Principles of income taxation

Global vs schedular design of income taxation

Global income tax	Schedular income tax
Income and deductions are combined to produce an overall taxable income amount to which the tax rate is applied	For each category of income, amount included in income and deductions allowed are determined separately

Countries usually combine elements of both global and schedular system

Australia, Canada and USA, which have a global approach generally, restricte the deductibility of expenses or losses with respect to certain types of income	European countries, which have a schedular approach generally, allow losses from one category to offset income from other categories

Income from employment:
Employee fringe benefits

- Fringe benefits are taxable, but with several exemptions (*e.g.* medical benefits, meals, cars). Some exclusions reflects differing societal views

- Fringe benefits can be valueted at fair market value, retail market value, resale market value or standard value

- Most of the tax systems allow substantial amount of employment income in the form of fringe benefit to escape tax because of valutation problems

  → Australian solution: a fringe benefit tax

- A particular type of fringe benefit: **employer-provided pension** (*usually, tax deduction of contributions and taxation of pension paid in the future)*

Income from immovable property:
Imputed income from owner-occupied housing

- The ownership of personal assets has long been recognized as an economic benefit in the case of owner-occupied housing

- Most countries do not apply a tax on imputed income because of difficulties in accurate valuation of property

No taxation of imputed income
\+ *deduction for interest costs incurred in purchasing a house*
\+ *preferential treatment of gain on sale*

= *a better tax treatment with respect to rental housing*

- However, The Netherlands tax imputed income and Sweden applies a real estate tax

Other income:
Gifts

Personal Gifts

- Generally, gifts in a private context are not taxable to the donee and are not deductible for the donor
- In the case of appreciated or depreciated property, some systems treat the gift or bequest as a realization event
- In Commenwealth countries, *inter vivos* transfers are realization events

Business or Employment Gifts

- *Problem*: the gift would be deductible as a cost of doing business to the donor and, in the case of personal gifts, would be exempt to tax for the donee
- *Two solutions*:
  1. Deny the deduction to the donor or tax the gift to the donee
  2. Allow deduction and tax the gift, but only over a *de minimis* amount
- In Commenwealth countries, business gifts are typically taxable to the recipient

Other income:
Prizes and award, scholarships and grants

Prizes and award

- Generally, they are taxable if they relate to the recipient's professional or business activities; they are not taxable if they derive from a life's work (*e.g.* the Nobel Prize, lottery prizes)
- However, in the USA, prizes and award are in general fully taxable, regardless of the nature of the activity which is being recognized

Scholarships and grants

- Different reasoning with respect to global or schedular approach
- In a global approach, which consuption as an important component of the tax base, payment for living expenses are taxable
- In a schedular approach, a typical taxable income is periodic payments for living expenses, like scholarships.
- Different consequences also with respect to a publicly financed or privately financed tuition

Other income:
Cancellation of indebtedness

- In principle, the faillure to repay the loan results in additional taxable income to the borrower. However, in many case, the borrower is in financial difficulty

- Generally:

    1. Cancellation of private debts are not taxable
    2. Cancellation of business debts are taxable
    3. Cancellation of business debts are not taxable if the taxpayer is in a bankruptcy or is insolvent

- In the USA, if exclusion is available, the taxpayer has to reduce certain tax attributes: firstly, any net operating losses; secondly, the tax cost of various assets

    → similar approach in Australia and Canada

Other income:
Gambling, illegal income

Gambling

- In many schedular systems, gambling income is taxable only if the gambler can be found to be in the business of gambling
- In the global system, gambling winnings are taxable whether they arise from occasional transaction or professional activity. However, in the case of a professional gambler, gambling losses for the year can only be deducted to the extent of gambling income

