Principle 1

Influencing the category of taxable objects

Introduction

Two very similar theories are invoked to justify income tax :

- firstly, the *theory of periodicity*, according to which taxable income includes all revenue recurring periodically (e.g. salary, interest, dividends, rents incl. farming rents, annuities and pensions, license fees, etc.) and

- secondly, the *theory of source*, according to which taxable income includes all revenue arising from a stable and lasting source.

If either theory were applied strictly, occasional income would escape tax. This would be contrary to the fundamental principles of modern taxation, according to which tax liability is based on the contribution capacity and on the concept of equality. Tax law has therefore become increasingly based on the *enrichment theory* or *theory of net wealth increase*, pursuant to which taxable income includes all revenue which increases the net worth of the taxpayer's assets and can be used without using initial capital[1]. This concept was developed during the course of the 20th century. However, it soon became apparent that extraordinary income required special treatment and could not be merely added to ordinary income. Furthermore, the fact that it did not recur on a regular basis needed to be taken into account. Appropriate measures were therefore taken by Western legislators, who introduced special taxes commensurate with the nature of the revenue.

Let us note that, in many jurisdictions, different types of income are taxed differently, even though they derive from a stable source[2]. Instead of calculating global income, revenue is initially divided into a series of categories : industrial and commercial income, income from non commercial professions, salaries and wages, moveable capital income, income from agriculture and forestry, and even rental and other sundry income. Taxable income is thus calculated in several steps, each of which has its own deductions and reliefs. Different issues may arise within any given category.

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[1] See e.g. Haig H.M. , The Concept of Income – Economic and Legal Aspects, in R.M. Haig et al.: The Federal Income Tax, New York 1921, p. 7; Simons H.C. Personal Income Taxation. The Definition of income as a Problem of Fiscal Policy, 3rd ed. Chicago 1938, P. 90
[2] See OECD report, pp. 38, 39, 57ff, esp. 59; e.g. France, Germany, Belgium and Italy.

Regardless of the applicable taxation system, the question arises as to whether income categories may be influenced by the taxpayer. If such is the case, the taxpayer then has a significant strategic tool, which enables him to influence the type of tax levied. Sometimes, he may even be able to avoid taxation altogether.

In other cases, the taxpayer merely avoids international double taxation. There is hardly any type of tax which does not raise a categorisation issue, whether relating to income, to enrichment, to wealth or to a mere transaction. With respect to direct tax, we shall address more specifically the following cases : capital gains (section 1), real estate gains (section 2), retirement fund benefits (section 3) and, for companies, liquidation proceeds (section 4). As regards to transaction taxes, we shall examine the categorisation issues relating to enrichment resulting from an inheritance (section 5) or a donation (section 6).

1. Capital gains or taxable income ?

1.1 Current legislations

In most Western countries, capital gains on private movable wealth are less heavily taxed, whilst in some others (*Greece, Switzerland*), they are even entirely free of tax.

Several reasons are given to justify this relative privilege. The income generated by this tax is greatly reduced by its collection costs, and numerous implementation problems arise when one tries to determine its time basis. For instance, which capital losses would be deemed deductible ? Can they be carried forward, and if so, over how many taxation periods ? Should all type of capital gains be considered as one category or should there be a distinction between short, medium and long term gains ? In the latter case, which time criteria would be fair ? Should the sale of a major – or even a majority – shareholding be given the same treatment as the sale of an insignificant one ? Should the taxpayer with a few, isolated sales be treated differently from the taxpayer who effects major transactions, whether in terms of quantity, frequency or both ? As we shall see, the taxpayer's status may be taken into consideration on the basis of more or less measurable criteria. Lastly, on a very practical level, certain tax authorities stress the need to preserve the fluidity of the capital market in the face of international competition, thereby justifying the reduced or nil tax rate applicable to such gains.

The following are examples of jurisdictions where the tax rates applicable to capital gains are inferior to those applicable to other profits. Please note that draft amendments regarding this type of income are already under way in several countries.

In the *USA*, the following tax rates apply to individuals' capital gains : 20% for securities held for over 18 months, 28% for securities held between 12 and 18 months and 39.6% (standard rate) for securities held for a shorter period.

