

## TAX REVENUE, UNCOLLECTIBLE TAX, TAX CREDITS

### Task Force on Harmonization of Public Sector Accounting — Working Group 2

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#### Preface

*This paper is based in large part on the OECD's paper from December 23, 2003, modified by the IMF's Government Finance Division staff in February 2004, and updated in June 2004 by the OECD. The main purpose of the paper is to set forth proposals for the revision of SNA (2008) regarding (1) the definition of tax revenue, (2) accrual recording of taxes, and (3) the recording of tax credits. Concerning the accrual recording of taxes.*

- *A combination of (1) tax assessment adjusted by coefficient and (3) time-adjusted cash amounts is proposed for consideration for recording tax revenue .*
- *Regular revisions of coefficients to smooth out uncollectible taxes over longer period also is proposed (see Annex 1).*

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## **I. DEFINITION OF TAX REVENUE**

### **1. SNA93, Definition (§7.48 and 8.43):**

“Taxes are compulsory, unrequited payments, in cash or in kind, made by institutional units to government units. They are described as unrequited because the government provides nothing in return to the unit making the payment, although governments may use the funds (...) to provide goods and services to other units (...) or to the collectivity as a whole.”

SNA93 provides an important additional element of definition: “Taxes versus fees” (§7.55 and 8.45, both strictly identical):

- If a licence (or certificate, or authorisation) is granted automatically on payment of the amounts due, it should be recorded as a *tax*
- If the issuance of the licence (or certificate or authorisation) implies a proper regulatory function of government (checking competence, qualifications, safety, quality etc.), the payment should be recorded as the *purchase of a service* produced by the government, unless the payments are clearly out of proportion to the costs of providing the services.

One issue to clarify is the borderline between revenue and disposal of non-financial assets, as sale of licenses can sometimes be recorded in the latter category. One case is the treatment of mobile-phone licences, that arguably involve the existence of a tangible asset. Other cases that may need clarification may involve exploitation oil licences, or even pollution rights or licences. The Canberra Group, one of the ISWGNA Task Forces may come up with proposals.

Another issues, although partially related to the previous question, is the question of securitization of taxes, or of lump sums paid to government against the right to collect future taxes. The underlying problem is the recognition of the revenue, particularly its time of recognition.

**SNA93 Classification:** taxes are broken down in the following way:

- D.2: Taxes on production and imports
  - . D.21: Taxes on products
  - . D.29: Other taxes on production
- D.5: Current taxes on income, wealth etc.
  - . D.51: Taxes on income
  - . D.59: Other current taxes
- D.91: Capital taxes

### **2. GFSM 2001**

Definition (§4.21): “Taxes are compulsory transfers received by the general government sector. They include fees that are clearly out of proportion to the costs of providing services, but exclude compulsory social contributions, fines, and penalties.”

**GFS breakdown** is quite different from SNA classification:

- Taxes on income, profits and capital gains
- Taxes on payroll and workforce
- Taxes on property
- Taxes on goods and services
- Taxes on international trade and transactions
- Other taxes

### **3. IFAC - PSC : “Non-exchange transactions” and taxes**

Extract of the final draft of PSC (Public sector committee of IFAC) ITC:

Chapter 2 (principles), §2.8: If a transaction is made at “a price that is not approximately equal to the fair value of the goods sold, that transaction falls within the definition of a non-exchange transaction.”

“Non-exchange transactions are defined in paragraph 1.10. Examples of non-exchange transactions include revenue from the use of sovereign powers (for example, direct and indirect taxes, duties and fines) and transfers.”

Chapter 3 (taxes): §3.1 quotes the IMF GFSM 2001, retaining the same definition of taxes as “compulsory transfers to the government”. “This ITC adopts a similar notion of taxes. (...) A government levies taxation on individuals and other entities, known as taxpayers, within its jurisdiction by use of its sovereign powers. A government exercises “sovereign powers” when it can legally enforce its decision.”

IFAC definition of asset involves the notion of *past event* (i.e., the taxable income), which 1993 SNA could take on board.

#### ► Proposals for the new SNA

**No important change in substance seems necessary with respect to the definition of tax revenue in national accounts, as well as to the borderline between tax revenue and purchase of service. However the revenue / sale of non-financial assets borderline needs to be examined, and the question of securitization tackled.**

**Reference to the accountants’ notion of “past event” could be incorporated in SNA.**

**In addition, the wording “because the government provides nothing in return” should be modified, “nothing in return” being replaced by “nothing in exchange”, consistently with the IFAC-PSC reflections on “non-exchange revenue”.**

## II. ACCRUAL RECORDING OF TAXES

### A. Current systems

Statistical and accounting systems traditionally make a distinction between the *time* of recording and the *amounts* to record. Sometimes accrual principle is referred to as exclusively a time of recording issue, whilst the amount to record will be characterised as being governed by the fair or market value principle. Sometimes, the question of the time and the amount to record are referred both as pertaining to the accrual principle. In practice, time of recording and amounts to record are difficult to distinguish (even though in concept the distinction is clear); this is particularly the case for taxes.

