup>. In line with the on going discussion in SG1 on tangible assets members of the group may wish to discuss 'fair value/unrealised gains and losses' at the same time as the solutions for capital gains.

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<sup>12</sup> IAS 38 Para 24

<sup>13</sup> IAS 38 Para 75 and following

<sup>14</sup> See also Para 30 of the Commission Working Document CCCTB/WP/001/doc

28. Uniqueness is another feature present in the characteristics of most intangibles that makes the 'measuring' of them a tricky procedure. For tax it is important who is primarily responsible for this measuring and what 'evidence' should be sought in relation to the valuation of any internally generated intangible or the valuation of an acquired intangible if acquired for non monetary benefit or equity. Some MS use expert valuations, other rely on the enterprises' valuations.
29. The issue is especially important if an intangible is sold or transferred or otherwise disposed between members of the same group of related companies. The role of such valuations in the consolidated tax base, where intra-group transactions will have considerably fewer tax implications, will change at the European level. Although there will be less of these, as in a consolidated EU tax base there should be no need for arms-length pricing, the issue remains important for groups who have entities both within the EU and outside the EU. The 'water's edge' will have to be defined and arrangements defined for many structural elements not just because of the question over the valuation of intangible assets. It should however be noted that the valuation of intra-group transactions of intangibles could remain important if the underlying assets formed part of any factors in a formula for apportionment of the consolidated tax base.
30. Specific tax rules on the subsequent expenditure for some intangible assets (eg. software upgrades) are currently present in some MS. The general principle (creating a new asset versus increase of the acquisition value) should however be the same or similar for tangible and intangible assets.

► *Would members of the group agree that principles for valuation of intangible assets should be the same or similar as for tangible assets. Do they think it is necessary to adopt some special rules for intangible assets and if so, why and which particular rules?*

#### **IV. Who is eligible to claim tax depreciation charges on intangible assets**

31. A legal ownership criterion will probably need some modification for intangible assets. Legal titles that 'make the asset available' for the company are different for tangible and intangible asset just as the legal implications may vary among MS.
32. It is important who is legally entitled to use the intangible asset. The title may be derived either from the statutory procedure (eg. a company obtains a patent registration) or from the contractual arrangement (eg. a licensing agreement that gives the company right to use an intangible asset).

► *Would members of the group agree that the person legally entitled to use the intangible asset can claim the depreciation charges on it?*

## **V. Timing**

33. Intangible assets' useful lives can be finite (eg. patents, copyright) or indefinite (eg. trademarks, brands). Intangible assets with indefinite useful lives should generally not be amortised either in accounting or in the tax area, because their value does not change depending on time. This treatment would be comparable to the general treatment of land.
34. In accounting the length of useful lives of intangibles with a finite life is determined by the enterprise. IAS 38 however insists that the amortisation period (and amortisation method as well) for an intangible asset with a finite useful life shall be reviewed at least at each financial year end. If the expected useful life of the asset is different from previous estimates, the amortisation period must be changed accordingly.<sup>15</sup>
35. According to IAS 38<sup>16</sup> the useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period only if there is evidence to support renewal by the entity without significant cost.
36. If there exists documentation for how many years the legal protection of an intangible asset will last or for how long time the right to use the particular intangible is provided, than the determination of the useful life of an intangible asset is very simple.
37. Taxation is likely to require more specific definitions and specification of the length of the useful life in respect of different types of intangible assets. Tax tends to be more hesitant to changes of the useful life after the recognition of the asset. In principle it is the same approach as in the case of tangible assets. In some MS intangibles are categorized according to the type when acquired (e.g. patent, trademark) and a fixed useful life is attributed to each category or to an individual asset.
38. It should be noted that the role of intangible assets vary in different industrial sectors. Sector specific guidance is therefore available in some MS.

► *Could members of the group comment on the issue of timing? Especially what special rules they see as necessary in case of intangible assets?*

► *Would members of the group agree that if there is a clear evidence of how long the useful life of an asset will be it should be amortised over such a period?*

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<sup>15</sup> IAS 38 Para 104

<sup>16</sup> IAS 38 Para 94

► *Would members of the group prefer to categorise intangible assets and attribute to each category a fixed period of time? Do they think that sector specific rules will be necessary for CCCTB?*

## **VI. Depreciable amount and mechanics**

39. The depreciable amount of an intangible asset with a finite life should be allocated on a systematic basis over its useful life in the accounting. Amortisation should begin when the asset is available for use<sup>17</sup>. Both rules are the same for all types of assets. The amortisation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably the straight line method shall be used.

40. The straight line method amortisation on an individual basis is the most common way for amortisation of intangible assets in currently applicable tax regimes and it seems to be relatively practical and well functioning at the moment.

41. Nevertheless the discussion on the possible pooling of intangible assets should not be put aside prematurely. The pooling method may bring a well balanced solution for the extremely diverse 'EU wide jurisdiction', where the uniform interpretation of common rules will be very important. The depreciation of assets in pools eliminates many troublesome complications that occur when each asset is treated on an individual basis such as the classification of the asset, pro rata calculations in the first and the last years, individual allocation at acquisition, etc. The difference between results arising from the two methods may be much less material than the difference between the two methods themselves.

► *What method would members of the group find as the most appropriate for the depreciation of intangible assets in CCCTB and why?*

► *Do any MS depreciate tangible assets on a pool basis, but intangible asset on an individual basis? If yes, would those MS explain the background to these different approaches?*

► *Would members of the group like to add any other issue they find important for the tax depreciation of intangible assets and that has not been mentioned in this document?*

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<sup>17</sup> IAS 38 Para 88