Introduction to the Principles of Business Taxation
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LEARNING OUTCOMES
After completing this chapter you should be able to:

▶ describe the features of the principal types of taxation likely to be of relevance to an incorporated business in a particular country (e.g. in terms of who ultimately bears the tax cost, withholding responsibilities and principles of calculating the tax base);
▶ describe sources of tax rules and explain the importance of jurisdiction.

Subject Focus

The overall objective of the tax element of the Financial operations syllabus is to examine those taxation principles generally applicable to business enterprises operating within tax systems of different countries in which CIMA students may be working and studying.

Knowledge of specific tax regimes is not required but may be used to illustrate principles.

Any questions requiring a computational solution will be based on plausible but fictitious tax rules and rates given in separately at the front of the exam paper.

Most questions on this segment of the syllabus will be in Sections A and B.

Chapter 1 concentrates on those principles of universal relevance to all tax systems.

Questions will highlight:

(i) the purposes of a tax system (i.e. raising money to meet government expenditures and to assist in the macro-economic management of the economy);
(ii) the underlying principles (or canons) of a good tax system;
(iii) generally important tax terminology by differentiating concepts (e.g. a direct from an indirect tax or a progressive from a regressive tax) or defining them (e.g. tax incidence, tax jurisdiction, an hypothecated tax, the tax gap, etc.).
Questions

1.1 In 1776, Adam Smith wrote in his book ‘The Wealth of Nations’ that there were four canons or key principles of a good tax – equity, certainty, convenience and efficiency. Briefly explain the meaning of each of these terms.

(4 marks)

1.2 Which of the following statements most accurately explains the meaning of the term direct tax?

A A direct tax is a tax that falls directly on the person who is expected to pay it

B A direct tax is a tax where the person responsible for paying the tax is placed in direct contact with the relevant tax authority responsible for assessment and collection of the tax

C A direct tax is a tax where a person ends up bearing the cost of the tax as he, she or it cannot pass the burden on to another person

D A direct tax is a tax which is fair to different taxpayers because it takes into account the taxpayer’s ability to pay

(2 marks)

1.3 Which of the following statements defines an hypothecated tax?

A The taxable person paying income to another person is required to deduct tax before making the payment

B The tax takes a decreasing proportion of income as the amount of income rises

C The relevant tax authority has the legal right to assess and collect tax

D The revenue raised by the tax is devoted to a specific type of government expenditure

(2 marks)

1.4 In 1776, Adam Smith proposed that an acceptable tax should meet four characteristics. Three of these characteristics were certainty, convenience and efficiency. Identify the FOURTH characteristic.

A Neutrality

B Transparency

C Equity

D Simplicity

(2 marks)

1.5 Explain the meaning of the term ‘competent jurisdiction’.

(4 marks)

1.6 Differentiate, with the aid of examples, between a progressive or regressive tax structure.

(4 marks)

1.7 (i) Define the term ‘tax base’ and explain why most governments are keen to have a wide tax base.

(2 marks)

(ii) Identify two of the three principal classes of tax and their tax bases.

(2 marks)

1.8 Identify main sources of tax rules governing the operations of tax authorities.

(4 marks)
1.9 Which of the following statements best describes the concept of effective incidence of tax?
   A The date an amount of tax is due for payment
   B The date an assessment for tax is issued by a tax authority
   C The taxable person or entity which has to account for the tax due
   D The taxable person or entity which bears the cost of the tax assessed
   (2 marks)

1.10 LM and LN are two companies resident in the same tax jurisdiction paying corporate income tax on their profits. In the same accounting period the two companies earned taxable profits of respectively $100,000 and $300,000 and paid tax after the end of the accounting period of respectively $25,000 and $90,000. Which of the following best describes the operation of this tax?
   A The tax is a regressive tax on corporate profits
   B The tax is proportionate to the profits earned
   C The tax is a progressive tax on corporate profits
   D The tax is a withholding tax on corporate profits
   (2 marks)

1.11 In no more than 15 words, define the meaning of ‘competent jurisdiction’.
   (2 marks)

1.12 An entity sells furniture and adds a sales tax to the selling price of all products sold. A customer purchasing furniture from the entity has to pay the cost of the furniture plus the sales tax. The customer therefore bears the cost of the sales tax.
   This is referred to as:
   A Formal incidence
   B Indirect incidence
   C Effective incidence
   D Direct incidence
   (2 marks)

1.13 What is ‘Hypothecation’?
   A Process of earmarking tax revenues for specific types of expenditure
   B Estimation of tax revenue made by the tax authorities for budget purposes
   C Refund made by tax authorities for tax paid in other countries
   D Payment of taxes due to tax authorities, net of tax refunds due from tax authorities
   (2 marks)

1.14 The ‘tax gap’ is the difference between:
   A When a tax payment is due and the date it is actually paid
   B The tax due calculated by the entity and the tax demanded by the tax authority
   C The amount of tax due to be paid and the amount actually collected
   D The date when the entity was notified by the tax authority of the tax due and the date the tax should be paid
   (2 marks)

1.15 Explain briefly THREE major principles of modern taxation.
   (3 marks)
Answers

1.1 The key principles of a good tax

Equity – A tax should be perceived by the taxpayer as being a fair tax, i.e. it should reflect the taxpayer’s ability to pay and not be avoidable by those to which it is intended to apply.

