Principles of Business Taxation – Introduction
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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.

Learning aims

The learning aim of this part of the syllabus is that students should be able to ‘describe the types of business taxation rules and requirements likely to affect an entity (in respect of itself and its employees)’.

The topics covered in this chapter are as follows:

- concepts of direct versus indirect taxes, taxable person and competent jurisdiction;
- sources of tax rules.

1.1 Introduction

Principles of business tax account for 25 per cent of the Financial Operations syllabus and therefore 25 per cent of the examination paper. In the first six chapters of this text we will cover general principles of taxation. General principles should apply in most countries and are not specific to any one country. In your studies you can use examples of general principles drawn from a ‘benchmark’ tax regime (e.g. the UK, the USA, etc.) or an appropriate local tax regime. This text mainly refers to the UK tax system, but any system could be used to illustrate general principles.
In the first part of this chapter, we will consider general principles of taxation, basic tax terminology and the classification of taxes. The chapter will then conclude with a consideration of the sources of tax rules in a country.

### 1.2 Taxation as a source of government revenue

It has been said that ‘what the government gives it must first take away’. The economic resources available to society are limited, so an increase in a government’s expenditure will mean a reduction in the spending capacity of the private sector. Taxation is the main means by which a government raises revenue to meet its expenditure. Taxation may also be used by a government as a means of influencing economic decisions or controlling the economy; in this way taxation will also reflect prevailing social values and priorities in a country. This characteristic helps explain why no two countries’ tax systems will be identical in every respect and it also explains why governments continually change their tax systems.

Revenue raised from taxation is needed to finance government expenditure on items such as the health service, retirement pensions, unemployment benefit and other social benefits, education, financing government borrowing (interest on government stocks), etc.

### 1.3 Principles of taxation

No tax system is perfect, but an ‘ideal’ system should conform to certain principles if it is to achieve its objectives without producing negative effects.

#### 1.3.1 Canons of taxation

In 1776 Adam Smith in his book *The Wealth of Nations* proposed that a ‘good’ tax should have the following characteristics:

- **Equity.** It should be fair to different individuals and should reflect a person’s ability to pay.
- **Certainty.** It should not be arbitrary, it should be certain.
- **Convenience.** It should be convenient in terms of timing and payment.
- **Efficiency.** It should be administratively efficient with a relatively small cost of collection as a proportion of the revenue raised. It should not cause economic distortion by affecting the behaviour of taxpayers.

These principles still apply today; in a modern tax system the three major principles of taxation are:

1. **Efficiency.** A tax should be easy and cheap to collect. It is in pursuit of this objective that so much tax is collected ‘at source’, by deduction from income as it arises. The UK PAYE (pay-as-you-earn) tax on salaries and wages is an example.
2. **Equity.** It is important that tax should be fairly levied as between one taxpayer and another. For example, in the UK, tax legislation is often complex, both to reduce the opportunities to avoid the tax and to promote fairness, although this is not always achieved.

3. **Economic effects must be considered.** The ways in which tax is collected can have profound economic effects which must be taken into account when formulating a tax policy.

Tax reliefs can stimulate one sector, while the imposition of a heavy tax can stifle another. For example, special allowances for capital expenditure may encourage investment in industry, while imposing heavy taxes on cigarettes and alcoholic drink may operate to discourage sales.

### 1.3.2 The American Institute of Certified Public Accountants’ (AICPA) statement – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals

The AICPA’s Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals lists ten principles for determining if an existing tax or a proposal to modify a tax rule follows good tax policy. The framework also recognises that it is not always possible to incorporate all ten principles into tax systems and that some balancing is needed.

The ten principles are:

1. equity and fairness,
2. transparency and visibility,
3. certainty,
4. convenience of payment,
5. economy in collection,
6. simplicity,
7. appropriate government revenues,
8. minimum tax gap,
9. neutrality,
10. economic growth and efficiency.

Most of these are included in Section 1.3.1; those that need additional explanation are:

- **Appropriate government revenues.** The tax system should enable the government to determine how much tax revenue is likely to be collected and when.
- **Minimum tax gap.** The tax gap is the difference between the amount of tax owed and the amount of tax collected. A tax should be structured to minimise non-compliance.

### 1.4 Basic tax terminology

This section explains some basic taxation terms that are used in the following chapters and that you need to understand and possibly use to answer questions in the examination.

#### 1.4.1 Direct taxes

A direct tax is one that falls directly on the person or entity who is expected to pay it. For example, the UK corporation tax is a direct tax. The formal incidence and effective
incidence of a direct tax are usually the same, although in some situations if it is known in advance that tax will have to be paid, it may be possible to charge a higher rate for the work so that the tax due will be covered.

A direct tax is levied on an individual or entity, so it can be designed to take account of certain individual or entity circumstances, for example, family size, financial commitments, level of investment in non-current assets, etc.

### 1.4.2 Indirect taxes

An indirect tax is one that is levied on one part of the economy with the intention that it will be passed on to another. For example, in the UK, value-added tax (VAT) is levied on all businesses involved with the production and distribution of a good for a final customer. In most cases the VAT will be added to the final price paid by the customer.

