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Individual Income Tax

Lee Burns and Richard Kreyer

I suspect that if a million monkeys were put in front of a million typewriters, by Wednesday one of them would have come up with an improved version of the Income Tax Act.

*—Paul Gerber, Senior Member
Administrative Appeals Tribunal
(Australia)*

I. Introduction

This chapter addresses the design and drafting of the income tax law for individuals.¹ The discussion covers the structure of the income tax, the definition of the tax base, the tax unit (i.e., identification of the taxpayer), the tax rate structure, and the administrative and collection aspects of personal income taxation. The discussion of the tax base in this chapter focuses particularly on employment income, including fringe benefits. The taxation of business and investment income is dealt with in chapter 16.

II. General Design

A. Schedular Versus Global Income Taxes

Two theoretical models exist for the structure of the personal income tax—schedular and global. A schedular income tax is one in which separate taxes are imposed on different categories of income. A global income tax is one in which a single tax is imposed on all income, whatever its nature.

In the benchmark schedular system, gross income and deductible expenses are determined separately for each type of income; in some cases, limited deductions or no deductions may be allowed. The rates of tax applicable to each category of income are then applied to the taxable amount of the income. The rates of tax may vary from category to category. Different procedures may apply to each category of income for the reporting,

¹ This chapter uses the term “individual,” commonly referred to in civil law countries as “physical person” or “natural person,” and refers to the tax as individual income tax or personal income tax.

assessment, and collection of tax. Some types of income may be taxable only through withholding; others may involve the filing of returns. Schedular systems used to be more widespread; a few countries still have such a system, or one with substantial schedular elements.²

In the benchmark global system, there is no matching of particular types of income to the expenses incurred to derive the income. All income and expenses are considered together to arrive at a single net gain that is subject to tax. Thus, under a pure global system, the category of income is irrelevant.

Between pure schedular and pure global taxation, there are many possibilities. One of these has been called "composite," under which a global-type system is superimposed on a set of schedular taxes.³ This approach involves combining some or most types of income for the purpose of imposing a progressive rate surcharge on top of the flat rates commonly imposed on the schedularized categories of income, as well as for the purpose of providing personal tax relief for family costs.

Many tax policy theoreticians consider the global income tax to be superior to the schedular system. It is commonly suggested that schedular taxation suffers from the following disadvantages:

(1) The separation of an individual's income into more than one tax regime may make it difficult or impossible to impose progressive taxation and to provide for personal tax relief (in the form of exemptions, deductions, or rebates). Progressive taxation is commonly seen as the most effective way of levying taxes on an ability-to-pay basis, and to the extent that ability to pay is indicated by an increase in total economic capacity, the tax should be levied on a taxpayer's total income. Under a schedular system, a progressive marginal rate structure may be applied to some categories of income only, leading to inequities between taxpayers who earn different types of income. Similarly, under a schedular system, personal tax relief must be either

² According to the latest legislation we could find (see Bibliography of Tax Laws), Burundi, the People's Republic of China, Eritrea, Ethiopia, Lebanon, Romania, Rwanda, Somalia, Sudan, the Republic of Yemen, and the Democratic Republic of the Congo (formerly Zaire) have a substantially schedular individual income tax, in which different rate schedules apply to different major categories of income. Although Hungary has a global definition of income and a progressive rate schedule for the consolidated tax base (see HUN PIT §§ 4, 30), there are so many special rules and separate rates for different kinds of income that the tax should be considered substantially schedular. While the Philippines started out with a global system, a schedular system was adopted in 1981, with wages being taxed separately from other income. See Angel Yoingco, *The Dynamics of Income Tax Reform* (1985); and National Internal Revenue Code §§ 21, 28, and 29 (J. Nollado, ed. (1985)). Since then, there has been some movement back toward a global system, although substantial schedular elements remain. Schedular taxes are imposed on foreign-source income derived by nonresident citizens, and on interest, dividends, and capital gains, while other income is aggregated and subject to tax under a progressive rate schedule. See PHL NIRC § 21. A number of other countries treat certain income from capital on a schedular basis, for example, CZE ITA § 36 (special rates of tax applicable to interest and dividends); KAZ TC § 13 (interest, dividends, and liquidation gains subject to final taxes); LSO ITA § 158(2) (final withholding tax on interest). See also *infra* note 12.

³ See Sylvain Plasschaert, *Schedular, Global and Dualistic Patterns of Income Taxation* 17 (1988). Examples of composite systems are those in Chile and Mozambique. The superimposed global tax is typically called a global complementary tax.

applied wholly against one category of income, such as employment income—in which case the relief may not be fully effective—or divided among various categories of income, which increases complexity.

(2) The schedular system is potentially more difficult to administer. Scarce administrative resources may be wasted on classification issues arising at the borders between the various schedules. For example, if income from employment and income from business are taxed under different schedules, then it becomes necessary to characterize a particular income-earning activity as being one of employment or business (self-employment). The border between an employer-employee and a customer-consultant relationship is difficult to draw.

(3) Any differences in the final tax burdens imposed under a schedular system on income in different categories will be exploited by taxpayers engaging in tax planning and restructuring to ensure that their income fits within the most advantageous category. Tax-planning activities of this sort not only impose economic dead-weight losses as resources are diverted into unproductive planning activities, but may cause serious economic inefficiency as taxpayers opt for income-earning activities that may be less efficient, but more lightly taxed.