**A.1 SNA93** (§7.59 and 60, §8.49 and 50, quasi-identical):

#### Time of recording:

*General principle:*

- “when the activities, transactions or other events occur which create the liabilities to pay taxes”. (§7.59)

*Practical principle:*

- “Some flexibility is (...) needed in the time at which (...) taxes are recorded. Income taxes deducted at source, such as *pay-as-you-earn* taxes, and *regular prepayments* of income taxes, may be recorded in the periods which they are paid and any *final tax liability* on income can be recorded in the period in which the liability is determined.” (§8.49)

The flexibility allowed is deemed to reinforce accrual recording in practice, not to give a license to follow a cash recording. First, the cash basis for PAYE taxes are much closer to the income date than other dates such as the declaration or assessment dates. Second, the reference to “prepayment” should in fact be taken to mean “provisional payments” or “instalments”. Those should not predate the time of income being taxed, and in case they would, those “prepayments” would be recorded as other payable by the tax authority. 1993 SNA (ESA 1995 and GFSM 2001) would gain clarify the term “prepayment”.

Amounts to be recorded:

*Parallel economy:*

- When economic activities “escape the attention of the tax authorities” (...) “the amounts of taxes to be recorded in the System are determined by the amounts due for payment only when evidenced by tax assessments, declarations or other instruments (...) which create liabilities in the form of clear obligations to pay”. (§7.59)

*Cash basis and uncollectible taxes:*

- “In some countries, and for some taxes, the amounts of taxes may diverge substantially and systematically from the amounts due to be paid.(...) In such cases, it may be preferable to ignore unpaid liabilities and confine the measurement of taxes within the System to those actually paid. Nevertheless, the taxes actually paid should still be recorded on an accrual basis at the times which the events took place which gave the rise to the liabilities.” (§7.60)

**A.2 ESA95:** Provisions in the ESA are generally directly inspired by those in SNA93. The §4.26 and 27 (for D.2) and §4.82 (for D.5) retain the same distinction and recommendation for the *time of recording* (“when the economic activity occur...” and “Some flexibility is ... needed in the time at which ... taxes are recorded.”)), but less so for the amounts to record, although the same position is taken on the parallel economy (“when evidenced by tax assessments, declarations”).

The question of the treatment of uncollectible taxes (amount to record) gave rise to a changes in the ESA 1995. It is important to contrast the two text, to measure the perceived existing element of flexibility in the 1993 SNA.

**A.2.1 ESA 1995 – Initial version**

Concerning unpaid taxes, §4.27 and 4.82 state that: “Taxes evidenced by tax assessments but which are never paid (for instance because of bankruptcy) are treated as if they had been paid; there are two eventualities:

- a) the writing-off of bad debt by the government which recognises that its claim can no longer be collected; this writing-off is recorded in the other changes in the volume of assets accounts of the government and the defaulting debtor
- b) the cancellation of the debt by mutual agreement between the government and the debtor. This cancellation is treated as a capital transfer from the government to the debtor in the capital account, with a simultaneous extinction of the claim in the financial account.”

In practice, **these guidelines appeared to be not sufficient**, to ensure homogeneity of recording practices and comparability of government balances: in particular provision a) above could be considered too dissymmetrical to provision b), and much more advantageous with regard to its effect on the B.9 balance.

In a context where the net borrowing/net lending of general government was serving as a critical criterion to assess government finance sustainability (and to allow Euro-Area membership), Eurostat and member states felt necessary to develop supplementary provisions and to amend ESA 1995 by way of Parliament and Council Regulation n° 2516/2000 of 7 November 2000 and Commission Regulation (EC) No 995/2001 of May 22, 2001. The rationale of the regulations is that “the impact on general government net

lending/net borrowing of taxes and social contributions recorded in the system on an accrual basis shall be equivalent over a reasonable amount of time to the corresponding amounts actually received.”

#### ***A.2.2 ESA95—existing version***

##### *Time of recording:*

*General and practical principles:*

- “This is when the activity took place which generated the tax liability or, in the case of some income taxes, when the amount of tax due is determined with certainty by the government”.<sup>1</sup>

##### *Amounts to be recorded: two practical methods*

*Method using the assessed amounts (1):* two modalities of recording are allowed:

- “If assessments and declarations are used, the amounts shall be adjusted by a coefficient reflecting assessed and declared amounts never collected (1.1). As an alternative treatment, a capital transfer, to the relevant sectors could be recorded equal to the same adjustment (1.2). The coefficients shall be estimated on the basis of past experience and current expectations in respect of assessed and declared amounts never collected (...).”