Furthermore, many regulations contribute to reducing, or even cancelling, tax charges : gains generated by a retirement fund (e.g. 401 k) are 100% tax free, gains on emerging securities held for over 5 years are partially tax exempt and the deduction of capital losses is widely authorised.

In *France*, the applicable rate is usually 26% (i.e. 16% plus 10% social contributions), as opposed to a maximum standard rate of 56.8% or even 66.8% (including additional levy). The first FRF 50,000.-- of capital gains were free of tax up to end 1998.
In *Canada*, capital gains are subject to a 37.5% tax rate, i.e. three quarters of the standard rate of 51%. Capital losses are, in principle, totally deductible over an unlimited period.

Among jurisdictions where local tax law differentiates between short term, so-called speculative gains and long term, so-called investment gains, we can cite *Germany* (shares held for 6 months, 2 years in the case of real estate investment companies) and *Spain* where the rate is reduced in accordance with the holding period. In the *United Kingdom*, draft budgets include rates ranging between 40% for short term gains and 24% for long term gains. In *Belgium*, although legislation provides for a maximum tax rate of 33% on short term gains, in practice this is rarely applied.

Furthermore, several tax systems will take into account the relative importance of the shareholding in a given company. In *Germany*, capital gains on a shareholding exceeding 25% at any time during the previous 5 years are treated as industrial and commercial income. In *Italy*, the new fiscal law, in force since July 1, 1998, distinguishes between qualified holdings in excess of 2% for quoted securities, and 5% for unquoted securities

Such gains are often only subject to tax once they reach a certain level. This condition may be cumulated with one of those listed above.
In *Great Britain*, each spouse is entitled to Sterling 6,800.-- tax-free capital gains p.a., in Ireland the tax free amount is Pounds 2,000.-- per couple. In Canada, several exemptions are allowed, for instance a principle exemption of max. Canadian dollars 400,000.-- for holdings in a small company.

Capital gains on the sale of securities are subject to tax treatments which vary according to the investor's status (whether resident or not, *for instance*), to the type of company (risk capital is often treated favourably) or its statutory registered office (local companies are privileged), to the type of shareholding (retirement plans are favoured) and to numerous other criteria, specific to each jurisdiction.

In *Switzerland*, capital gains derived from the management of private movable wealth are, in principle, exempt both from federal and cantonal taxes. However, individuals' assets are already subject to wealth tax at cantonal level. A first draft of legislation taxing capital gains derived from the management of private wealth was published, but shelved under the fiscal harmonisation legislation. At cantonal level, *Grisons* which was the sole exception, also modified its law. However, the 1996-97 rise of the stock market inevitably brought forth new projects. Furthermore, as we shall see, tax is levied on capital gains derived from a professional activity.

1.2 Tax strategy

From an exclusive point of view of tax strategy, the taxpayer should favour tax reduced or even tax exempt capital gains over interest or dividends both of which are added to his taxable income. He might therefore endeavour to sell his shares and bonds prior to the payment of dividends, respectively interest. However, caution will be required under certain legislations, especially when such transactions are effected systematically or otherwise resemble professional management. If shares are sold, attention should be paid to market movements subsequent to the distribution of dividends. In principle, prices should drop in accordance with the amount paid out. However, it is not unusual for prices to increase because of positive market expectations resulting in buying orders given from the first day when the share is traded ex dividend. It is essential that the taxpayer avoids taking only tax criteria into consideration as stock market evolution and brokerage fees resulting from such transactions must be taken into account.

Notwithstanding the above, tax treatment is a major factor in the individual taxpayer's investment choices. A taxpayer should attempt to ascertain the rate of marginal tax applicable to any additional income he generates.

Let us take for instance the case of a Swiss taxpayer with a marginal tax rate of 40%, who buys CHF 100,000.-- worth of bonds at 5% (i.e. that his last taxable franc is taxed at 40%), his return after tax is as follows :

Capital	100,000.--
Interest received	5,000.--
Less income tax on interest received (40% rate)	(2,000.--)
Balance, equivalent to a 3% return after tax	3000.--

In order to obtain the true return, one would need to deduct the inflation rate.
If we would now consider a 20% marginal income tax rate (instead of 40% as above), the return would be 4%.(i.e. interest received 5000.- minus 1000.- income tax).

