Chapter 1

Features of taxation and the regulatory environment

Chapter learning objectives:

Lead	Component	Indicative syllabus content
C1 Distinguish the different types of taxes	Distinguish between: a. Direct vs indirect b. Corporate vs personal	• Features of direct and indirect taxes • Features of corporate and personal taxes
C2 Calculate corporate tax	a. Explain the basis of taxation	• Exempt income • Income taxed under different rules • Allowable expenditure • Capital allowances • Reliefs • Tax on sale of asset
C3 Explain relevant issues that affect taxation	Explain b. Ethics of taxation	• Corporate residence • Types of overseas operations (e.g. subsidiary or branch) • Double taxation • Transfer pricing • Tax avoidance • Tax evasion

1. Introduction

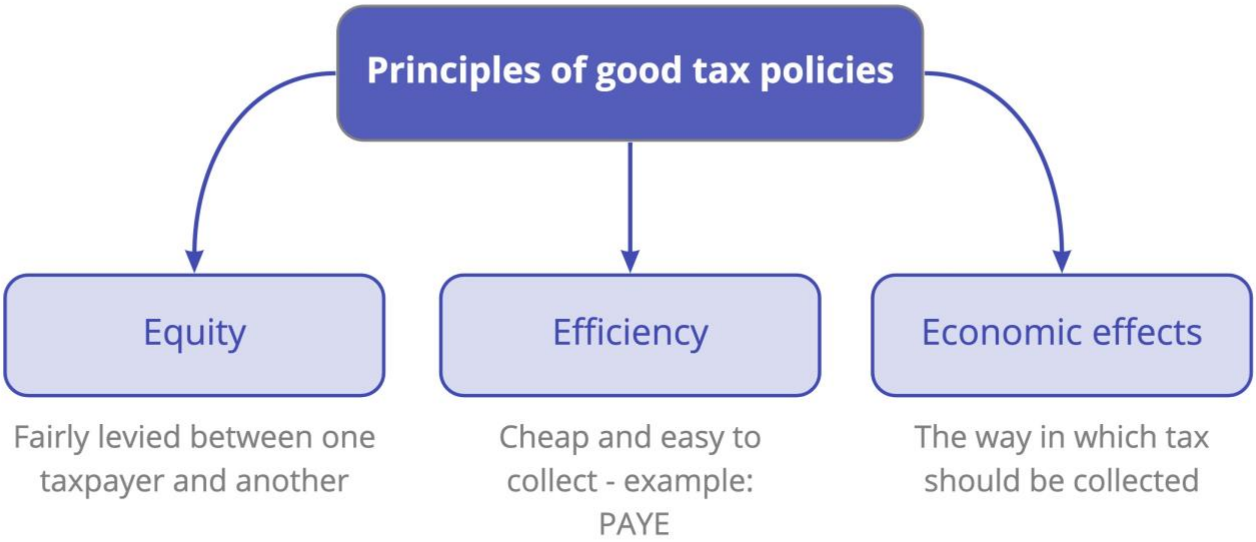
Governments need tax revenue to finance:

- expenditures on public services such as hospitals, schools, police, pensions and social benefits.
- government borrowing.

Characteristics of a good tax system:

- It should be **fair** – must reflect a person's ability to pay.
- It should be **absolute** – certain not arbitrary.
- It should be **convenient** – a person should pay it with ease.
- **Efficient** – with minimum collection costs.

Major principles of good tax policies:



Direct and indirect taxation:

Tax can either be direct or indirect:

Direct tax:

- Imposed directly on person or enterprise required to pay tax.
- Person or enterprise must pay tax directly to the tax authorities on their income.
- Tax on personal income (salary).
- Tax on business profits or tax on disposals of chargeable assets.

Examples of direct taxes are:

- Income tax
- Capital gain tax
- Corporation tax

Indirect tax:

- Imposed on one part of the economy with the intention to pass the burden of tax onto another.
- Imposed on a customer for goods or services.

Example – sales tax, such as VAT (in the UK).

