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INTERNATIONAL EXPERIENCE IN TAXATION FRAMEWORK

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ABOUT ARTICLE

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Abstract: While employment is an activity exclusively engaged in by individuals, business and investment activities may be engaged in by individuals or legal persons. Consequently, the rules for taxing income from business and investment cut across the taxation of individuals and legal persons. Countries with separate tax laws for individuals and legal persons need to coordinate the rules for taxing business and investment income, even though these may not always be uniform. Regardless of the overall design of the income tax, it is common to provide special rules for taxing business or investment income. These rules primarily relate to the tax base, timing of the recognition of income and deductions, and collection of tax. By far the most important are the timing rules. Particularly in the business context, these rules must negotiate the difficult terrain that bridges financial accounting and taxation. While uniformity between tax and financial accounting may seem desirable, countries have adopted quite different approaches: some countries have achieved substantial uniformity; in others, tax and financial accounting are substantially independent.

INTRODUCTION

The characterization of an amount as business income is important in both scheduler and global income tax systems. Under a scheduler system, it is common for separate taxes to be imposed on employment, business, and investment income. Consequently, the characterization of an item of income determines which tax regime applies to it. Under a global system, there is often a notional scheduler breakdown of

income types under which business income is specifically mentioned as a type of income that is included in gross income. Even if the notion of income is completely global, special rules, particularly tax accounting rules, may apply to business income. Other types of income derived by individuals may be calculated using different rules. The starting point in determining whether an item of income is business income is to determine whether the activity giving rise to the income is properly characterized as a business. This issue is considered first below, followed by a discussion of inclusion rules related to business income. The third topic covered in this section is deductions for business expenses.

In the absence of a definition in the income tax law, the term "business" will have its ordinary meaning. In broad terms, a business is a commercial or industrial activity of an independent nature undertaken for profit. The concept of a business may overlap with the notion of employment for tax purposes. Whether this is the case will depend on the definition of employment that is included in the law. For administrative reasons, employment should be defined for income tax purposes to include all continuing service relationships where most or a significant part of the service provider's income is derived from one customer and that income essentially represents remuneration for the service provider's labor. This will include some independent contractor relationships (i.e., relationships that are within the ordinary meaning of business). Where employment is defined in these broad terms, the definition must be coordinated with the definition of business so that the same economic activity is not characterized as both a business and an employment for income tax purposes. This could be achieved by providing that a business does not include an employment.

Two basic models are used to determine the taxable income arising from business activities (referred to as "taxable business income") of a taxpayer for a tax period: the receipts-and-outgoings system and the balance-sheet system. Under the receipts-and- outgoings system, generally used in common law countries, the determination of taxable business income is based on the calculation of all recognized income amounts derived by a taxpayer in the tax period and all deductible expenses incurred by the taxpayer in the tax period. Under the balance-sheet method, common in many European civil law jurisdictions, taxable business income is calculated by comparing the value of the net assets in the balance sheet of the taxpayer at the end of the year plus dividends distributed by the taxpayer during the year with the value of the net assets in the balance sheet of the taxpayer at the end of the previous year. A positive difference constitutes taxable business income, while a negative difference is a business loss. While the two models may sound quite different, in practice, they are similar in many respects. In theory, the starting point for the balance-sheet method is the taxpayer's financial accounts, while the receipts-and-outgoings system starts with gains and expenses that are recognized for tax purposes. In practice, however, most taxpayers in receipts-and-outgoings regimes use accounting records of commercial profits and losses as a starting point to show gross income and expenses. The recorded income and outgoings are then adjusted as necessary to reflect the differences between tax and commercial accounting rules. Similarly, while the balance-sheet method explicitly commences with commercial accounting records, these must be adjusted to reflect differences between tax law and commercial accounting practice. In some circumstances, the two systems may yield the same determination of taxable business income. Not all business taxpayers are required to compile comprehensive accounting records that include balance sheets. Accordingly, in jurisdictions that use the balance-sheet method to calculate taxable business income, smaller businesses operated by sole traders and self-employed persons (particularly those that account on a cash basis) may be allowed to