It follows that the heavier the tax burden, the less advantageous it is to receive taxable returns. The taxpayer is thus encouraged to make his gains on shares or investment funds whenever such types of investment are less heavily taxed.

Another investment strategy consists of buying bonds traded at a low level because their nominal interest is below market level. The taxpayer receives a low (taxable) interest, while making a capital gain as the bond is refunded at par value upon maturity. To counteract this strategy, several jurisdictions have issued a series of regulations covering low interest investments ('LII').

In certain jurisdictions for example, the famous Luxemburg SICAV funds are not treated as shares but as investment funds. Qualified interests or dividends are therefore added to the taxpayer's income, even when it is not allocated. Upon redemption, parts in SICAV receive the same treatment as parts in investment funds.

In *France*, companies tend to reward their executives by granting them stock options, i.e. the right to buy shares of the company at a certain price, a right which the employee may not exercise before a certain date if he wishes to benefit from a privileged tax treatment. If the market value is higher than the price quoted at the time when the right was issued, the taxpayer makes a long term capital gain, taxed at a rate inferior to the maximum income tax rate (34.9% against 54% including CSG and CRDS). A further tax rebate may be granted on the purchase price of the shares. Capital gains tax on securities linked to options prior to September 20, 1995, amounted to 26% including CSG and CRDS. In *Switzerland*, the tax treatment of shareholder options is regulated by a circular dated January 16, 1996.

Certain multinational companies use "*phantom options*", i.e. shareholding schemes based on *stock options* and run by an offshore company.

In general, the financial market technicians try to combine several financial instruments, with a view to convert normally taxable income into tax exempt gains.

However, within the context of tax strategy, it may, under certain circumstances, be more advantageous for revenue to be qualified as ordinary income instead of capital gain. Although this occurs pretty rarely, depending on the applicable tax system, the taxpayer may benefit from reported losses (i.e. capital losses) or even expenses deductible under ordinary income tax. Moreover, in the event that his other income is subject to high levels of fluctuation, the taxpayer will try to even the rates by incurring capital gains or capital losses during the relatively advantageous tax periods.

2. Real estate gain, income or capital gain ?

Real estate gains are given special treatment under most tax systems. This is due to the fact that they are seen by the legislator as indicating the taxpayer's increased contribution capacity. Moreover, real estate gains are considered to be at least partly due to the State guardian of security and economic welfare. The tax on real estate gains is also, rightly or wrongly, perceived as being a fair tax, in particular because it helps fight speculation. This is why the detaining period is often taken into account to determine the tax rate. This type of tax offers several advantages : it is easy to levy (the transaction is usually registered in the land register) and benefits from a high level of return and flexibility.

In practice, tax treatments fall into the following categories :

1) Standard tax regime is applied in accordance with the commercial category of the real estate or the taxpayer's professional status;
2) Special tax liability exists only when real estate gain is incurred by a private person on a non commercial basis;
3) Real estate gain is subject to a special tax regardless of status or category.

The tax strategy will vary depending on the type of tax treatment applicable. The taxpayer may, to a certain extent, determine his status and the category of the real estate (commercial or private). However, he will need to assess carefully the consequences in terms of amortisation, of tax rebates linked to the detaining period, of gains assessment rules and of mortgage interest deductions. It is up to him to decide where he wishes to invest, thereby deciding on the tax treatment applicable. As a last resort, he may choose to forego investing in real estate : by keeping his assets liquid he would escape the tax on real estate gains altogether.

In certain countries such as *Switzerland*, all three systems coexist. At federal level, only the first method is used and commercial gains are added to taxable benefits. At cantonal level, nearly 50% of all cantons use the special tax method applicable only to private real estate gains. The remaining cantons use the last method, sometimes known as 'the Zurich system'. Commercial assets include all assets used either wholly or mainly for an independent profit-making activity.

Within the context of tax planning, taxpayers often try to change real estate gains into capital gains derived from securities. Instead of selling a property, they transfer it to a real estate company in the hope of selling the shares and incurring a low or nil tax liability.

In many jurisdictions, the tax authorities have attempted to counteract this strategy. They may for instance assimilate the sale of the shares to the sale of the property, thereby subjecting the gains to the special tax on real estate gains. This practice does, however, raise several difficult questions : first of all, it assumes that the transfer of shares is known. Should this be the case, further issues arise : what happens if only some of the shares are sold ? Which is the determining shareholding ? What is the treatment applicable to a hybrid company ? How is it possible to differentiate between a real estate company and a company with a fairly large proportion of assets in real estate ?