*Cash amounts (2):* with a flexibility option

- “If cash receipts are used, they shall be time-adjusted so that the cash is attributed to the period when the activity took place to generate the tax liability (or when the amount of tax was determined, in the case of some income taxes) (2.1). This adjustment may be based on average time difference between the activity (or the determination of the amount of tax) and cash tax receipt (2.2).”<sup>2</sup>

#### **A.3 GFS Manual 2001**

Relevant provisions in the GFS manual 2001 are in §3.55 to 3.60 (“Implementation of the accrual basis”). They are quite similar to SNA93 provisions regarding the *time of recording*, but differ noticeably for the *amounts* to be recorded, in that it tightens considerably the recording of uncollectible taxes.

##### *Time of recording:*

*General principle:*

- “Taxes and other compulsory transfers should be recorded when the activities (...) occur that create the government’s claim to the taxes or other payments.” (§3.55)

*Practical principle:*

- “(...) as a practical deviation from the general principle, income taxes deducted at source, such as *pay-as-you-earn* taxes, and regular *prepayments* of income taxes may be recorded in the periods in which they are paid, and any *final tax liability* on income may be recorded in the period in which it is determined.” (§3.59)

##### *Amounts to be recorded:*

- Due to uncertainties related to economic activities, “only those taxes and social security contributions that are evidenced by tax assessments and declarations (...) are considered to create revenue for government units.” (§3.56)
- “It would be inappropriate to accrue revenue for an amount that the government unit does not realistically expect to collect. Thus, the difference between assessments and expected collections represents a claim that has no real value and should not be recorded as revenue.

<sup>1</sup> See ESA95 Manual on government deficit and debt, chapter III.1 (interpretation of ESA95 §1.57 and 4.26).

<sup>2</sup> See Regulation (EC) No 2516/2000 of 7 November, 2000 of the European Parliament and Council.

The amount of taxes and social security contributions that is recorded as revenue should be the amount that is realistically expected to be collected.” (§3.57)

It can be concluded from this wording, that the GFS Manual 2001 supports the change to the ESA 1995, and arguably reinforces it, and at the same time expresses a strong preference for the ESA 1995 recording (1.1)<sup>3</sup>.

#### A.4 IFAC – PSC

ITC, §3.6: “Taxes give rise to assets and revenue, which under accrual principles, should be recognised when the “taxable events occurs”. The taxable event is the past event that the government, legislature or other authority has determined will be subject to taxation.”

§3.9: “For many taxes, the reporting entity will be aware that the amount that the government is entitled to collect under the tax law is higher than the amount that will be collected. The amount collected is lower due to the underground economy (or black market), fraud, evasion, non-compliance with the tax law and error. The difference between what is legally due under the law, and what the government will be able to collect is referred to as the “tax gap”. Amounts previously included in tax revenue that are determined as not collectible do not constitute part of the tax gap.”

Two approaches are mentioned to accounting for the tax gap:

1. “The first approach would require entities to estimate the full amount legally due under the tax law and to recognise that amount as revenue. The entity would also be required to recognise an expense for the amount of the tax gap. ....The Steering Committee questioned whether these amounts would meet the definition of an asset, as there is no expectation that they would provide future economic benefits or service potential to the entity.
2. “The second approach is to disclose (...) such information about the nature and the extent of the tax gap as can be reliably estimated (...) but will not distort the statement of financial performance.” “The Steering Committee is of the view that the second approach is more compatible with the principles being proposed in this ITC.”

The ITC departs noticeably from statistical standards **[TO BE CONFIRMED]**:

- It seems not to include uncollectible taxes as being part of the tax gap to net out, as part of the preferred option of the steering committee; and
- The gross option envisages covering the parallel economy, which no statistical standard does.

Several paragraphs are dedicated to the analysis of taxes as assets to the extent that the inflow of resources “embodies future economic benefits or service potential”.<sup>4</sup>

§7 The Steering Committee view is that:

“Taxes are non-exchange transactions and should be recognised as revenue when:

- a) the taxable event occurs, that is the past event that gives rise to the control of the resources;

<sup>3</sup> A draft discussion paper by Johann Bjorgvinsson (IMF), entitled “Recording of taxes and other revenues in the GFSM 2001 System”, submitted to the Steering group on Revenue Statistics (OECD Working Party N°2 on Tax Policy Analysis and Tax Statistics, held on 18 November 2003) confirmed that “Option 1.1 and option 2 above are more in line with the spirit of the GFS 2001 Manual and its recording principles.” For certain types of taxes (income taxes on individuals), a combination of the two options was recommended.