calculate income as the difference between taxable receipts and deductible expenses. The relationship between the determination of business income for tax purposes and financial accounting rules is analyzed in detail in the appendix to this chapter. Those materials note that the principal purpose of financial accounting is to provide an accurate analysis of the profitability of an entity to the managers and owners of an entity, as well as to creditors and potential outside investors. Income tax, in contrast, is concerned with the measurement of the net economic gain of a taxpayer in a fixed period for the purpose of collecting a portion of the gain as tax. These differences explain why classifications used in one system may not be relevant to the other. For example, because financial accounting is concerned with presenting owners, creditors, and investors with an accurate reflection of the ongoing profitability of an entity, it places some emphasis on classifying gains by reference to their regularity. Distinctions of this sort that are drawn for accounting purposes are generally not carried over for tax purposes in jurisdictions that use the balance-sheet method of calculating taxable income. The accounting distinctions are, however, relevant in some jurisdictions that use the receipts-and-outgoings method of determining taxable income.

A second area in which financial and tax accounting rules differ is the treatment of income to which a future liability may attach or income that is related to goods or services to be provided in future years. This difference is relevant to both methods of determining taxable business income. Financial accounting uses a variety of means to ensure that the calculation of income does not present a distorted view of true long-term profitability when a taxpayer’s right to retain income is contingent on the provision of goods or services in the future or is otherwise associated with potential future liabilities. Income tax rules, by way of contrast, are not as concerned with qualifying or deferring recognition of income for the purpose of noting the taxpayer's future obligations. Instead, they tend to recognize income when the taxpayer has command over the gain, while deferring recognition of the consequent obligation until it is actually satisfied. The relationship between tax and financial accounting is important in the design of income tax rules in developing and transition countries. These two types of jurisdictions differ from each other in key respects in terms of their financial accounting systems, and both types of jurisdictions differ again from industrial countries. Most developing countries have relatively comprehensive financial accounting rules, usually based on the systems of one or more of the member countries of the Organization for Economic Cooperation and Development (OECD). In many cases, however, local accounting rules have not evolved in line with changes in industrial countries that were adopted to reflect changes in commercial practice. A different situation exists in most transition countries, where financial accounting rules were designed for application in a centrally planned economy and are now undergoing or have undergone reform. The adoption or reform of accounting laws has ameliorated the problem, but the accounting laws alone are not sufficient for income tax purposes. In many cases, statutory regimes are not supported by developed commercial accounting practice or judicial precedents that can be used to fill in the gaps in accounting statutes.

Given that the income tax is imposed on an annual basis, it is necessary to specify the income tax year. The tax year will normally be specified as the calendar year, or as a fiscal year set to complement the government's fiscal year. In the discussion below, this is referred to as the “normal tax year.” In many jurisdictions, taxpayers may be permitted to substitute a different 12-month period as their tax year. However, allowing taxpayers to choose a tax year that differs from that of other taxpayers may result in some revenue loss if taxpayers are able to exploit the inconsistency. It is suggested, therefore, that a

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taxpayer should be allowed to use a substitute tax year only with the permission of the tax administration, and, for this purpose, a procedure for applying for permission should be provided in the law or regulations. Permission should be granted only when the taxpayer demonstrates a legitimate need to use a substitute tax year. To ensure that there is no loss or unacceptable deferral of tax resulting from the move to or from a substitute tax year, the tax administration should be allowed to prescribe conditions for the use of the substitute tax year. The right to apply for permission to use a substitute tax year may be restricted to corporate taxpayers or may extend to other business taxpayers (although cases where a sole trader can demonstrate a need to use a substitute tax year are likely to be rare). A taxpayer using a substitute tax year may wish to cease to do so or to change to another substitute period (perhaps as a result of takeover). A procedure for making such changes may be provided, and, ordinarily, the rules outlined above should also apply to such applications. Special rules are needed for "transitional" years when a taxpayer changes its tax year. The transitional period should be specified as the period commencing at the end of the taxpayer's last complete tax year to the beginning of the changed tax year. This ensures that the different years mesh with the rest of the legislation and prevents transitional problems, such as an extended tax year (greater than 12 months) when a taxpayer changes from one tax period to another. The tax law is typically enacted (and amended) for application to the normal tax year. For example, changes to the income tax law may be stated to apply to the calculation of tax liability for a particular year and all subsequent years. Where taxpayers may use a substitute or transitional tax year, it is necessary to specify the law that is to apply to that tax year. For example, it may be provided that the law applicable to a normal tax year applies also to a substitute or transitional tax year that commences during the normal tax period.