Test Your Understanding 1: Direct and indirect tax

Which of the following is an example of indirect tax?

A. Sales tax

B. Income tax

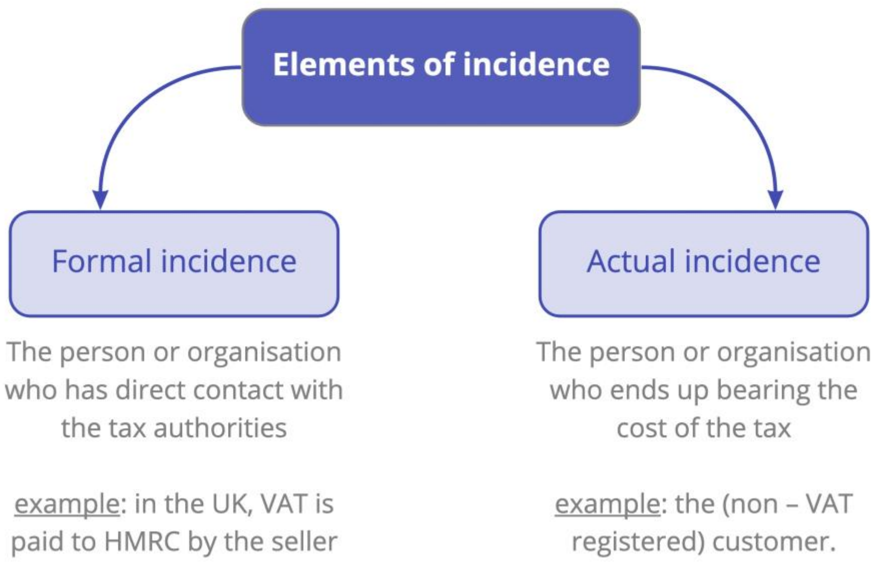
C. Capital gain tax

D. Corporation tax

2. Definitions of key terms

Incidence

Tax incidence refers to the burden of a tax and how it is distributed between a company and its consumers.



Tax base

Tax base identifies subjects of taxation. For example:

- Income
- Disposal or consumption of assets

Taxable persons

Persons accountable for tax payments:

- Individual
- Entity

Competent jurisdiction

- The tax authority have the legal powers to assess and collect taxes.
- A taxable person normally pays tax in the taxable entity's country of origin.

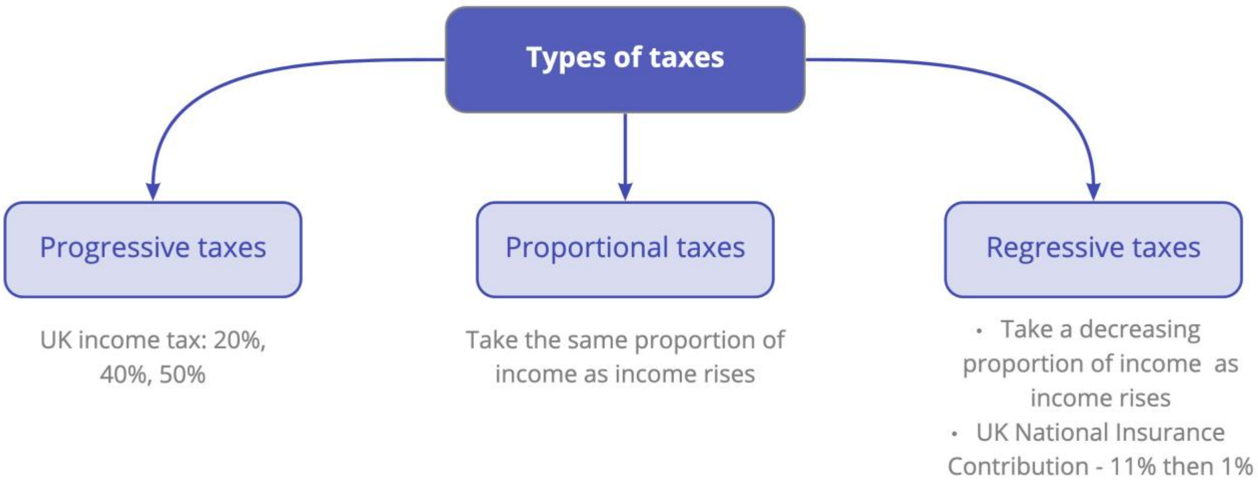
Hypothecation

- Certain taxes are devoted entirely to certain types of expenditures.
- For example; road tax

Tax gap

- The gap between tax that is theoretically collectable and the amount actually collected.
- Tax authorities aim to minimise the gap.