<sup>4</sup> However, §3.30 and 31 discusses the issue of considering the “right to tax” as an intangible asset of the government. It finally states that « the right to tax cannot be recognised as an asset because it is not possible to establish the cost or fair value of the asset; therefore it fails the criteria for recognition of an asset.”

- b) it is probable that the future economic benefits or service potential will flow to the entity; and
- c) the fair value of the economic benefits or service potential flowing to the entity can be measured reliably.”

That is when the amount of tax in question meets the asset criteria.

## **B. Assessment**

### **B.1 Asset recognition**

The recording of taxes on an accruals basis is clearly different from the recording of cash, usually implying the recording of a financial transaction under Other accounts receivable / payable (F.7). The assets that flow to the entity as a result of taxes include cash or the right to receive cash. It involves recognition of an asset, which is defined in broad terms similarly in both SNA and IPSAS. However, the IFAC-PSC link the recording of tax revenue with the “flowing of future economic benefits or service potential to the entity” and with the time when “the fair value of these benefits can be measured reliably”.

There is broad agreement in principle; the coverage of the parallel economy is troubling. One issue is the reference to past events, that SNA may be interesting to pick up.

### **B.2 Amount to record**

The present guidelines in SNA93 to implement the accrual recording are not sufficient. To protect the analytical usefulness and comparability of government balance, it is desirable not to allow to record *amounts* of tax revenue unlikely to be collected that would improve artificially the net lending / net borrowing.

This should not also leave limited room or none at all for recording write-off of accrued taxes (bad debt) through other changes in volume.

The three possibilities developed in the revised ESA 1995 meet these ends:

- (1.1) Assessed amounts as due adjusted by a coefficient reflecting the assessments never collected
- (1.2) Assessed amounts as due are entirely recorded, but the amounts assessed by coefficient as never collected are treated as a capital transfer.
- (2) Time-adjusted cash amounts.

However, there is a question of whether (1.2) is acceptable from the point of view of the measure of government revenue, and international comparability. From the GFS stand-point, this alternative is not acceptable since GFS does not only emphasize the net lending/ net borrowing concept, but also the total revenue and total expense and their composition (structure), e.g. the expenses by economic types and functions. It is therefore important when creating practical recording rules that these rules lead to collection of meaningful economic data that are easily comparable between countries. The option to choose between gross or net recording of revenue and expense, as given in these general principals, will complicate such comparability between countries. Similarly, the recording of capital transfers to other sectors is not economically meaningful, when these capital transfers are due to over-assessment in taxation.

Another question relates to clarifying where the PSC ITC stands on this issue.

It is clear that 1.1 and 1.2 make use of the technique of a “coefficient”. One question is how does one measure it? Another question is the way to tackle the difference between the estimated coefficient and the realised collection. Part II.C deals with this issue.

The use of a *coefficient* to reflect the assessments never collected, as described in [Annex 1](#), will make the ESA95 paragraphs 4.27 and 4.82 unnecessary regarding unpaid taxes, since regular revisions of the coefficients will smooth out uncollectible taxes over longer period.

### B.3 Time of recording.

With reference to the role of the GFS as a fiscal instrument for measuring the government's impact on the economy, it is seen as vital that both the *accuracy and reliability* of the accrual recording and the *timeliness* of revenue data are adequate for this fiscal role. For the GFS to keep its expected role in fiscal analysis and fiscal decision making, the development of general and practical rules for revenue recording has to take account of this requirement, and *optimize the trade-off* between the quality of accrual recording and the timeliness of the data. This may involve as an example combining possibility (1.1) (assessment adjusted by a coefficient) and possibility (2) (time-adjusted cash amounts) that could be considered for the future SNA recommendation.

A numerical example showing the possible trade-offs to which authorities may respond, including uses of combination (recording rule) is described in the following box, and as well in [Annex 2](#) by using two examples of how to record personal and corporate income taxes according to this rule.

## C. The Coefficient

### C.1 The Coefficient in concept

The coefficient captures the amounts of taxes uncollectible: that is the amounts that were recorded ("accrued") but that will eventually not be paid, due to various events, such as bankruptcies, corrections etc. For a given tear of income or event being taxed, the uncollectible amount will be known far after the event.

In the following box, a simplified example is used to illustrate the *main principle* behind the coefficient calculation for personal income tax. The personal income tax assessed for 1995 is \$100,000 (the assessment is made in July 1996). The income tax related to 1995 paid during 1995 is \$90,000. Of outstanding tax liability (\$10,000) related to year 1995, \$6,000 was paid during the following years (ended 2000), and \$4,000 was never collected. The tax-coefficient for personal income tax, based on 1995, is  $\$4,000 / \$100,000 = 4\%$ . Based on this simple coefficient calculation, the personal income tax recording in **2001** may use the 4% coefficient to reflect the income tax never collected.