Illegal income

- In all of systems, illegal income is taxable (*pecunia non olet* principle)
- In a schedular system, the income must fall into a taxable category
- In the case of civil law obligation to repay the amount taken, the taxpayer has no legally right to keep the income

this can influence the income inclusion

Other income:
Windfalls, subsidies

Windfalls

- Windfalls, that are an occasional income, generally are not taxable unless they arise in a business setting
- In the Commonwealth countries a windfall is not derived from a taxable source of income and is not included in the income tax base
- A special category of windfall gais is damages: damages for personal injuries are typically not taxable even if calculated with reference to lost earning or earning capacity

Subsidies

- Subsidies granted in respect of acquisition of assets are not taxable but reduce the tax cost of assets
- Public welfare payments are not taxed unless they are in the form of wage supplements like unemployment compensation

Realization and recognition of gain

A capital gain (or loss) is **realized** if the property is sold, exchanged or disposed of

Several countries have adopted a «**mark-to-market**» method for financial instruments or in the taxation of foreign investment companies

All systems also contain rules which allow for the **deferral** («rollover») of realized gain in some circumstances

Realization and recognition of gain

USA	Germany
Any exchange of property in which there is a «material difference» between the properties exchanged will result in realization. The gratuitous transfer is not a realization event	*The taxation of the gain is subject to the «accrual method» of income determination; the increase in value does not lead to taxation as long as there in no disposal of asset*
The Netherlands - Sweden	**Canada**
Similar to Germany	*Realization occurs if the taxpayer disposes of most of the important incidents of ownership in the asset. For financial istitutions used the «mark-to-market» method*
Japan	**France**
A sale or exchange of assets is a realization event. The CIT use the «mark-to-market» method for financial derivate products	*It requires realization (also transfer of business property by gift or death is a realization event).*
Australia	**United Kingdom**
It requires realization. Introduced a comprehensive accrual system for the treatment of financial assets	*The term «disposal» cover any transfer of beneficial ownership.*

Capital gains and losses

- In some countries, typically Continental, all income which arises in a business is taxed in the same fashion

  → there is no difference between income and capital gain

- Gains realized by individuals on investment assets often are not taxed or taxed only in special circumstances

- In the UK, the distinction between ordinary income and capital gain is applied both to business enterprises and to private person

  → Both categories of capital gain were not subject to tax because gains were not income from a source, but gains from the disposal of the source itself

- In a global system, capital gains are always included in the tax base, though with a taxation at a preferential rate

Capital gains and losses

Country experiences

- In the USA capital gain realized on the sale or exchange of a capital asset is entitled to preferential treatment if it has been held for over one year

  → The problem is the definition of «capital assets»

- Germany has a typical schedular approach:
  - Private capital gains are not taxable
  - All gains realized in business are included in the taxable business profit

  → A special rule extends taxation to gains resulting from the sale by private persons of stock in corporations over a thresold

- In Japan, for individual, gains on assets held for less than 5 years are fully taxable, while only ½ gain is included in income for assets held for more than five year.

- In France gains on fixed assets in a business held for more than 2 years are taxed at a preferential rate

Deductions

All systems recognize that

deducible expenditure must have some connection to taxable income

and

expenditures for personal consumption should, in most cases, not be deductible

Deductions
Mixed business and personal expenses

All of systems must deal with the basic problem of expenditure which have both an income-producing and a consumption dimension

Two choices

Disallows the deduction of any expense of «mixed» character unless there is a specific statutory rule

- Germany
- United Kingdom

Allows partially or wholly the deduction after an careful apportion of mixed business and personal expenses

- France
- Canada
- Sweden

Deductions
Mixed business and personal expenses

Commuting

- Even if commuting expenses have a clear business connection, their level is tied up with the personal decision as to where to live in relation to the workplace
- Several systems deny commuting deductions or give a limited deduction
- Only the expenses of travelling in the course of business are deductible

Moving expenses

- In many cases exmployer-reimbursed expenses are not included in income, although directly incurred expenses in the same situation would not be deductible
- In the Commonwealth systems, moving costs are considered personal in the same way as commuting expenses