As an indirect tax is not levied on the eventual payer of the tax, it cannot be related to the individual circumstances of that taxpayer.

### 1.4.3 Incidence

The incidence of tax refers to the distribution of the tax burden. The incidence of a tax is on the person who actually pays it. For example, the incidence of an income tax is on the taxpayer as it is the taxpayer who is assessed and pays the tax.

Incidence can be split into two elements:

1. **Formal incidence.** The person or entity who has direct contact with the tax authorities. For example, the formal incidence of a sales tax (or VAT) will be on the entity making the sale. It is the entity making the sale that must account for the transaction and pay the tax collected to the revenue collection authorities.

2. **Effective (or actual) incidence.** The person or entity who ends up bearing the cost of the tax as they cannot pass it on to someone else. If a sales tax is added to the selling price, it is passed on to the customer and it is actually the customer who ends up paying the tax. The effective incidence is on the customer.

### 1.4.4 Taxable person

A taxable person is the person accountable for the payment of a tax. Tax is levied on the taxable person who is responsible for its payment. For example, in the UK, traders have to register for VAT as a taxable person; they can then charge VAT to customers and recover the VAT paid to their suppliers (see Chapter 3 for more details on VAT).

### 1.4.5 Competent jurisdiction

Jurisdiction can be interpreted as meaning power. The tax authority must have the legal power to assess and collect taxes. Taxation is either the sole responsibility of the central government or the combined responsibility of the central government and local authorities within a country. The responsible authorities will pass one or more taxation laws. The primary characteristic of any law is that it is enforceable by sanction (i.e. fine, imprisonment, etc.). An unenforceable law will be ignored. Before a court can order enforcement, it must be competent to hear and determine the alleged non-compliance with the law.
For example, the UK legislation is applicable to UK subjects and non-UK subjects who by entering the UK, whether for a long or short time, have made themselves subject to the UK jurisdiction. UK statutes apply within the UK as jurisdiction is territorial.

For an entity to be subject to tax in a country, it must first be proved to be within that country’s legal power to apply its tax rules to the entity. The competent jurisdiction is therefore the country whose tax laws apply to the entity.

The basis of jurisdiction can vary between countries, making it difficult to determine and collect taxes from multinational entities (see Chapter 5 for a discussion of the jurisdiction of multinational entities).

### 1.4.6 Hypothecation

Hypothecation means that the products of certain taxes are devoted to specific types of expenditures. For example, a tax on motor vehicles could be hypothecated (devoted entirely) to expenditure on building and maintaining roads. Earmarking is an informal hypothecation of taxes. Hypothecation is unpopular with Chancellors/Ministers of Finance as it considerably reduces their choices in public expenditure decisions.

### 1.4.7 Withholding responsibilities

Persons or entities paying various types of income to persons or entities abroad are usually required by the law of a country to deduct tax from the income before making a payment. The tax deducted is called withholding tax and it is the responsibility of the person or entity making the payment to correctly deduct it. The person or entity making the deduction is responsible for paying the tax deducted to the tax authorities and preparing the correct documents to properly account for it (see Section 5.5 for more detail on withholding taxes).

### 1.4.8 Tax rate structure

Direct taxes are assessed on individuals, so it is possible to set tax rates that cause marginal and average rates of tax to change according to the size of the individual’s tax base. The government’s political objectives and current social objectives determine the level of tax and the way rates vary with income. The three possibilities are:

1. progressive taxes, which take an increasing proportion of income as the income rises;
2. proportional taxes, which take the same proportion of income as income rises;
3. regressive taxes, which take a decreasing proportion of income as income rises.

Example of rate structures:

A earns $95,000 profit for the year.
B earns $42,000 profit for the year.

In country 1 the tax on profits is 20 per cent on all earned profits.
In country 2 the tax on profits is 0 per cent on the first $20,000; 10 per cent on amounts between $20,001 and $50,000; and 30 per cent on amounts over $50,001.
How much tax would A and B be subject to in each of the countries?

<table>
<thead>
<tr>
<th>Country</th>
<th>A</th>
<th>B</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country 1</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$95,000 × 20%</td>
<td>$19,000</td>
<td>20% Proportional</td>
</tr>
<tr>
<td>B</td>
<td>$42,000 × 20%</td>
<td>$8,400</td>
<td>20% Proportional</td>
</tr>
<tr>
<td><strong>Country 2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>($30,000 × 10%) + ($45,000 × 30%)</td>
<td>$16,500</td>
<td>17.4% Progressive</td>
</tr>
<tr>
<td>B</td>
<td>$22,000 × 10%</td>
<td>$2,200</td>
<td>5.2% Progressive</td>
</tr>
</tbody>
</table>

Indirect taxes cannot normally be progressive on the individual as they are either assessed on:
- the number of goods (excise duty) or
- the value (VAT) of the goods.

