Principles 8 and 9

Splitting or merging taxable objects or subjects

Introduction

Through demerger, taxable objects or subjects may be split into two of several, separately taxed, parts. Conversely, taxable assets or subjects may be united through merger.

These strategies are common in company taxation and often occur in combination : demerged businesses uniting with other businesses. However, they may also be of interest to individuals, in the sense that their income and wealth can be taxed in separate units rather than in one block.

Such a strategy may be implemented within one given jurisdiction and tax system, in which case it is usually used to obtain a better progressive tax rate, the classical objective being to change an income with a high progressive tax rate into two or several incomes subject to lower progressive tax rates. Sometimes, demergers aim to create a taxable income subject to different tax treatments or jurisdictions. Depending on the circumstances, it may be advantageous to combine demergers with tax postponement, for instance in the case of a taxpayer enjoying an exceptionally high income, but for a limited period in time.

Options available to individuals and companies shall be examined separately.

PRINCIPLE 8 – SPLITTING TAXABLE OBJECTS OR SUBJECTS

1. Individuals

1.1 <u>Separate spouse taxation</u>

First of all, we would like to point out that the purpose of this section is not to advocate divorce on fiscal grounds ! In a global perspective, not only would direct taxes require consideration, but also inheritance tax, where rates applicable to non family members are usually extremely high. Non-married couples also find themselves at a disadvantage in other major areas such as retirement or health planning.

Nevertheless, in many jurisdictions, married couples are considered as one entity. Since spouses are not subject to separate taxes, their incomes are added for tax purposes. The legislator does his best to counter the resulting inequalities

At one end of the range, some jurisdictions apply a separate taxation system, whereby both spouses' incomes are added, then divided in order to determine the applicable tax rate. Splitting is deemed partial when the determining dividing factor is not 2, but a fraction.

Another method consists in admitting a certain deductible amount for couples, or even a given percentage of their income. In that case taxable income is not reduced only in order to determine the applicable tax rate.

One could also imagine a deduction commensurate with the amount of tax due, or else the creation of a family ratio. Finally, another practice, very common in Switzerland for example, is to institute separate rate bands. Married and single taxpayers are subject to different tax rates. This system is often found in combination with other methods described earlier in this chapter.

From a tax planning perspective, always depending upon the applicable jurisdiction, postponing or bringing forward the date of the wedding, divorce or legal separation, be it only by a few weeks, may result in considerable tax savings.

1.2 Special indemnities and retirement fund payments

It is in such cases that splitting of taxable income is particularly closely linked to the postponement of tax.

In *France*, separate taxation also occurs when French taxpayers are paid directors' fees for attending board meetings held by their group's foreign subsidiaries. Depending on the tax laws of the foreign subsidiary's registered office, total tax exemption may apply.

Another splitting technique which may be used in *France*, is the bonus, calculated on a daily basis, and given to a salaried employee on a foreign assignment. Originally, it was an allowance to cover costs incurred during the stay abroad. Over the years, it became a bonus, free of income tax but subject to limiting regulations by the tax authorities.

In *Switzerland*, the payment of capital retirement funds should be carefully planned. A taxpayer about to become pensioned has a certain operating freedom, since the product of the so-called “*second pillar”* pension (employer and employee contributions) is paid out in accordance with the regulations of the retirement fund, i.e. generally at the age of 65. The so-called “*third pillar* “(3a) may be cashed in as early as between 60 and 65. One strategy consists of separate capital payments, thereby avoiding cumulation which, depending on the jurisdiction, may generate a tax liability with a high progressive rate.

Depending on the jurisdiction, special bonuses may be paid in the form of an allowance, compensation for relocation, golden handshakes, etc. The splitting technique which allows for separation between bonus and ordinary taxable income will consist of monitoring the bonus category, or even its time for payment.

1.3 Estate planning

In view of the ageing population, inheritance tax is bound to become an increasingly important element of tax planning strategy. Strangely, it would appear that continental taxpayers rely more heavily on the State than Anglo-saxon populations, for whom the protection of family wealth clearly includes estate planning.