Deductions
Mixed business and personal expenses

Clothing

- Generally, coutries allow a deduction for clothing if it is not adaptable to personal use (*e.g.* typical professional clothing such as uniforms)
- Cost of «civil» clothes not associated with a particular profession are not normally deductible, even if as a practical matter they are necessary for the profession (*e.g.* dark blue suit for lawyers)

Business travel

- Generally, travel expenses, including meals and lodging, incurred while «away from home» on business, are deductible
- Many countries limit the deductibiliy of travel expenses at ½ of them or identify a fixed deductible cost
- The UK allows deduction only if the travel purpose is «wholly and exclusively» linked to business activity

Deductions
Mixed business and personal expenses

Business entertaiment

- In view of the administrative difficulties, none of the systems tax the recipient of the entertainment directly
- The denial or limitation on the deduction ensures that some amount is included in the tax base, though it is not taxed to the person enjoying the consumption

Child care

- A policy debate has brought to limited personal deduction or credit for child care expenses
- In the Commonwealth systems, the deduction is denied, viewing them as not being incurred «in course of» employment

Educational cost

- All of the systems take generally the same approach, disallowing the expenses of basic education but allowing deductions where the taxpayer is improving or maintaining existing skills

Deductions
Hobby losses

- In a schedular system, for an occasional activity, which does not fall in any taxable category, neither income nor expenses would be taken into account for tax purpose

- In a global system, the profit is taxable and real issue involves the deduction of the costs

  → In the USA, if an activity is found to be «not engaged in for profit», deductions generated by its may only be used against the income from the activity

- In the UK, the law requires that the trade must be carried on a commercial basis and with a view to a realization of profit

- In Germany, for the income to be taxable and the losses deductible, there must be objective evidence of a profit: the activity will generate a net profit in a resonable time after the activities have been started

Deductions
Capital costs and recovery methods

- Generally, it requires capitalization of any expenditure which has created an asset which will last for more than one year
- The capital cost recovery system allows a deduction for the capital costs over something like the actual useful life of wasting assets in order to properly reflect the taxpayer's income
- Usually, tax accounting follows commercial accounting
- Many countries use accelerated depreciation allowances as an incentive for particular forms of investment
- Goodwill has variuos depreciation rules: in the USA, Canada, Australia, it is not deductible, while in Germany, France it is deductible

Deductions
Personal costs

Interest

- From a theoretical point of view, personal interest can be view, not as additional consuption, but simply the cost of a preference for current as opposed to deferred consumption
- However, only business-related expenses are deductible, so personal interest would be disallowed
- Many countries, within personal interests, allow the deductability of a limited amount of interest on personal residence mortgage

Personal losses

- Generally, gain and losses on private assets are not taken into account
- In the USA, a loss due to damage to personal assets can be deducted if the damage is attributable to a «casualty», which has been interpreted like a sudden and unexpected event

Deductions
Personal costs

Medical expenses

- Medical expenses may be deducted or claimed as a tax credit in several of the systems, though they are viewed as personal expenses
- Countries with a publicly-funded health care systems allow a lesser deduction
- In the USA, a deduction is available for medical expenses that exceed a percentage of income

Charitable donations

- Most of the systems allow a deduction or credit for contributions to organizations, private or public, which perform charitable, religious, cultural, or educational services
- There are typically limits on the deductible amounts based on a percentage of the taxpayer's income
- In Sweden, charitable contributions are not deductible because they are viewed as personal expenses

Deductions
Limitations on deductions and losses

Illegal payments, Fines, Penalties

- Generally, these expenses are not deductible
- In the USA, a case law established that the illegal payments and fines were not deductible if the deduction would «frustrate sharply defined national or state policies»
- In France, Japan and the Netherlands, bribes are deductible as long as the payment is «necessary» for the business