A number of issues arise in the design of the income tax as it applies to assets. Some issues may be specific to particular classes of assets, while others may be relevant to all assets. It is suggested that the asset rules be structured so that the rules common to all assets are included in a single regime of general application. These rules include those for determining the cost base of assets, realization and recognition rules, and rules for determining gain or loss on disposal. In systems based on the balance sheet, they will include rules for determining the balance-sheet value of assets. Specific rules for particular classes of assets can then build on these basic rules. This approach not only ensures that rules are provided for all assets, but also means that there is a fundamental consistency in the basic treatment of different classes of assets. An alternative approach in some countries is to provide detailed rules for a particular class of asset (such as investment assets), with much briefer rules provided for other assets. It is recommended that this approach be avoided. A separate asset regime of general application is supplementary to the operation of the inclusion and deduction provisions in the law. It is not the purpose of the regime to bring amounts to tax or allow amounts as a deduction. Rather, its purpose is to elaborate the meaning of concepts used in the inclusion and deduction provisions. The main areas that can be dealt with in a separate asset regime are timing and calculation matters. The timing rules identify the tax year in which the inclusion and deduction provisions apply to an asset, and the calculation rules provide for the determination of the taxable or deductible amount. Depending on the asset, the taxable amount may be a gain calculated by subtracting the cost base of the asset from the consideration received for the asset, and the deductible amount may be a loss calculated by subtracting the consideration received for the asset from the cost base of the asset. In other cases, such as inventory, the taxable amount may be the consideration received, and the deductible amount may be the cost of

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the asset. In either case, the asset regime should provide for the determination of the cost base of, and consideration received for, assets.

An asset can change its tax status in a number of ways. For example, a trader may take some stock from inventory for personal use or consumption (or vice versa, although this is much less common). An item of inventory can also become a business asset of another type, such as depreciable or amortizable property, or vice versa. Similarly, property acquired as business assets or inventory may subsequently be held as an investment asset, or vice versa, and in some cases may thus be subject to different tax rules. Rollover treatment, which can be applied to most changes of tax status, is the equivalent of saying that the asset was originally acquired for its ultimate use, and so the interim period in which the asset was held for some other use is thus ignored. A deemed disposal for cost will normally lead to no gain or loss recognition. For example, if an item of inventory is removed for personal consumption by the taxpayer, the taxpayer will be treated as having disposed of the stock at the time it was taken out of inventory for cost, which will offset the deduction obtained for the cost of inventory. Some systems (e.g., Germany), however, treat a withdrawal of assets from business use as a disposal for market value. A special rule is needed when a personal-use asset that would be depreciable property if it were a business asset is converted to a business asset. If rollover treatment were applied in this case, the taxpayer would be able to recognize some personal consumption costs for tax purposes. For example, if a taxpayer converted a machine from personal-use property to inventory, the decline in value due to personal use could be recognized as a loss if the property were rolled over at cost. Such conversions should be treated as disposals for market value.

A lease is an agreement under which the owner of an asset (the lessor) grants another person (the lessee) the right to use the asset for a stated period. As consideration for the right, the lessee agrees to make rental payments to the lessor. At all times, the legal ownership of the asset remains with the lessor. The commercial accounting treatment of a lease and its tax treatment will depend on whether the lease is a "finance lease" or an "operating lease." A finance lease is an arrangement that is legally structured as a lease, but has the same economic effect as a sale on credit and purchase of the leased asset. Thus, under a finance lease, the lessor effectively transfers the benefits and risks of ownership of the leased asset to the lessee while retaining legal title in the asset. An operating lease is one in which the legal and economic ownership of the leased asset remains with the lessor so that the lease payments are genuinely for the use of the leased asset. Under tax law, three broad approaches to the use of finance leases are adopted. One approach is to give effect to legal form, so that all leases are effectively treated as operating leases for tax purposes. This means that the lessor would be treated as the owner of the leased asset and thus the person entitled to claim depreciation and other deductions relating to ownership. The rental payments are treated as income of the lessor and a deductible expense of the lessee. The other two methods broadly accord with commercial accounting treatment of finance leases. In contrast to the strict legal approach, commercial accounting rules recognize the economic reality of a finance lease by treating it as a sale and purchase of the leased asset. Thus, the lessee (not the lessor) is treated as the owner of the asset, which is entered into the lessee's books as an asset of that taxpayer. The lessor is shown for accounting purposes as having made a loan to the lessee, the rental payments being treated as payments of principal and interest on the loan. Treating a finance lease for tax purposes in the same way as other leases gave rise to arrangements under which such a lease could be used to transfer tax benefits from a person who could not use them to a taxpayer who could. Consider, for