Tax rate structure

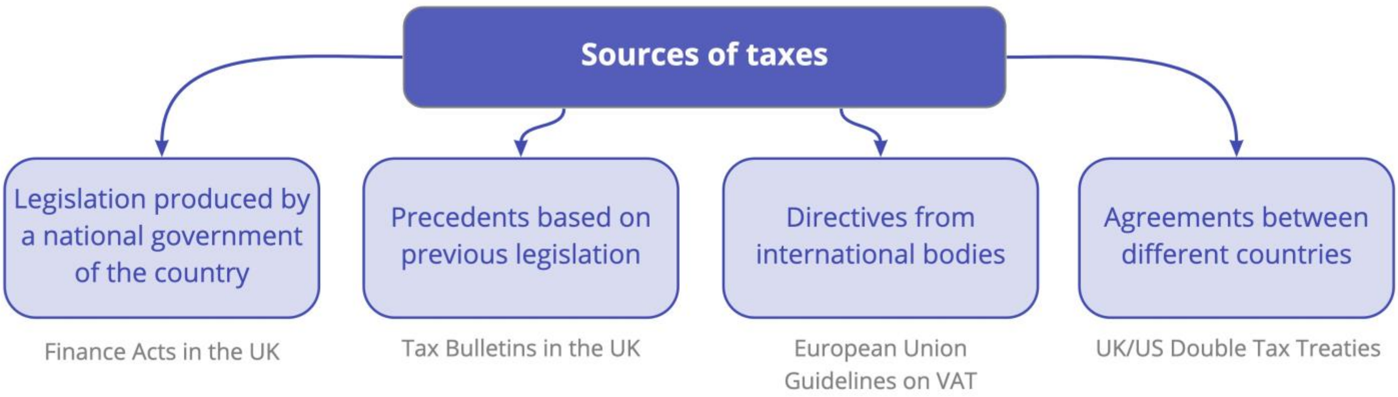


Test Your Understanding 2: Tax rate structure

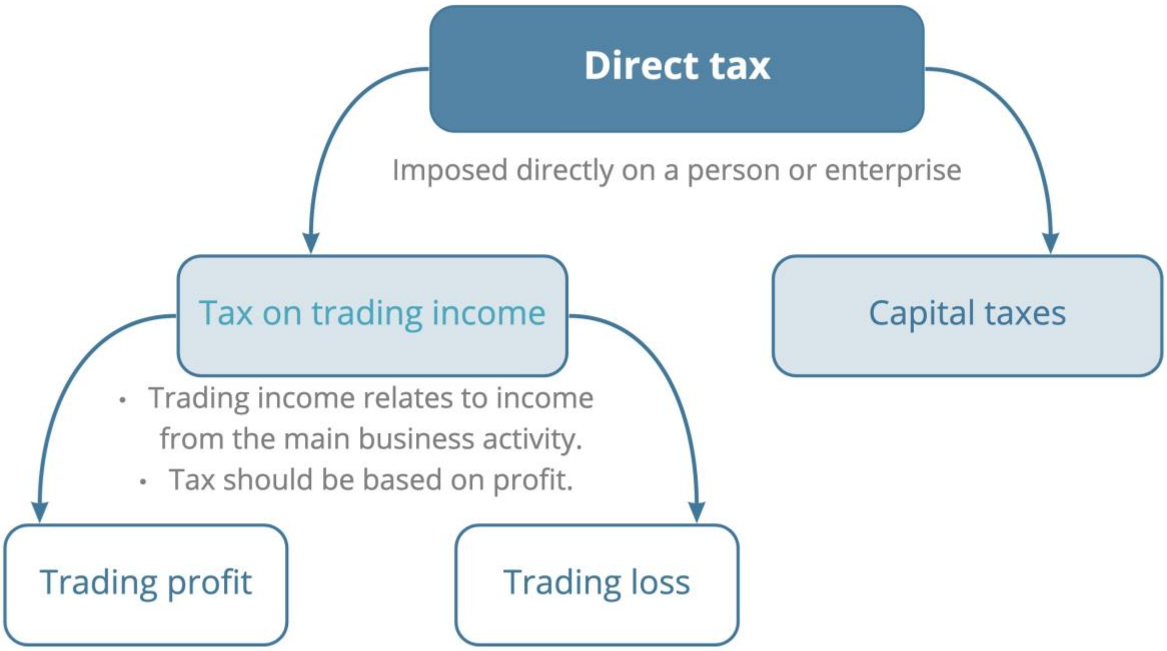
Match examples of different tax types.