The status of the French 'société civile immobilière' (hereinafter "SCI") makes it possible to change tax categorisation. Shares of SCI owning real estate in France are usually considered as movable property.

This results, on an international level, in a transfer of tax sovereignty in terms of inheritance tax, since real estate is taxed by the jurisdiction of location whilst movable property is usually taxed at the deceased's last place of domicile.

Furthermore, it is easier for a French taxpayer to sell SCI shares than a building : he incurs less publicity and the transaction costs are lower (4.8% in 1997). Finally, donations to direct descendants are often simplified if property is held through an SCI. Interposing an SCI makes it possible, in certain cases, to lighten the tax burden through loans, by separating bare ownership from usufruct and finally by means of a *"donation-partage*". All these operations require careful planning and consultation with a French expert.

In some jurisdictions, real estate companies are given unfavourable treatment, for instance by means of particularly strict requirements in terms of loan-capital ratio. This increases the risk of double taxation for the real estate company, which can then be taxed at the level of the company and again at the level of the shareholders, who may be disallowed from maximising deductible interest by granting disproportionate loans.

Certain jurisdictions impose a special tax on real estate companies. Classic examples are France, where real estate held by offshore companies are subject to a 3% tax, and Spain, where the former 5% tax rate was recently reduced to 3%. In *Switzerland*, this special tax is justified by some cantons on the basis that such companies are exempt from real estate transaction taxes.

3. Retirement fund income or ordinary income ?

Most jurisdictions encourage retirement schemes, but the means vary depending on each particular tax system. In some cases, premiums are tax deductible, in others, the tax rates applicable to insurance payments are low, or nil. Often both approaches are combined.

Within the context of tax planning, the taxpayer will address the following issues : should he receive remuneration (salary or fees) as well as wealth returns in the form of ordinary income, taxable as such, or can he try to change them, short or long term, into retirement fund payments ?

Depending on the jurisdiction, merely changing the category of payment can either result in its partial or whole tax exemption, or subject it to a special tax.

Swiss legislation often makes it possible to convert a taxable return into tax exempt insurance income. With regards to single premium life insurance policies, any payments made to the insured upon maturity or in case of redemption, are tax exempt, provided the contractual relationship lasted at least 5 years and the insured is over 60 years old. A 55 year old taxpayer investing his savings into such an insurance can freely dispose of them 5 years later without being taxed on any benefits. By way of comparison, if he were to manage his wealth in the usual manner, the interest and dividends would be added to his taxable income, or he would need to transform his income into capital gains on private movable wealth, with all the accompanying risks, in order to avoid tax. However, tax authorities would probably no longer agree upon such a tax privilege if the taxpayer has reached the legal age of retirement when he paid in his premium.

4. Liquidation proceeds or ordinary income ?

It is true that a company has more leeway to determine its taxable income. It must, however, comply with the provisions of civil law and in particular produce a balance sheet in accordance with commercial regulations and practice. Arbitrary categorisation of given transactions or elements on the balance sheet for purely fiscal motives could jeopardise creditors or shareholders (in particular minority shareholders) and result in legal proceedings.

Building up reserves is authorised, and even encouraged by the legislator. It is important to distinguish between reserves under commercial law and under tax law. The first are encouraged by the legislator in order to protect the creditors. They are built up when part of the commercial assets are not given their true value, or are not given any value in the balance sheet, or when liabilities have been overvalued. In principle, such reserves are taxed under all systems. However, the tax authorities meet with several problems when trying to assess reserves : should capital or real estate gains be taxed on being recorded in the books of the company or prior to realisation ? Most jurisdictions will not do so and this is how latent fiscal reserves come to exist. Similarly, which amortisation rates are acceptable to the tax authorities ? In other words, what is the actual depreciation of that particular asset and what will be its residual value at a given time in the future ? Here again, the tax authorities often have to accept more or less loosely determined forfeitry rates, which give rise to more latent fiscal reserves. To quote another example : there may be a case where provisions need to be made to cover a risk, the extent of which has not yet been determined. Such provisions will necessarily be fixed subjectively, once more leading to fiscal hidden reserves.