In this respect, the splitting principle represents a major strategic tool. In the case of several heirs, the deceased's wealth will obviously be divided by the tax authorities at the time of succession. Even if the heirs decided to keep the inheritance undivided, they would incur individual tax liabilities : their share of the inheritance is added to their taxable wealth - if any - and the income derived from said share to their ordinary income. However, the fiscal consequences of the ensuing wealth and income increase is different depending on the marginal progressive rate applicable to the heir prior to the time of succession. Henceforth, from a purely fiscal perspective, it is possible to reduce the global tax burden by taking into account the likely evolution of each heir's financial situation. The donor could for instance calculate the expected tax consequences for each situation. To illustrate, let us take two simplified examples :

a) in the event that the heirs' respective financial situations vary greatly, should the donor privilege the less wealthy by speculating on their never reaching the maximum rate, instead of allocating assets to an already wealthy heir, plagued by a high progressive tax rate on his wealth and on the related income ?

b) Conversely, if all heirs enjoy similar financial situations, should the donor split his estate into equal parts to prevent any single heir from reaching the maximum progressive tax rate ?

It goes without saying that reality is made of several intermediary variations, the tax implications not being the most important criteria.

Further scenarios can be considered. It might be advantageous to skip a generation to enhance the effectiveness of splitting taxable income. In most continental jurisdictions, whenever this amount exceeds the freely disposable share of the estate, it may only be taken in full consultation with the children, who may then agree to renounce their legal entitlement. In practice, they will often agree to renounce their share of the estate, either totally or in part, in favour of their own children, especially in cases where they are mature and free of financial worries. The following illustrates a generation skipping case.

Mr and Mrs X, both 75, have two children, aged 50 and 53, respectively. Both children are professionals with stable career situations. Their private wealth will suffice to cover their old age and they have an insurance portfolio to cover potential disasters. The donor could therefore allocate the disposable share of his estate to his grandchildren without even seeking the agreement of the heirs entitled to a legal share of the estate. Another option, whereby the surviving spouse is given the usufruct of the children's share, will be examined below. In that case, the bare owners are the children.

In planning their estate, donors are advised to take into account the possibility of a predeceasing grandchild, to carefully assess each heir's situation (starting with the donor's spouse) and to study the risks entailed by possible economic or legal changes. A generation skipping transfer is subject to varying taxes depending on the jurisdiction. In most states of the *USA*, additional tax is due as this is assimilated to a double devolution. It is therefore essential to study each case individually.

In many jurisdictions, a common planning technique consists of splitting the estate into usufruct and bare ownership, as expressly stated under article 473 CCS in *Switzerland*.

Usufruct may be an excellent option from a fiscal point of view. Let us take the case of an old couple with children : upon death of one of the spouses, the other is made a usufructer, the children becoming bare owners. Under many legislations, the extinction of the usufruct right upon death of the surviving spouse does not generate any tax liability, whereas if the surviving spouse had fully inherited, certain tax authorities would levy inheritance tax twice : firstly at the time of devolution between spouses, secondly at the time of transfer from the surviving spouse to the children.

Moreover, the donor may already effect the split during his lifetime, for instance by giving the bare property to his children while reserving the usufruct. Often in such a case, the only tax levied is gift tax, based on the value of the bare ownership. Tax on the usufruct will be calculated either according to the donor's life expectancy or to a sliding scale pursuant to the relevant law.

Another splitting method consists of making a donation of a property while reserving a lifetime right of occupancy, the value of which will be based on an annuity capitalised in function of the beneficiary's life expectancy. In some jurisdictions, a right of occupancy changes the attribution of tax liability. The donor's taxable wealth is reduced by the value of the encumbered asset, whilst the related income and charges are transferred to the owner encumbered with the right of occupancy.

In *France*, setting up a usufruct is also a way to split taxable items. A taxpayer could thus grant bare ownership of all or part of his assets while retaining the usufruct. Only the bare ownership transfer will be subject to tax. Furthermore, the donor will not be liable to any tax on the capital gains subsequent to the donation. This transfer could also be combined with either another split or a *“donation-partage”*, as for instance when a wealthy spouse makes a tax free donation to the other, and both spouses then make a donation in favour of their children, thereby maximising deductions.