Expenses associated with tax-exempt income

- Generally, it denies a deduction for expenses incurred in connection with tax-exempt income
- If expenses are related to several categories of income, it is made an allocation, based on the amounts of income
- In Australia and Canada, there is no deduction for the cost incurred in connection with capital gains, thought the cost generally can be included in the cost basis of the assets in most cases

Deductions
Limitations on deductions and losses

Other limits or restrictions

- Passive activity rules restrict the deductibility of losses which arise in any active in which the taxpayer does not «materially participate»
- Losses in passive activities can be used only to offset income from passive activities
- Losses in the category of business income can reduce income in other taxable categories
- In Sweden, a loss in the category of business does not reduce income in other taxable categories, but it can be carried forward without limitation against business income in future years

Accounting

A basic question in all systems is the extent to which the timing rules used in determining financial income also control questions of timing for tax purpose

In many cases, all systems recognize a simplified «cash» method of accounting

Accounting
Accrual method

- Income must be recognized and an account receivable entered in the balance sheet when property is delivered or the performance of the service is completed

- Generally, the accrual method is used to account for income from business

- The «prudence principle», and its different approaches from accounting and tax point of view, produces the most important differences between book income and taxable income

- Usually, special tax rules substiantially modify the book income

- French and German system have a very close linkage between book and taxable income

Accounting
Cash method

- Income is recognized when the taxpayer receives money or other assets at his disposition
- Expenses are recognized at the time the taxpayer disposes of the funds
- Generally, the cash method is used to account for income from:
  - ✓ Employment
  - ✓ Renting of real estate or securities
  - ✓ Profit of small businesses
  - ✓ Non-commercial personal services
  - ✓ Trading profits

Accounting
Inclusion of advance payments

From a financial accounting point of view:	*From a tax point of view:*
Income is not taken into account since the unconditional right to the income has not yet been established	Income is taken into account since taxpayer has received the cash and is in a position to pay the tax

This is a classic example of the conflict between financial accounting principles and tax accounting

- For the US and Canada, their inclusion in income is necessary to «clearly reflect income»
- In the UK, Germany, prepayments follow general accounting principles

Similar reasoning with respect to **deferred payments**

Accounting

Obligations and other financial instruments

- In general, there is an increasing tendency to abandon traditional realization and tax accounting approach in this area, and to tax such instruments on an internal rate of return or mark-to-market basis

- Countries have different tax approaches with respect to «original issue discount obbligation»: discount element can be:
  - ✓ a capital gain
  - ✓ an interest

  and its tax treatment can change if obligations are held by:
  - ✓ individuals
  - ✓ businesses

- With respect to financial instruments, UK legislation allows to choose between mark-to-market and accrual method for tax purpose

- The US use a mark-to market approach with respect to many type of commodities futures, foreign currency and option contracts

Attribution of income
Taxable unit

Any decision regarding the taxable unit involves emphasizing some policy goal and social value

- In some cases, each individual is treated as a taxable unit and there is no aggregation of income of family members
- Other systems require or allow the married couple (or certain other forms of cohabitation) to be treated as a taxable unit
- Several solutions are adopted with respect to income of dependent children: for some countries they are separate taxpayers, for others their income are taxed together with the adults who have the resposability for their care

Attribution of income
Taxable unit

In a system of progressive rates it is impossible to have an equal treatment of married couples

If 2 single persons with roughly equal income married, their tax burden would be increased, since the aggregation of their income in the married rate structure would increase the impact of the progressive rates

- In Germany married couples are taxable units and it is used the «splitting procedure» to avoid «marriage penalty»
- For Canada and Australia, each individual is a taxable unit. However, the income of both spouses is aggregated for purpose of determining the entitlement to certain personal tax allowances
- In France the taxable unit is the «foyer fiscal», which is composed of husband and wife, dependent childer and any qualified disabled person. The total income is then taxed according to the «quotient familial» system

Attribution of income
Alimony and child support

It can be two different approaches:

- Treat the payment as a kind of «splitting» of the income between the two former spouses. So, the alimony would in effect be deductible by the husband but taxed to the wife