The tax authorities will accept these various reserves as they do not evade taxation altogether; taxation is only deferred until such time as the company is either sold or liquidated. The taxpayer may sometimes postpone the tax burden for long periods of time. Depending upon the applicable legislation, by deferring tax until the company is liquidated, he can modify the category of tax due : the annual tax on profits is converted into tax on liquidation proceeds.

Within the context of tax planning, the taxpayer must address the following issues :

What is the margin available in terms of building reserves ?

Is ordinary, immediate taxation heavier than tax due on eventual liquidation proceeds ? In this respect, the taxpayer will take into consideration the interest rates obtained by postponing the payment of tax. As is always the case in situations where a comparison is made based on factors that will only be known in the future, the answer is never definite.

In *Switzerland*, liquidation proceeds are treated differently under each tax system. The federal tax authorities, and numerous cantons have created a special tax to which the usual rate is applied. A reduced rate is granted in some cantons while some others use a degressive rate depending on the number of years of existence of the business. Depending on the circumstances, a liquidation may prove tax advantageous.

5. Inheritance or ordinary income ?

In view of its importance in the case of individuals, we shall examine the categorising of income in the context of inheritance tax.

In most countries, wealth transfer in the event of death is subject to a special tax. This type of contribution has an old tradition. In Roman times, a 5% inheritance duty existed. It was justified by the fact that the state acted as a provider of services by maintaining the estate for the benefit of the heirs, ensuring its proper transfer and even helping with its allocation. However, as time went by, these duties increased dramatically and turned into genuine taxes on wealth transfer. Sometimes, this type of tax expressly aims to avoid concentration of wealth.

In several jurisdictions, the inheritance tax rate varies depending on the degree of the relationship between the heir and the deceased, and on the value of the estate. Regulations vary greatly from one jurisdiction to the other. Generally, inheritance tax is high when the value of the inheritance is high and the heir (or legatee) is a distant relative of the deceased. The following rule of principle applies : whenever inheritance is taxed at a higher rate than ordinary income, social charges included, it is more advantageous to categorise it as ordinary income.

For instance, and especially in the case of non family beneficiaries, the estate planner could consider paying a salary (social contributions included) or even fees based on a agency contract , instead of making a donation. However, in some jurisdictions, severance indemnities in favour of servants are either tax exempt or subject to low tax rates. In some jurisdictions, the taxpayer could also consider a retirement fund in favour of such employees, which is often a particularly tax advantageous solution.

It goes without saying that planning should be part of a global strategy. Not only does the estate generate a tax liability, the beneficiary himself is subject to a periodic and ordinary tax once in possession of his share of the estate. The beneficiary's marginal tax rate should therefore also be taken into account and compared with that of the donor.

Depending the applicable legislation further special considerations apply to couples who manage a business, since the death of one spouse may lead to the liquidation of matrimonial property. It may therefore be advantageous to define the property status of certain assets or elements of income by means of an appropriate marriage contract.

The settlor should also examine the consequences of insurance planning. Depending on the legislation of the deceased's last place of domicile, single risk insurance benefits (the risk being death) may be treated as income, thereby escaping inheritance tax.

6. Inheritance or gift ?

This alternative is mainly considered within a given family, where the choice is between a final gift and an advance on the estate. In the latter case, the assets, or their counter-value, shall be returned to the estate to determine the share of each heir.

Logic prescribes that gifts receive exactly the same tax treatment as successions, failing which it would only be too easy for the taxpayer to avoid inheritance tax by effecting major donations prior to his death. The respective legal dispositions are generally in harmony and applicable tax rates similar. However, tax neutrality is defeated on several counts :

1) First of all, by definition, a gift is made prior to the settlor's death; tax planning is recommended in the event that tax rates change in the intervening period. The usual assumption is that succession rates will increase.

2) Similarly, if the taxpayer expects an increase in value of part of his assets, making a donation of that part prior to said increase enables him to reduce his tax liability. It will, however, be necessary to examine the consequences of a donation on other taxes (e.g. wealth, capital gains and income tax) and compare the marginal tax rates to be borne by donor and beneficiary.