Real estate will often be held through a real estate company (SCI). In the above mentioned case, parents would transfer their property into an SCI, while expressly reserving their rights to usufruct. The assessment criteria applicable to usufruct are more flexible than in the case of gift tax. Then, the parents would give SCI shares to their children and claim the usual deductions (FF 300 000.- for each children per spouse).

A taxpayer could also subscribe a life insurance whereby, upon redemption, the contract would be split into "a usufruct" and bare ownership. The spouse will usually be the beneficiary of the usufruct, thereby avoiding inheritance tax, while reserving the right to manage and use the capital (cf. art. 587 CCF). Bare owners, namely the couple's children, will only have a claim on the amount in capital.

In *Belgium*, inheritance tax rates vary between 3 and 80%, depending on each heir's relationship to the deceased and on the amount inherited. Please note that, in that country, the extinction of a usufruct does not affect inheritance tax or transfer duties.

In the past, creating a trust has been useful to achieve a tax effective split of income in the *United States*. A parent could set up a trust in favour of each of his children, thus reducing his assets in proportion with the value of the assets transferred in trust. Income tax reduction occurred as a result of the splitting of wealth into several settlements. In principle, to avoid tax liability on the trust income, the grantor could waive his powers, which he could nevertheless retain fully via an intermediary offshore company and without incurring any tax liabilities.
The American tax authorities therefore effected fundamental changes in the taxation of the income distributed by these trusts to American taxpayers. Hence the trust's cumulated income was treated differently and heavily taxed. Tax planning through trusts requires the know how of an American tax expert, since further legal changes seem to be on the agenda.

Again in the *United States*, an estate may be advantageously split between spouse and children. Since spouses are not subject to inheritance tax and children can inherit up to USD 550,000.-- free of tax (in 1998), each spouse should make his children benefit from full tax exemption, for instance by preserving each spouse's exemption. It will therefore be important to avoid that the whole estate first goes to the surviving spouse and then to the children. Each spouse will therefore name his children as his heirs, together with the other spouse. The remaining spouse's interests may be preserved by setting up a credit shelter trust (to which the children's share is transferred) in case he or she should ever need the money.

Finally, at the time of printing, the free gift trust is still an American institution. This trust can effect a maximum of three distributions of set amounts, in favour of either one or several nominated beneficiaries. Such distributions are tax free, since the tax authorities do not levy any tax on accumulated profits. However, this does not reduce inheritance tax liability.

2. Enterprises

2.1 <u>Transfer to a legal entity</u>

The transfer by a taxpayer of some of his assets to a legal entity is an important income splitting method. The company must be taxed separately from its shareholders. However, this type of operation is only advisable when several conditions are fulfilled. First of all, the separated assets should not generate a tax burden in excess of the original block of assets. Calculations may be difficult and they are always partly based on speculations. This is because a legal entity is usually subject to tax regulations which are quite different from those applicable to individuals. The degree of uncertainty increases with the planning period. Also, transactions between the original owner and the legal entity may generate unpredictable tax consequences. Finally, if the structure is deemed inappropriate, the tax authorities might be entitled to reduce or cancel the benefits expected from the split.

Let us assume a situation where the holder of an operating company has a high tax liability as a result of his commercial income being added to his private income. Regardless of other factors, it may be advantageous for him to transfer his commercial assets into a limited company, so that commercial income is linked to a separate entity. Depending on the jurisdiction, the resulting global tax burden (company tax liability added to the owner's individual liability) may then be inferior to the original one. The owner will only be taxed on the basis of his private income (e.g. investment or rental income). He will often receive a salary, or even interest or rental income from the company. These payments will, in principle, be deductible by the company. However, the tax savings resulting from the split decrease in inverse proportion to their importance. Even worse, if payments are made in the form of dividends, or if the tax authorities qualify them as hidden profit distributions, the taxpayer may suffer economic double taxation. However, he is under no obligation to effect such distributions and may, at will, postpone the latent related tax charge and choose to realise it during a favourable period, for instance when marginal progressive tax rates are lower.
In the event of the sale of shares, the buyer will only rarely take this latent charge fully into account when calculating the purchase price of the shares.
The situation is different in countries where systems exist to avoid dual economic taxation. This applies to most OECD countries, especially *France* where tax credit amounts to 50% of shareholders' distributions, to be deducted from their tax liability.