#### *Coefficient calculation for income tax on individuals (general principle):*

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>Sum</u>
Income tax assessment (July 96)	100,000						
Cash payments (Jan95-Jan96)	90,000						
Tax liability (Y1995) paid each following year		4,000	1,000	500	250	250	6,000
Taxes (Y1995) never collected		2,000	1,000	500	250	250	4,000
Outstanding tax liability (Y1995)	10,000	4,000	2,000	1,000	500	0	

The tax-coefficient for personal income tax is  $\$4,000 / \$100,000 = 4\%$ . For some countries the information above may not be available, which calls for the best approach to this main principle.

### C.2 Measure of the coefficient



Whilst the coefficient is known exactly after a few years (assuming a tax reporting system capturing the year of income to which each tax payment relates to), some estimates will be needed, for provisional account or event for final accounts.

The calculation can of course be repeated for more years, and the average results (even weighted by recent trend-changes) will be used to estimate the coefficient. Over longer period the coefficient will, of course, need regular revisions due to e.g. changes in tax collection methods or the economic prosperity. It is therefore necessary to have floating assessment (more recent years) of the coefficient, which takes account of the recent trend-changes (even weighted). By doing these adjustments, the amounts of uncollectible taxes will be smoothed out over longer period. This will mean that taxes never collected will be corrected through *revenue recording*.

### **C.3 Treatment of the difference occurring between the estimated amount and the actual amount**

It is implausible that GFS compilers would agree to perpetually revise taxes of previous years, as the actual cash flows allows a finer and finer estimates of the actual coefficient for each year of income. Instead, it is likely that an estimated coefficient will be fixed for a year, perhaps at first estimate, or after a few reviews. The question is then: what should we do from the difference between the actual amounts and the estimates?

There are two classes of answers (developed in annex II):

- (1) Delete or create the difference in question in the books of government, at time the difference is established by way of:
  - (1.1) and other change in volume
  - (1.2) a tax revenue or expense
  - (1.3) a tax revenue negative or positive
- (2) do nothing.

Approach 1.1 is not appealing as, it allows uncollectible taxes to be recognized. Approach 1.2 does not yield the same revenue measure as correct accrual methods. Approach 1.3 gives a correct revenue measure but the time of recording is questionable. In general class 1 give rise to entries at the time the accountant recognize the non-collectible character of the asset (or the excess of cash inflows over recognized assets). This is not satisfactory.

Another option is simply to do nothing: it does not involve deleting (or adding) the remaining other accounts receivable. It starts with the observation that mistakes in forecasting will tend to compensate. Hence, the cumulating of “wrong” other accounts receivable will be small, particularly in comparison to the total stock of other accounts receivable applicable for the tax in question. It is hence suggested to do nothing.

One issue is how the system copes with systematic mistakes in coefficient averages or with structural changes of coefficient. One consideration is that the coefficient need not be fixed forever, but reflects observed collection practices: it is hence adjusted over time, with a lag. Hence a structural increase in ratio of tax collectible would seem to yield to only a one-off increase the stock of other collectible (size depending on the number of year the coefficient is established). However, even that one-off difference will tend to disappear over time: de facto, when the coefficient is based on past averages (only), the “realized difference” of -1 on 2003 tax observed early 2006 will allow a revision of ratio, perhaps down from 96 to 95.8<sup>5</sup>, which will gradually build a stream of “excessive” that will gradually reduce the original stock of other payable receivables.

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<sup>5</sup> One could use a weighted average, overweighting recent years. To a limit, the coefficient of one year T could be set equal at that just observed in T-3 (no average).

This discussion above should be taken on board as a basis for the future SNA recommendation.

### ► **Proposals for the new SNA**

To replace §7.59-60 and 8.49-50:

**Like most transactions, taxes and social contributions should be recorded on an accrual basis in the SNA. Accrual recording means basically that flows have to be recorded when economic value is created, transformed, exchanged or extinguished.**

**The implementation of this recommendation for taxes and social contributions raises two questions:**

- the time of recording
- the amounts to be recorded

#### **1. Time of recording:**

**This is when the activities, transactions or other events occur which create the liability to pay taxes, and not when they are actually paid. In the case of taxes, this usually means when income is paid or when a transaction (purchase of goods and services etc.) generating the liability is made.**

**Some flexibility is permitted in two cases:**

- **Taxes on income:** in some cases the liability to pay income taxes can only be determined in a later accounting period than that in which the income accrues. This is the case when amounts due are evidenced and known with sufficient certainty only through tax assessments, declarations etc.
- **Parallel economy:** some activities, transactions or events escape the attention of the tax authorities. The liability to pay taxes cannot be related to the underlying economic event, but only to the time when the tax assessment is made.