Example of regressive tax	\$10,000 salary pays tax of \$1,000 = 10%, but a salary of \$20,000 pays tax of \$3,000 = 15%
Example of progressive tax	\$10,000 salary pays tax of \$1,000 = 10%, and a salary of \$20,000 pays tax of \$2,000 = 10%
Example of proportionate tax	\$10,000 salary pays tax of \$1,000 = 10%, but a salary of \$20,000 pays tax of \$1,800 = 9%

Sources of tax rules



3. Direct taxes



Note:

The accounting profit needs to be adjusted for tax purposes as in many countries there are differences between what accounting standards allow you to show as an income/expense and what the tax system deems to be the income/expense. These adjusted profits will enable you to calculate the taxable profit.

Pro-forma:

The standard pro-forma used to calculate tax on trading income is as follows:

Trading income	
	$
Accounting profit	X
Add back: disallowable expenses	X
Less: disallowable/exempt income	(X)
Add: accounting depreciation	X
Less: Tax depreciation	(X)
Taxable profit	X

The taxable profit will then be charged at the appropriate tax rate for that accounting period.

Exempt income	Any income which does not relate to main trading activity
Disallowable expenses	Expenses that have been deducted from the accounting profit (allowable under the accounting standards, but for tax purposes cannot be claimed).
Depreciation	Not allowed for tax purposes Added back and replaced with tax depreciation
Tax depreciation	Used instead of accounting depreciation Specifics will be provided in the question

Capital taxes

Capital tax gains are gains made on:

- Disposals of investments and other noncurrent assets.
- Listed stocks and shares - the most common taxed assets.
- **Proceeds from sale less cost of the asset,** at a simple level.

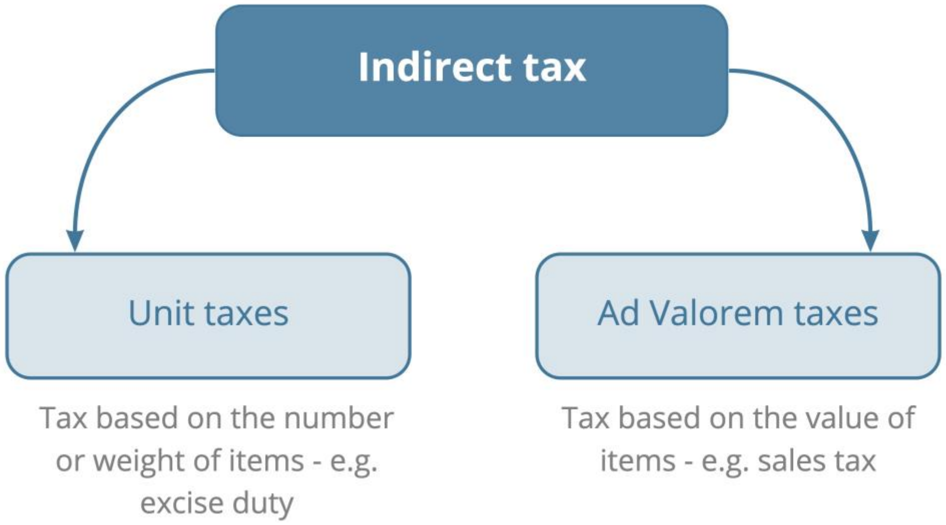
Pro-forma:

The standard pro-forma used to calculate capital taxes is as follows:

	$
Proceeds	X
Less: Costs to sell	(X)
Net proceeds	X
Less: Cost of original asset	(X)
Less: Cost to buy	(X)
Less: Enhancement costs	(X)
Less: Indexation allowance	(X)
Chargeable gain	X

The **chargeable gain** will then be charged at the appropriate tax rate for that accounting period.

4. Indirect taxes

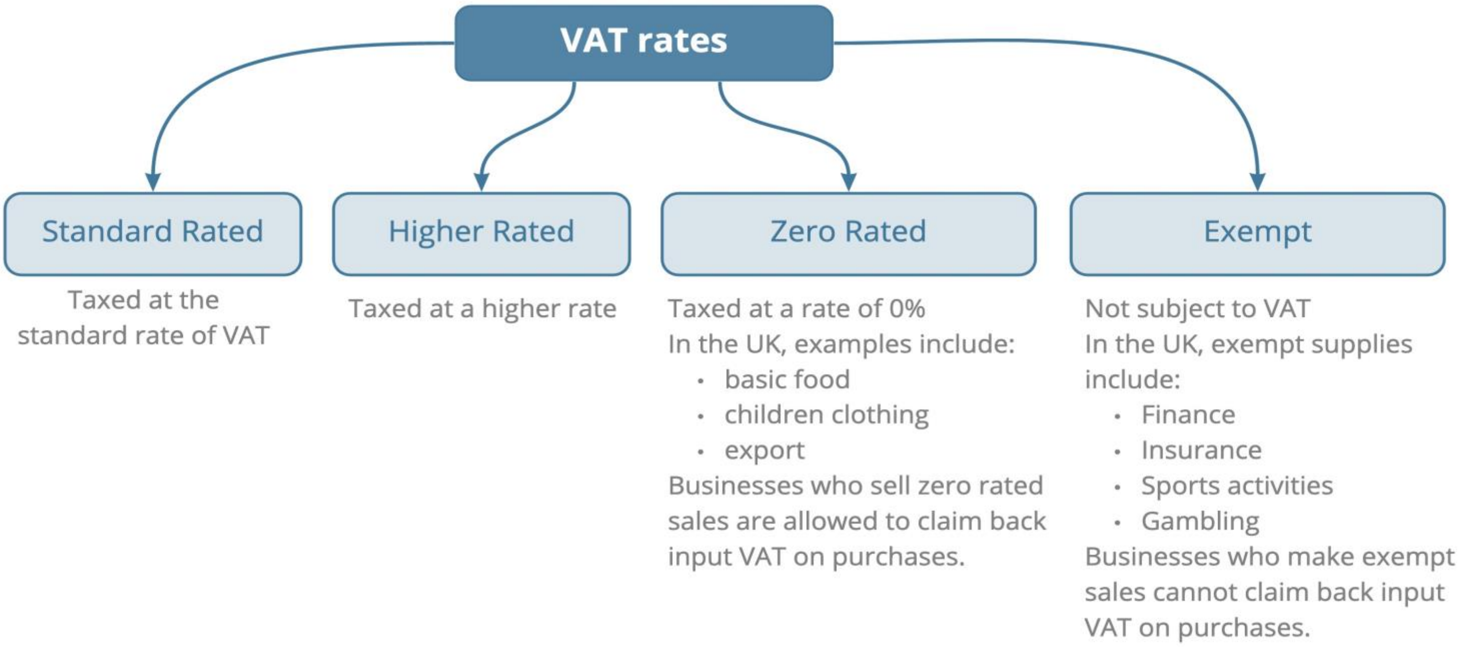


Examples of indirect taxes	
Consumption tax	• Added to purchase price • Single stage, or multi-stage VAT • Cascade tax
Property tax	• Land and building tax in most countries • Cars, boats etc. to be made aware of
Wealth tax	• Pension funds • Insurance policies • Works of art
Excise duty	• Type of unit tax used to discourage over-consumption • Pay for health-care • Tax on luxury products