A transfer to a legal entity may also be advantageous if it occurs prior to the taxpayer's emigrating to another country.

Careful consideration is required when envisaging a transfer of part of one's assets to a *Liechtenstein* family foundation, since it could generate gift tax liability, for which the rates vary depending on the law of the country of residence of the founder. Also, several jurisdictions do not acknowledge the legal validity of such a foundation, which is then deemed transparent for tax purposes, the foundation's beneficiary being taxed as if he was the legal owner of the assets. Furthermore, there is an increasing tendency to institute an obligation to declare all assets held abroad, whether directly or indirectly, any violations incurring penal sanctions. Such considerations also apply to trusts.

It is therefore essential that the transfer results in a true property transfer. The probability of a trust being seen as valid increases (a) if the trust is discretionary, (b) if the trust is irrevocable and (c) if the settlor, or even his spouse or minor children, are not beneficiaries.

Similarly, the *Liechtenstein* family foundation should not appoint the founder, whose instructions should not be binding upon the directors of the foundation. In many jurisdictions, it would be advisable to submit the matter to the tax authorities in order to ascertain the tax treatment.

2.2 Demerging enterprises

2.2.1 Two or several independent companies

For many, non-fiscal motives, the founders of a company in the process of creation may wish to carry out their activity through several entities, thereby creating an incidental split of the taxable elements, the consequences of which should be carefully assessed.

More often, an existing company can be set up in another jurisdiction. If the company creates a branch, the tax liability, if any, of the latter's permanent establishment will be restricted pursuant to the applicable double taxation treaties.

From a fiscal perspective, splitting taxable items is particularly useful to ascribe transactions to tax advantageous jurisdictions, to use several jurisdictions in competition and reduce the dependence on a single jurisdiction, to obtain generous loss reports, to generate transfer prices and to invoke double taxation treaties.

2.2.2 Ordinary company –v– real estate company

In this context, an ordinary company means a company carrying out a commercial, craft or industrial activity and subject to the companies' standard tax rate.

Some companies are subject to special tax regulations as a result of their activities. We shall study the most common : a real estate company. As seen earlier, the sale of all or part of the shares of a real estate company may, under certain jurisdictions, be assimilated to the sale of the property itself.

Two hypotheses may be envisaged :

- The real estate company is treated as such, regardless of its non-property activity. By splitting the activity into two companies, one real estate, one ordinary, the latter could become subject to normal taxation.

- Despite its ancillary real estate activity, the ordinary company is taxed as an ordinary company. Splitting the company would mean that the ancillary activity will be subject to the special real estate company tax status.

Tax considerations matter especially in the first hypothesis. In the second, creating a real estate company is rarely tax advantageous, unless it is part of an appropriate structure. The taxpayer will instead endeavour to reduce the value of his business with a view to a transfer *inter vivos* or in the context of succession planning, where it is sometimes essential to transfer property into a separate company.

Both businesses will often retain close links : one company may rent the other's premises, as in the textbook cases of hotel or storage companies.

2.2.3 Holding company –v–ordinary company

The above considerations also apply to the split between an ordinary company and a holding company.. In practice, the former company often acquires shares in other companies in the course of its activity. Such investments may either be strategic or correspond to investments of non-distributed profits. Both can generate unfavourable tax treatments, especially in jurisdictions where private capital gains are tax exempt whether commercial capital gains carry a tax liability.

Several tax systems reduce the tax liability of holding companies under more or less restrictive conditions. A holding company may also acquire shares in the ordinary company, thereby becoming its parent.
In practice, the most common cases are those of the real estate and the holding companies. A split of a business could be considered whenever a particular activity is linked to a specific tax treatment in a given jurisdiction. This may be in the form of a tax privilege granted to activities related to the protection of the environment, high technology or medical objectives. A company may also decide to demerge in order to develop its activity independently in locations where it can enjoy a tax holiday or tax rebates linked to a given geographic location.