**Therefore, in these two cases, the right time of recording the taxes is not the time when they accrued (the time when the economic event generated the obligation to pay taxes), but the time when the taxes were known as due to be paid with sufficient certainty. This is not necessarily similar to the accounting period of the payment.**

#### **2. Amounts to be recorded**

**Accrued taxes are often understood as due taxes (or taxes due to be paid). The difficulty here is that recording due amounts of taxes and social contributions - at the time they are due or generated - should not lead to record amounts that are uncollectible, or unlikely to be collected. The net borrowing / net lending of the general government should not be artificially improved by the recording of amounts which are known to be uncollectible.**

**The general recommendation is to record in national accounts:**

- **either assessed amounts as due adjusted by a coefficient reflecting the assessments never collected (in the recent past)**
- **or cashed amounts (but recorded at the time they were accrued, or due).**

### **III. THE RECORDING OF TAX CREDITS**

#### **A. Current Systems**

##### **A.1 SNA93 and ESA95**

Nothing is provided for the recording of tax credits in the national accounts manuals.

##### **A.2 GFSM 2001**

Chapter 5 (Revenue) states in §5.23:

“Tax credits are amounts deductible from the tax that otherwise would be payable. Some types of credits can result in a government unit making a net payment to the taxpayer. Such net payments are treated as an expense rather than a negative tax.”

See also in §5.34 the special case of “tax credits” in favour of shareholders (“any net payment to shareholders is treated as a negative tax rather than expense”).

Chapter 6 (Expense) states in §6.87 concerning the definition of “Miscellaneous other expense”, indent “Net tax credits”:

“When the amount of a tax credit exceeds the amount of tax otherwise receivable from a taxpayer and the excess is paid to the taxpayer, the net payment is treated as expense rather than negative tax.”

§6.87 clarifies that, for GFS, only the net payment in excess of tax payable, once diminished by the tax credit, is to be recorded as expense (under Miscellaneous other expense).

##### **A.3 OECD Revenue Statistics**

For discussions in the “Working Party n°2 on Tax Policy Analysis and Tax Statistics”, the following criteria were taken into consideration, referring to the Revenue Statistics Interpretative Guide (§20-21).

For this Guide, two types of tax credits are distinguished:

1. “Wastable tax credits, i.e. tax credits which are limited to the amount of the tax liability and therefore can never give rise to a payment by the authorities to the taxpayer
2. “Non-wastable tax credits, which are not so limited, so that any excess of the credit over the tax due can be paid to the taxpayer.”

“The interpretative guide suggests that any amount of tax credit that exceeds tax liability and is accordingly paid out by the tax authorities should be classified as expenditure.”

As a result of a survey conducted in year 2002, ten OECD countries appear to currently have such non-wastable tax credits. This can affect the level of tax-to-GDP ratios. Again, it was made clear that: “Revenue statistics require that only that portion of a non-wastable tax credit that is used to reduce or eliminate a taxpayer’s liability should be deducted in the reporting of tax revenues. For convenience this may be referred to as the “tax expenditure component” of the credit. The part of the tax credit that exceeds the taxpayer’s tax liability and is paid to that taxpayer should be treated as an expenditure item and not be deducted in the reporting of tax revenues. This part may be referred to as the “transfer component” of a non-wastable tax credit.”

##### **A.4 IFAC – PSC**

Paragraphs 3.24 and following make a distinction between “Tax expenditures” and “Expenses paid through the tax system”. By nature, tax expenditures target only taxpayers.

§3.27: “The key distinction between tax expenditures and expenses paid through the tax system is that, for expenses paid through the tax system, the benefit is available to entities irrespective of whether they pay taxes, or use a particular mechanism to pay their taxes. The majority view of the Steering Committee is that, in respect of expenses paid through the tax system, the form of the payment should not influence the amount of revenue recognised, therefore revenue should be increased by the amount of the expense and an expense recognised for the same amount.”

§3.28: “A minority view expressed in the Steering Committee is that the key issue is the amount of tax that the jurisdiction can assess. This will be the net amount, rather than the gross favoured by the majority of the Steering Committee. Therefore, in line with the proposed treatment for tax expenditure, and guidance issued by the OECD, taxation revenues should be reported net of expenses paid through the tax system to the extent that an individual taxpayer’s tax bill is reduced to zero.”

## **B. Assessments**

OECD Government Revenue statistics and *GFSM 2001* agree to treat a tax credit as expense (instead of being deducted from revenue) only for amounts that are actually paid by tax authorities to the tax payer. However, due to technological developments, some governments increasingly apply automatic deductions from tax payer’s bills (netting tax credits from the tax payer’s obligations), actions tantamount to benefits. The source data may not allow separate recording of expenses, reducing international comparability. What would be the criteria and mechanisms for expensing tax credits? Tax allowances are also close substitutes for tax credits.