Certainty – A tax should have a clear purpose and not have an arbitrary effect on taxpayers.

Convenience – A tax can be easily assessed and collected.

Efficiency – The costs of collection are small as a proportion of the revenue raised and it does not distort the economic behaviour of taxpayers, individuals or businesses.

1.2 Direct tax

The answer is A

B the definition of formal incidence of a tax. This is true for many direct taxes

C the definition of effective incidence of a tax. This is a common characteristic of most direct taxes

D the definition of equity. Most direct taxes attempt to have an equitable effect.

1.3 Hypothecated tax

The answer is D

A the definition of a withholding tax or deduction of tax at source

B the definition of a regressive tax

C the definition of tax jurisdiction.

1.4 The answer is D

1.5 Competent jurisdiction

The jurisdiction of a tax authority is its legal right to assess, collect and enforce the payment of a tax. Jurisdiction is conferred by the statutes of central or local government, clarified and extended by actions of the Courts and extra-statutory rules of the tax authority itself.

Jurisdiction is defined in terms of a territory (e.g. a country or part of a country such as a state, county, district or city). Taxable entities (e.g. individuals or businesses) become subject to the tax rules of a tax authority by being resident in that territory, by virtue of physical presence for a sufficient period of time or by being legally situated therein (e.g. through a company’s incorporation) or by being controlled therein.

An individual or enterprise falls within the competent jurisdiction of a tax authority of a territory where he, she or it is obliged to apply its tax laws.

1.6 Progressive versus regressive taxes

A progressive tax is one where its rate structure results in an increasing tax yield as the value of the taxable source (e.g. income) increases; a regressive tax has the opposite effect.

In the UK, both income and corporation tax are progressive taxes with multiple rates between 10% and 40% (income tax) and 0% and 30% (corporation tax). In contrast, the UK’s local authorities charge Council Tax on the rateable value of taxpayers’ property.
Council Tax is basically a regressive tax because two taxpayers with homes or business premises of the same rateable value will pay the same amount regardless of differences in their incomes and ability to pay. The taxpayer with a lower income will effectively pay a higher percentage rate of Council Tax.

1.7 Tax base

(i) A tax base is the assessed value of a set of assets, investments or income streams that is subject to taxation. Governments prefer a wide tax base for any given source of tax revenue in order to increase overall tax revenues without resorting to high rates of tax.

(ii) The three principal forms of tax are income taxes, capital taxes and consumption taxes.

The main tax bases used for these taxes are:

For income taxes – profits from business enterprise; salaries and non-cash benefits in kind from employment; dividends, rents and interest from investment
For capital taxes – gains from the sale or gift of appreciating assets; gifts of accumulated wealth by individuals in their lifetimes or on death
For consumption taxes – either the value of sales of goods and services (i.e. for VAT and sales taxes) or the quantity of goods produced or sold (i.e. for excise duties).

1.8 Tax rules

The main sources of tax rules are:

(i) Domestic legislation (i.e. Finance Acts (in the UK) and Tax codes (other countries))
(ii) Extra-statutory guidelines issued by the tax authorities
(iii) Supranational regulations (e.g. EU directives on VAT)
(iv) Case law decisions made by domestic and supranational (e.g. the European Court) judicial bodies
(v) International tax treaties on double taxation.

Any four of the five sources mentioned will obtain full marks.

1.9 The answer is D

A The date an amount of tax is due for payment is merely an administrative rule
B This is also merely an administrative rule
C The person who pays the tax may or may not be the person on whom the effective incidence of tax falls. (e.g. The effective incidence of personal or corporate income tax fall on the individual or company responsible for paying the tax. In contrast, VAT, is paid by the trader who collects the tax charged on sales that he makes but the incidence falls on the final consumer who is not able to re-claim the tax charged to him on his purchase).

1.10 The answer is C, as the burden of tax falling on the company increases as the profits rise.

A Regressive means the effective (or average) rate of tax falls as profits increase
B Proportionate means that the effective rate remains the same irrespective of the level of profits
D A withholding tax is a tax deducted before a payment is made (i.e. remitted) to a person resident in another tax jurisdiction.
1.11 The competent jurisdiction is the country whose tax laws apply to the entity.

1.12 The answer is C

1.13 The answer is A

1.14 The answer is C

1.15 (i) Efficiency – tax should be easy and cheap to collect
(ii) Equity – should be fair between one tax payer and another
(iii) Economic effects must be considered