Conclusion

The principles studied in this chapter are frequently applied to fields other than direct taxes. A demerger may thus allow for savings on VAT or custom duties by multiplying the number of small, tax free transactions.

Finally, let us recall that splitting taxable items is often found as part of a global tax planning exercise which combines different strategies, including postponing the tax liability of one of the parties to the split, maximising deductibles or even obtaining full tax exemption, relocating the taxpayer or the taxable income into another jurisdiction.

PRINCIPLE 9 – MERGING TAXABLE SUBJECTS OR OBJECTS

Two taxable items or two independent taxpayers are merged into one. Although the choice is limited in the case of individuals (section 1), businesses (section 2) may include this merging technique in their tax planning strategy.

1. Individuals

Under many tax systems, couples are taxed on their cumulated income. The family, including minor children is then taken as an economic entity and taxed as a whole.

As a result, marriage usually represents a disadvantageous merging of taxable income. However, as seen earlier, legislations offer various methods to lighten the tax burden.

Exceptionally, merging can result in tax savings, given that progressive tax rates stop progressing once a certain level is reached.

In *France*, under the "*family ratio*" system, each taxpayer's spouse and dependants represent one or several shares to be deducted from taxable income. To illustrate, income will be divided by 2 for a couple, by 2.5 for a couple with one child or by 6 for a couple with 5 children. The shares increase in case of invalidity, whether suffered by the spouse or by a child. Conversely, any children's income is added to the taxpayer's taxable income, which results in a rapid upward progression of the tax rate. However, the taxpayer enjoys several further benefits : he receives a fraction of additional shares; he is entitled to a tax rebate if the child goes to school and the calculation ceilings applicable to several tax rebates are raised; moreover, rebates are also granted when calculating housing tax.

From a succession point of view, the French community of property clause with attribution to the surviving spouse is advantageous for spouses. The tax authorities consider that both spouses own the assets in common, so that the death of one of them does not generate inheritance tax liability.

A life annuity contract is another form of asset merging, whereby co-contractors decide that the survivor is sole owner of the assets, starting from the date of purchase. As a result, the assets – often real estate – escape the inheritance law upon death. Used cautiously, a life annuity can permit tax savings, especially for common-law couples. However, the tax privilege only applies to the main residence purchased jointly up to a value of FRF 500,000.--.

In *Germany*, the family ratio only applies to spouses. A deduction per child (DEM 6,264.—in 1997) is admitted. After dividing the parents' joint taxable income by two, the rate of tax is calculated and applied to the income. In a progressive tax system, the overall tax charge is reduced when the spouses belong to different income tiers.

In many Anglo-Saxon jurisdictions, joint ownership often applies to a bank account which is then directly transferred to the co-tenant upon his partner's death. Assets are therefore merged. Joint ownership is used not so for tax saving reasons than to avoid the lengthy and costly probate procedure applicable in the event of death.

2. Enterprises

Merging can take different forms : absorption, pure merger (two companies disappear and a new entity results) or quasi-merger (both companies remain in existence under a holding company). Such restructuring measures are dictated by economics. However, the tax aspect needs to be taken into account, at least incidentally, since it can, under certain circumstances, lower costs, for instance by reducing the marginal tax rate. This is the case when a flourishing business absorbs a loss-making company. Depending on the fiscal strategy, a merger can even extend the postponement period applicable to losses.

2.1 Liquidation of a legal entity

In the context of an international group, it can be advantageous to liquidate one or several subsidiaries to change them into branches, agencies or mere representative offices. This partial merging of taxable assets can give rise to various tax benefits : better use of double taxation treaties, transfer of losses to the company's headquarters, avoiding withholding tax and even sometimes improved indirect taxes.

Conclusion

Mergers are seldom used mainly for tax planning. For individuals as for businesses, the tax aspect is usually a result rather than a cause of said operations.