## **C. ► Proposal for discussion for the new SNA**

The definition of tax credits is a delicate issue, governments having very different ways of using this sort of measure.

**Definition:** a tax credit is a reduction of tax offered to households or other entities – most often of tax on income – which is embedded in the tax system. To be recorded as such, this reduction should be part of the tax system, calculated on the same base and over the same time period like taxes.

**a) Case of “non-wastable tax credits”:** one of the difficulties is that some tax credits may be not limited to deduction from due taxes: in some cases, any excess of the credit over the tax due is to be paid by the government to the taxpayer.

The part of the tax credit that exceeds the taxpayer’s liability and is paid to the taxpayer should be treated as an expenditure transaction (often a social benefit) and not be deducted in the reporting of global tax revenues.

### **b) Borderline with social benefits and subsidies**

Some social benefits (like retirement pensions) and subsidies (to corporations for hiring specific categories of workers, young or handicapped workers etc.) should not be recorded as tax credits – deducted from due taxes - just because they may be netted from the amounts of taxes due to be paid in some circumstances. There should be no global netting of tax liability and benefits or subsidies resulting in a decrease of the tax burden.

The recording of tax credits should meet some criteria:

- The tax credit measure must appear as part of the tax law, the tax code and on tax statements. To that extent, could only be deducted from a given tax, amounts that are calculated on the same base as the tax (usually the income), and over the same period of time. Thus, possible VAT reimbursement to specific categories of the population cannot be deducted from the tax on income.
- The amount recorded as tax credit – deducted from tax due – cannot exceed the amount of tax due by beneficiaries. This element in excess is an expenditure of government.
- Individual information should be available through the tax statement of households or other entities benefiting from the measure.

## ANNEX 1. Examples of how practical principles are applied

### Example 1 Personal Income Tax.

Taxes have to be recorded best at time the economic activity occurs, which may impair timeliness needs. Alternative methods may yield quicker final accounts. It involves using time-adjustments so that the cash is attributed to the period when the activity (...) took place that generated the liability, with a *final tax liability on income* may be recorded in the period in which it is *determined*.

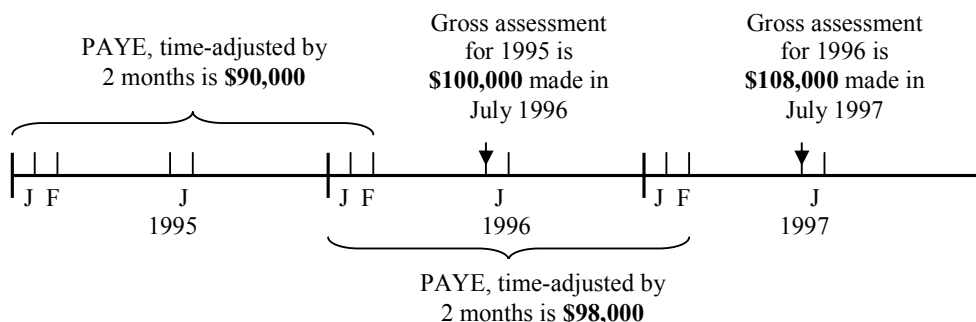
An alternative method, used in Iceland can be applied as follows:

- (1) record all income taxes deducted at source (PAYE) related to the recording year when deducted,
- (2) time-adjust those taxes related to the recording year, but paid in following year, on the basis of the due for payment principle.<sup>6</sup>
- (3) record the final tax liability in the period in which the liability is determined. When deciding the final tax liability, the gross tax assessment is adjusted by a coefficient reflecting the assessments that will never be collectable, and as well by the tax amount that has already been paid (i.e. by provisions (1) and (2)).

Consider the following example:

- The recording year is 1996.
- The (1) PAYE and (2) time-adjusted income tax, related to 1996, is \$ 98,000.<sup>7</sup> The adjustment period (due for payment period) is two months,<sup>8</sup> i.e. January and February. The corresponding figure for 1995 is \$ 90,000.
- The gross income tax assessment related to 1996 is \$ 108,000 made in July 1997, and the corresponding gross assessment for 1995 is \$ 100,000 made in July 1996.
- A coefficient is used to adjust the gross assessed income tax to determine the tax assessment that will never be collectable. The coefficient is based on calculation from previous years' experiences and is in this example 4%.
- Under the usual accrual principle the amount to record in 1996 is \$ **103,680** ( $108000 \times 0.96$ ), and will be known in August 1997 (T+8 months).
- The alternative method yields quicker results: by March 1997 (T+3 months). The personal income tax recorded in 1996 is \$ **104,000**, i.e.