Value added tax (VAT)

- VAT is charged each time a product is sold (output tax).
- The government allows registered businesses to claim back all the tax they have paid (input tax).
- The tax burden is passed to the final consumer, unregistered for VAT.
- VAT payable = output tax – input tax.

- Output tax is VAT charged on sales to customers.
- Input tax is VAT paid on purchases.
- VAT aims to tax most business transactions that are referred to as taxable supplies.



Implications of VAT supplies

- Identify the type of supply in order to claim back input tax.
- Input tax can only be claimed back on taxable supplies; zero and standard rated goods and services.
- Exempt supplies are outside the VAT system so VAT cannot be charged to customers and the input tax on purchases cannot be claimed back.

How to calculate VAT

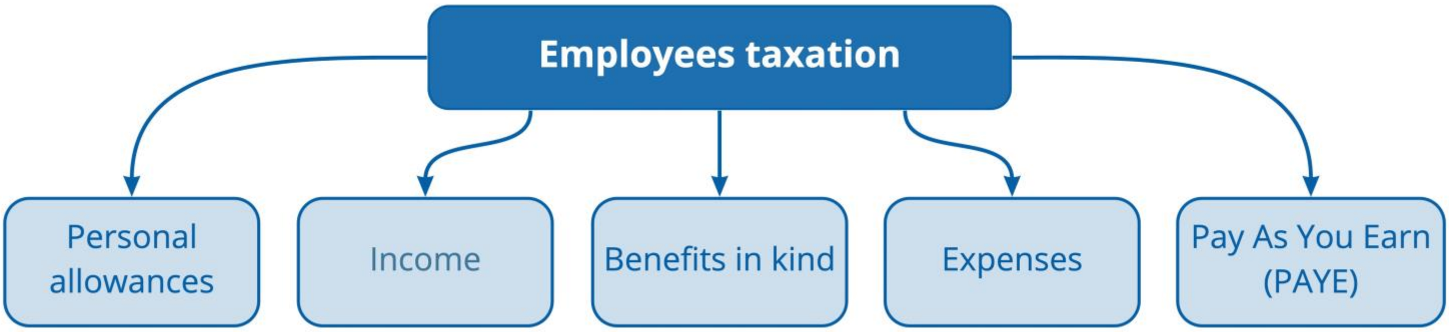
- Taxable supplies, therefore, have a selling price exclusive of VAT (net price) and a selling price inclusive of VAT (gross price).
- If an exclusive price is given, VAT is calculated by:

  Exclusive price × tax rate

- If an inclusive price is given, VAT is calculated by:

  (Inclusive price/(100 + tax rate)) × tax rate

5. Impact of employee taxation



- Employees are taxed on their earnings under income tax.
- Earnings can include:
  - Salaries
  - Bonuses
  - Commissions
  - Benefits in kind
- Benefits in kind are non-cash benefits in lieu of further cash payments such as:
  - Company cars
  - Living accommodation
  - Loans
  - Private medical insurance

Deductions

Certain expenses which are wholly, exclusively and necessary for employment can be deducted. Examples include:

- Business travel
- Contributions to pension plans
- Donations to charity through a payroll deduction scheme
- Professional subscriptions

Most governments expect enterprises to withhold tax on employees' salaries and report earnings to the tax authorities.

In the UK, this tax system is referred to as Pay-As-You-Earn (PAYE).

Social security

- Both employees and companies have to pay social security taxes based on salaries paid to employees.
- This tax is used to fund benefits such as the hospitals and retirement benefits.
- In the UK, this is called national insurance.