example, a person who wishes to acquire an item of substantial plant. The person does not have sufficient funds to self-finance the acquisition and will thus need to borrow. In the ordinary case, the person will be able to deduct the interest expense and claim depreciation deductions in relation to the cost of the asset. Suppose, however, that the person is not in a position to use these deductions, or at least not immediately. The person may not expect to earn enough income for several years to take advantage of the deductions, so that the benefit of the deductions is deferred. Alternatively, the person may be a tax-exempt entity, such as a government instrumentality, which cannot utilize the deductions at all. Another possibility, particularly in developing and transition countries, is that the person may be entitled to a tax holiday, and so, again, cannot use the deductions. In these cases, arrangements can be entered into whereby a financier acquires the asset and leases it to the person under a finance lease. Because the financier is the legal owner of the asset, it is entitled to claim deductions related to ownership. The effect of the finance lease is to transfer the tax benefits associated with ownership to the financier, although, through the terms of the lease, the economic benefits and obligations are with the lessee. The availability of the tax benefits means that the financier is able to provide the lessee with a lower cost of funds. The arrangement, however, is detrimental to the revenue because it results in the full utilization of what would otherwise be unused tax benefits. Tax law treatment of finance leases in a manner similar to accounting treatment can be accomplished in two ways. In some jurisdictions, courts will use general interpretation principles to read the tax law as giving effect to the underlying economic form of a lease, not its apparent legal form. In others, the tax law has been drafted to achieve this result explicitly. It is recommended that this approach be adopted in developing and transition countries. Tax laws drafted to achieve a result similar to commercial accounting practice should make it clear that for tax purposes, the arrangement is treated as a sale on credit from the lessor to the lessee, and so the lessee is treated as the owner of the property and the lessor as a financier. The deemed purchase price is the present value of the rental payments to be made under the lease, and the price is treated as financed through a loan from the lessor to the lessee. Each payment the lessee makes under the lease is treated as a repayment of principal and interest under the loan. The interest component is calculated according to actuarial methods on the principal outstanding at the commencement of each payment period, with the balance of the payment treated as repayment of the principal. The interest component of each payment is treated as an interest expense of the lessee and interest income of the lessor. The central issue is the determination of whether a lease is a finance lease. It is suggested that several alternative tests based on commercial accounting rules be prescribed. The essence of these tests is to identify cases where economic ownership of an asset effectively passes to the lessee. Under these tests, a lease will be treated as a finance lease if any of the following circumstances is present: ƒ

- the term of the lease (including any period under an option to renew) is equal to or greater than 75 percent of the estimated economic life of the leased asset;
- the lease contains an option to purchase the leased asset at end of the lease for a fixed or determinable price;
- the estimated residual value of the property to the lessor at the end of the lease term is less than 20 percent of its fair market value at the commencement of the lease;

- the present value of minimum lease payments equals or exceeds 90 percent of the fair market value of the asset at the commencement of the lease term;

- the leased property is custom-made for the lessee and, at the end of the lease term, will have little or no value to anyone other than the lessee.

Taxes imposed on income from business are normally self-assessed, which imposes on the taxpayer, in the first instance, responsibility for calculating taxable income and the tax due on that income and for making installment payments at designated times. The taxpayer's calculations are reviewed by revenue officials when returns are filed and may be subject to further audit. The self-assessment system may be supplemented by a withholding system applicable to certain business payments.

The most crucial element of the system for collecting business tax is the formula for determining installment payments. The object of the system is to require businesses to pay tax on a regular basis throughout the year as income is derived, not when final liability is determined after the end of the tax year. This formula ensures revenue flow to tax authorities, prevents deferral of tax payment, and minimizes the risk of disbursement of income before the appropriate proportion is remitted as payment of a tax liability. Related issues are mechanisms for adjusting payments if the taxpayer's business income changes during the year and reconciliation of installment payments with the final tax liability.

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