PAYE and time-adjusted income tax related to income year 1996	\$98,000
Gross assessment related to income year 1995	\$100,000
Income taxes that will never be collectable ( $\$100,000 \times 0.04\%$ )	-\$4,000
Adjusted assessment ( $\$100,000 - \$4,000$ )	\$96,000
PAYE and time-adjusted income tax related to income year 1995	-\$90,000
Final tax liability related to 1995 recorded when determined (1996)	\$6,000
<b>Personal income tax recorded in 1996</b>	<b>\$ 104,000</b>



<sup>6</sup> Due for payment recording shows transactions at the latest times that the corresponding payments can be made without additional charges or penalties.

<sup>7</sup> Only cash payments related to the income year 1996 are recorded.

<sup>8</sup> This period can, of course, be of different length (due for payment period), and it can be based on average time difference between the activity and cash tax receipt.

## Example 2 Corporate Income Tax

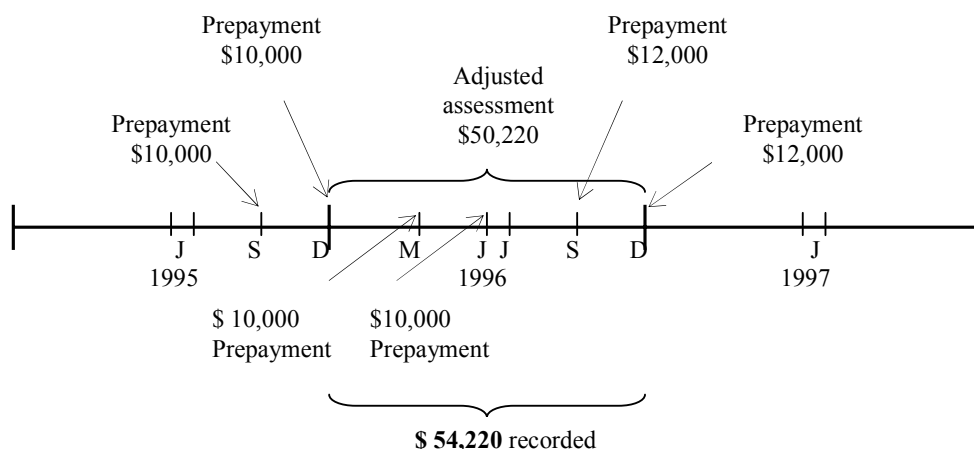
**Taxes have to be recorded best at time the economic activity occurs, which may impair timeliness needs. Alternative methods may yield quicker final accounts. It involves using time-adjustment s so that the cash is attributed to the period when the activity (...) took place that generated the liability, with a *final tax liability* on income may be recorded in the period in which it is *determined*.**

The levy of corporate income tax is normally based on income (profits) declarations provided by the corporations.<sup>9</sup> An alternative method, can be applied as follows: The tax liabilities, usually related to the previous year, are recorded in the period in which they are determined, and adjusted by a coefficient reflecting the assessments that will never be collectable and by the amount that has been prepaid.<sup>10</sup>

Consider the following example:

- The recording year is 1996
- The income tax assessment for 1996 is \$54,000 (made in July 1996 and based on income declarations related to year 1995)
- In end of each of the following months – September (1995), December (1995), March (1996), and June (1996) – prepayments (\$10,000) were made related to the 1996 corporate income tax
- In end of September (1996) and December (1996), prepayments (\$12,000) were made related to the 1997 corporate income tax
- The coefficient used to adjust the corporate income tax to reflect the tax assessments never collectable is 7%. The coefficient used has be calculated from previous years' experiences.
- Under the usual accrual principle the amount to record in 1996 is \$ XXXXX (.....), and will be known in July 1997 (T+7 months).
- The alternative method yields quicker results: by January 1997 (T+1 month). The corporate income tax recorded in 1996 is **\$54,220**, i.e.

Gross assessment of corporate income tax in 1996	\$54,000	
Income taxes that will never be collectable ( $\$54,000 \times 0,07\%$ )	<u>-\$3,780</u>	
Adjusted assessment ( $\$54,000 - \$3,780$ )	\$50,220	
Cash prepayments related to Y1996 paid Y1995	- \$ 20,000	(\$10,000 + \$10,000)
Cash prepayments related to Y1997 paid Y1996	\$ 24,000	(\$12,000 + \$12,000)
	-----	
<b>Income tax recorded</b>	<b>\$ 54,220</b>	
	=====	



<sup>9</sup> These taxes are usually assessed on the total incomes of corporations from all sources and not simply profits generated by production (see *SNA 1993*, paragraph 8.52)

<sup>10</sup> As a practical deviation from general principle, regular prepayments of income taxes may be recorded in the periods in which they are paid (See *section IV*).