Benefits of PAYE

The benefits of having a PAYE system are:

- Tax is collected at source; hence taxpayers are less likely to default payment.
- Tax authorities receive regular payments from employers – helps to budget cash flows for the government.
- The tax authority only has to deal with the employer, rather than a number of individuals.
- Most of the administration costs are borne by the employer, instead of the government.

Note:

You will not be assessed on the calculation of employment taxation but you should have a general appreciation of how an entity deals with taxation with regard to employees. To give this some appreciation, a pro-forma has been included for illustration purposes.

Pro-forma

	$
Salary	X
Plus: Bonuses	X
Plus: Benefits	X
Less: Subscription for trade purposes	(X)
Less: Occupational pension amounts	(X)
Less: Allowable expenses for business purposes	
	X
Less: Personal allowances	(X)
Taxable income	X

The taxable income will then be charged at the appropriate tax rate for that accounting period.

6. Tax administration

Record-keeping

Enterprises need to keep records to satisfy tax requirements for the following taxes.

Corporate income tax

- All records required to support their financial statements.
- Additional documents required to support the adjustments made to those statements when completing the tax returns.

Sales tax

Adequate records should be maintained of all sales and purchase records, such as:

- Orders and delivery notes
- Purchase and sales invoices
- Credit and debit notes
- Import and export documents
- Bank statements
- Cashbook and receipts
- VAT account

Overseas subsidiaries

- Tax authorities would require documentation about the transfer pricing policy between the subsidiary and the parent.
- Transfer pricing is the amount charged for goods or services provided by one to the other.
- Most tax authorities require the price to be the same as it would be if charged to a third party.

Minimum retention of records

- Minimum length of time for the retention of records.
- In the UK, it is 6 years retention of all records relating to earnings and capital gains.

Powers of authorities:

- Impose penalties and interest on late payment of tax.
- Review and query filed returns.
- Request special reports if believed that inaccurate information has been submitted.
- Examine records of previous years (in the US, tax authorities can go back 20 years).
- Enter and search the entity's premises and seize documents.
- Pass on information to foreign tax authorities.

Tax avoidance and evasion

Tax avoidance:

- Tax planning to arrange affairs
- Within the scope of law
- Minimising tax liability

Tax evasion:

- Illegally manipulating the tax system to avoid paying tax
- An intentional disregard of law to escape tax
- Including a claim for a tax deduction for expenses that are not deductible
- Under declaring income and claiming fictitious expenses

Test Your Understanding 3: Tax avoidance and tax evasion

An intentional disregard of the law to escape tax is called _______________ (tax avoidance/tax evasion).

Preventive measures

The tax authorities use various methods to prevent both tax avoidance and tax evasion:

- Reducing opportunity, e.g. by deducting tax at source and the use of third-party reporting.
- Simplifying tax structures by minimising relief, allowances and exemptions.
- Increasing perceived risk by auditing tax returns and payments.
- Developing good communication between tax authorities and enterprises.
- Changing social attitudes towards evasion and avoidance by maintaining an honest, customer friendly tax system.

- Creating a fair tax system and encouraging an increasing commitment.
- Reducing lost revenue by reviewing the penalty structure.

7. Solutions: Test Your Understanding

Test Your Understanding 1: Direct and indirect tax

Correct option: A

Sales tax is an example of indirect tax.

Test Your Understanding 2: Tax rate structure

Solution:

Example of **progressive** tax	\$10,000 salary pays tax of \$1,000 = 10%, but a salary of \$20,000 pays tax of \$3,000 = 15%
Example of **proportionate** tax	\$10,000 salary pays tax of \$1,000 = 10%, and a salary of \$20,000 pays tax of \$2,000 = 10%
Example of **regressive** tax	\$10,000 salary pays tax of \$1,000 = 10%, but a salary of \$20,000 pays tax of \$1,800 = 9%

Test Your Understanding 3: Tax avoidance and tax evasion

An intentional disregard of the law to escape tax is called **tax evasion**.

8. Chapter summary