3) Prior to any change of domicile (whether intercantonal or international), it will be advisable to compare the respective inheritance and gift taxes. An extreme comparison shows that it is preferable to make a gift to one's companion while domiciled in the Swiss canton of *Schwytz* (where there are neither inheritance nor gift taxes) than to die in *France* and leave her lumbered with an inheritance tax often in excess of 50%.

4) Where a taxpayer owns property in different countries, the admission and possible international division of debts may either generate traps or opportunities. Despite favourable dispositions, either under local law or under

double taxation treaties, the division may prove disadvantageous for the taxpayer owning real estate in high tax countries. This is especially the case when the location of the property determines the rate in terms of inheritance tax, whilst debts are allocated on a *pro rata* basis between the countries (or Swiss cantons) involved in the succession, namely the country where the deceased was last domiciled and those where he owns real estate.

The situation changes totally in the case of a gift, because gift tax is calculated on the value of the property after deduction of all related expenses and debts. It follows that, if a property is located in a country where succession tax is high, the taxpayer may have an interest in taking on as many mortgages as possible and in making a donation during his lifetime. The subsequent gift tax is bound to be less than the succession tax incurred in the absence of estate planning. The mortgage will provide liquid assets which will be taxed at the domicile of the deceased in the event of his death.

5) Depending on the local jurisdiction, a taxpayer may make a gift in the form of an interest-free loan. On the economic level, waiving interest is an economic advantage and may be assimilated to a gift. In some jurisdictions, waiving interest is assumed if the loan is private. If the borrower, for example a close relative, can make these funds profitable, his marginal tax rate should be compared to that of the donor on the same profits.

   The donor may of course state in his will that the debtor receives the debt as a bequest. Upon the donor's death, debtor and creditor are therefore one and the same person and the debt is automatically extinguished.

6) Anticipating or postponing the payment of tax creates further tax planning possibilities.

7) In *France*, succession tax cannot be deducted from the estate. However, gift tax may be deducted if the donor decides to pay it himself, so that taxable estate is reduced accordingly. Since the rates for inheritance and gift taxes often soar to 60%, a donation may represent a significant advantage over a bequest, since the legatee will end up with 62.5% after tax and the donee 40%.

   In *Belgium*, a manual gift, also known as "*Handsel*" is commonly used in order to minimise tax liability. A manual gift must be made three years prior to the donor's death, failing which it must be reported and will be subject to inheritance tax. It must bear a fixed date binding on the tax authorities. Belgian taxpayers have developed several techniques to ensure that this type of gift is recognised by the tax authorities.

   Some Belgian taxpayers were encouraged to transfer their property into real estate companies with a view to effecting the *Handsel*.

In *Great Britain*, the rate applicable to inheritance tax can be as high as 40%, whereas taxable gifts are taxed at 20%. Furthermore, it is relatively easy to make tax exempt donations.

In the *United States*, tax exempt donations are limited to USD 10,000.-- p.a.

Undoubtedly, the choice between gift and succession is a major planning tool for many taxpayers. The incidence of civil law dispositions will also require careful consideration, for instance in the case of a beneficiary pre-deceasing the donor; what tax rate applies to a possible right of return ? Also, in the case of international settlements, one should examine the consequences of the foreign applicable law.

As we shall see in Principle 8, close relatives may receive intermediate forms of benefits : the donor may retain a right of usufruct or occupation, or else specify that an annuity should be paid to him.

Conclusion

A double entry table could be drawn, where the column and row headings include the different categories of taxable assets, indicating the possibilities to influence the income category.

Figure 1. Influencing the categorisation of taxable income : tax consequences.

CATEGORISING INCOME	ordinary	real estate	Liquidation	retirement fund	inheritance	donation	sundry
ordinary							
real estate							
liquidation							
retirement fund							
inheritance							
donation							
sundry							

The size of the table would vary depending on the idiosyncrasies of each tax system, because income subject to special tax treatment must first be categorised in accordance with legal provisions and, often, defined under jurisprudence and the tax authorities' practice. Income categories could include lottery gains, severance or professional relocation indemnities, seniority and other bonuses. In each case, the taxpayer could maximise his ability to recategorise while remaining within the limits of legality.

The categorising of taxable items sometimes depends on the category of the taxpayer, which leads us to principle 2 which deals with the taxpayer's status.