- Treat the payment as a personal expense to the husband and therefore non-deductible. For the wife, it is taxable on the view that it has increased her power to consume or, alternatively, treated in the same manner as interfamilial gifts, so non-taxable

The same issues arise with respect to payments of child support to the custodial parent by non-custodial parent

Attribution of income

Limitations on assignment of income

In a system with progressive rates, taxpayers have an incentive to attempt to shift income to related taxpayers who are not treated as part of the same taxable unit but who are part of the same economic family unit

- Techniques to shift earned income typically involve contractual arrangements which create rights to income in related parties
- In the US, earned income is taxable to the earner and the tax burden could not be shifted by contractual arrangments, even if those arrangements were not tax motivated and were effective for civil-law purpose
- In Canada, where the taxpayer transfer property to a spouse or minor child, any income from the property is attributed to the transferor
- In UK, a gift of property is effective to shift the burden of tax on the income to the transferee

Individual income tax
(IRPEF)

Individual income tax (IRPEF)

- **Taxable persons, Rate, Residence for tax purposes:**
- Basis of the tax
- Taxable base for residents and non-residents
- Categories of income

IRPEF: rate and taxable persons

- **Taxable persons**
  - Resident individuals
  - Non-resident individuals
- **Progressive tax rates**
  - Lowest rate: 23% up to € 15.000
  - Highest rate: 43% over € 75.000
  - The above rates are increased by:
    - A regional surcharge varying between 1.23% and 3.33% depending on the region;
    - Local surcharge of up to 0.9% depending on the municipality
    - And additional temporary surcharge of 3% (if an individuals have an income exceeding 300.000 Euro).
- **Tax calculated independently on a year-by-year basis (tax period = calendar year)**

IRPEF: residence for tax purposes

- **Three (alternative) residence tests:**
  - Registration in the list of resident population, or
  - Habitual abode in Italy (residence under civil code), or
  - Centre of vital interests in Italy (domicile under civil code)
- **Most part of the tax period**

Anti-avoidance rule: an Italian national is deemed to be resident in Italy if he emigrates to a country considered to be a tax haven, even if his name is removed from the Italian civil registry of the resident population. This is a rebuttable presumption: the burden of proof that actual residence is outside Italy is shifted to the taxpayer.

IRPEF: residence for tax purposes

- Tests on a year-by-year basis
  - During a given tax period, an individual is either a resident or a non-resident of Italy
  - Residence status may change on a year-by-year basis

An example

France citizen student

I	F
	
Abitual abode	Familiar interests
Study interests	Building owned and leased

Is she an Italian resident for tax purposes?

Yes

Individual income tax

- Rate, Taxable persons, Tax Residence
- **Basis of the tax**
- Taxable base for residents and non-residents
- Categories of income

Basis of the tax

The basis of the individual income tax is the ownership of income either in cash or in kind

Individual income tax

- Rate, Taxable persons, Tax Residence
- Basis of the tax
- **Taxable base for residents and non-residents**
- Categories of income

Taxable base for residents and non-residents

- **Residents** are taxed on their world-wide income
  - Tax credit for taxes paid abroad
- **Non-residents** are taxed only on Italian source income
- The taxable base is the aggregate amount of <u>relevant</u> income produced by the taxpayer in the tax period
  - The attribution of income to a period is governed by the rules provided for the category of income to which it belongs;
  - Income subject to final withholding or substitute tax is excluded from the taxable base.

Individual income tax

- Rate, Taxable persons, Tax Residence
- Basis of the tax
- Taxable base for residents and non-residents
- **Categories of income**

Categories of income

Income from employment
(*e.g.* bank clerk)

Business income
(*e.g.* retail store)

Income from capital
(*e.g.* interest from a bank account)

Miscellaneous income
(*e.g.* gains from sale of listed company shares)

Income from immovable property
(*e.g.* rented sea house)

Income from self-employment
(e.g. painter)