These taxes can only be progressive or regressive on the individual if different rates of tax are charged on different goods. For example, if higher rates of tax are charged on goods that tend to be bought by those on higher incomes, the indirect tax could be said to be progressive.

### 1.4.9 The tax gap

The tax gap is the difference between actual tax revenue received and the amount that would have been received had 100 per cent of the amount due been collected. Tax authorities aim to minimise the tax gap by collecting as high a proportion of the tax due as possible.

### 1.5 Tax bases and classification of taxes

A tax base is something that is liable to tax. Taxes can be classified by tax base, that is, by what is being taxed. Taxes may be based on:
- income – for example, income taxes and taxes on an entity’s profits;
- capital or wealth – for example, taxes on capital gains and taxes on inherited wealth;
- consumption – for example, excise duties and sales taxes/VAT.

For example, in the USA, the Federal government taxes income as its main source of revenue. State governments use taxes on income and consumption, while local governments rely almost entirely on taxing property and wealth.

A more detailed classification of taxes is that used by the Organisation for Economic Cooperation and Development (OECD 1976): taxes are grouped into categories similar to those above and then each group is sub-divided into more detailed headings.

The OECD classifications are used to assist when comparing one country with another. For example:

- 2000 Taxes on income, profits and capital gains
- 2100 Paid by households and institutions
- 2110 On income and profits
- 2120 On capital gains
- 2200 Paid by corporate enterprises
- 2210 On income and profits
- 2220 On capital gains
You can access the full OECD classification on the OECD website at http://www.oecd.org/dataoecd/20/39/35589632.pdf the full OECD classification is to be found at annexe 1 of the document.

You do not need to learn the full OECD classification, but you must know the main categories of tax.

1.6 Sources of tax rules

The nature of tax rules vary considerably from one country to another; however, it is possible to categorise the sources and influences on those rules. Within any country the balance between each source will be different, but in most countries the same elements will be present to a greater or lesser extent. The main sources of tax rules in a country are usually as follows:

- All tax systems are based on domestic primary legislation either at the central government level or at the local authority level or both. In some countries the legislation is very detailed and specific, setting out every possible item of income and expense. In other countries the legislation is less detailed and is supplemented by court rulings or case law.
- The practice of the relevant taxing authority will create precedents which will be followed in the future. Tax authorities sometimes issue guidelines or interpretations which are aimed at clarifying the taxation legislation.
- Supranational bodies may issue directives which the government of a country has to include in the legislation, for example, European Union (EU) directives on VAT.
- International tax treaties signed with other states are also a source of tax rules as the agreements often vary from the country’s own tax regulations.

1.7 Summary

This introductory chapter sets out general tax principles, basic terminology, classification models for taxation and sources of tax rules. You need to learn these definitions and be prepared to use them to answer questions in the examination.
Revision Questions

? **Question 1**
Which of the following is NOT one of Adam Smith’s characteristics of a good tax?

(A) Equity  
(B) Certainty  
(C) Simplicity  
(D) Efficiency  

(2 marks)

? **Question 2**
In no more than 15 words define ‘incidence of tax’.  

(2 marks)

? **Question 3**
An indirect tax is a tax that:

(A) is levied directly on an individual  
(B) is based on earnings of an individual  
(C) is paid indirectly to the tax authorities  
(D) is levied on one person with the intention that it is passed on to another  

(2 marks)

? **Question 4**
List the three main tax bases used in developed countries.  

(2 marks)

? **Question 5**
Which of the following is not usually a source of tax rules in a country?

(A) Domestic primary legislation  
(B) International tax treaties  
(C) The practice of the tax authorities  
(D) International law  

(2 marks)
Question 6
With reference to an entity paying tax, which of the following is the best definition of 'competent jurisdiction':
(A) The country whose laws apply to the entity
(B) Any country where the entity has operations
(C) Any country where the entity has an office
(D) Any country where the entity has employees

Question 7
The effective incidence of a tax is
(A) the date the tax is actually paid
(B) the person or entity who finally bears the cost of the tax
(C) the date the tax assessment is issued
(D) the person or entity receiving the tax assessment

Question 8
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

Question 9
BM has a taxable profit of $30,000 and receives a tax assessment of $3,000. BV has a taxable profit of $60,000 and receives a tax assessment of $7,500. BM and BV are resident in the same tax jurisdiction. This tax could be said to be
(A) a progressive tax
(B) a regressive tax
(C) a direct tax
(D) a proportional tax
Solutions to Revision Questions

Solution 1
The correct answer is (C), see Section 1.3.1.

Solution 2
The incidence of a tax is the person who actually pays it. See Section 1.4.3.

Solution 3
The correct answer is (D), see Section 1.4.2.

Solution 4
The tax bases are:
- Income
- Capital or wealth
- Consumption
See Section 1.5.

Solution 5
The correct answer is (D), see Section 1.6.

Solution 6
The correct answer is (A), see Section 1.4.5.

Solution 7
The correct answer is (B), see Section 1.4.3.
Solution 8
The correct answer is (C), see Section 1.4.3.

Solution 9
The correct answer is (A), see Section 1.4.8.