While a global income tax may be preferable from a conceptual perspective, the purest form remains a theoretical ideal only. In practice, all global income taxes contain some schedular elements and most existing income tax systems lie on the spectrum between schedular and global. While some countries with a global income tax define income without breaking it down into categories,⁴ others have a schedular structure to the identification of taxable amounts, whereby such amounts are defined according to categories of income.⁵ Such a definitional structure has two general implications. First, if an item is not included in any of the categories, then it is not included in income. Some countries may have a residual category, but even that is often not open-ended.⁶ Second, it will often make a difference into which category an item of income falls, because each category has its own rules.⁷ Even in jurisdictions that do not define income by reference to categories, judicial doctrines may classify income into different types.⁸

⁴ See COL TC § 26; HUN PIT § 4 (*but see supra* note 2); RUS IT § 2; USA IRC § 61.

⁵ See AUT EStG § 2; BEL CIR § 6; CAN ITA § 3; DEU EStG § 2; FRA CGI § 13; ESP IR § 23; GBR ICTA §§ 15–20; JPN IT § 22; LSO ITA § 17.

⁶ See DEU EStG § 22; LSO ITA § 17 (1)(d); SGP ITA § 10(1)(g). *See also infra* secs. III(A) and VI.

⁷ See, e.g., FRA CGI § 13(3).

⁸ This approach is common in jurisdictions that have derived their income tax principles from the United Kingdom. For example, AUS ITAA (1997) § 6-1(1) provides that assessable income consists of “ordinary income and statutory income.” Statutory income is any amount that is expressly included in assessable income under a provision of the tax law (ITAA (1997) § 6-10(2)). Ordinary income is income classified according to ordinary concepts (ITAA (1997) § 6-5(1)). The definition of income classified according to ordinary concepts has been elaborated by the courts. An amount derived is ordinary income if it has its source in an earning activity. The earning activities identified by the courts are the employment of one’s labor, the investment of capital, or the application of labor and capital combined (i.e., the carrying on of a business). This has led to what is, in effect, a judicial categorization of income into employment, business, or investment income. The courts have recognized that an amount derived that

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Moreover, whatever the basic definition of income, distinctions are often made in the legislation for a range of policy and technical reasons. For example, if capital gains are included in the tax base, they may be treated differently from other types of income.⁹ Similarly, different rules may apply to expenses incurred to derive different types of income,¹⁰ or discrete sets of rules may be considered appropriate for particular types of income.¹¹

Finally, the global systems of many countries have become partially schedularized by the use of final withholding taxes on certain types of income, particularly dividends and interest, and lower tax rates on capital income.¹² It has been suggested that in these jurisdictions partial schedularization may actually increase the progressivity of the income tax by eliminating opportunities for taxpayers to exploit timing differences and other preferential treatment that may apply to different types of income and expenses.¹³

B. Single or Separate Tax Laws

exhibits some of the essential characteristics of employment, business, or investment income (such as periodicity and anticipation of receipt) may be ordinary income, although it does not have its source in an earning activity. Examples of such amounts are pensions and annuities.

⁹ Capital gains may be distinguished because they are subject to preferential rates of tax, are partially exempt from tax, or are adjusted for inflation, or because restrictions are imposed on the deduction of capital losses.

¹⁰ For example, many jurisdictions distinguish interest outgoings from other expenses for the purpose of imposing quarantining rules. *See infra* ch. 16. These rules may require further categorization of income types because interest expense incurred to earn a particular type of income may be deductible only against that type. Another expense-quarantining rule found in some jurisdictions is a restriction on the deductibility of employment expenses, which requires drawing a distinction between employment and business activity.

¹¹ An example is farming income, which is taxed on the basis of estimates in a number of countries. *See* FRA CGI § 64; DEU EStG § 13(1); AUT EStG § 21. In such countries, it will be important whether a particular activity is considered farming or nonfarming business. Obviously, this is also the case in countries where income from agriculture is exempt. *E.g.*, GEO TC § 43.

¹² Belgium effectively abolished progressive income tax on dividends and interest in 1985 and replaced it with a final withholding tax system; *see* BEL CIR §§ 171, 261, 269. Germany, which had a progressive tax on interest, collected very little on it and introduced a withholding tax in 1994 in order to be able to collect at least some revenue on interest income; *see* DEU EStG §§ 43, 43a. **Scandinavian countries, led by Sweden, have recently moved toward schedularization and final withholding taxes on income from capital. *See* Leif Mutén, et al., *Towards a Dual Income Tax?* (1996). *See infra* sec. XII, for discussion of final withholding tax on employment income. *See infra* ch.16 for discussion of final withholding taxes on investment income.**

¹³ *See* Mutén, et al., *supra* note 12. The specific manifestation of this exploitation often is the deduction of interest expense and other losses against positive capital income. As a result of such deductions, the tax base for capital income may be very small without schedularization.

A basic structural question for income tax law is whether to have all income taxes in a single law or to have two separate laws, one for individuals and one for legal persons (companies and other taxable entities).¹⁴

A range of models exists.¹⁵ In some countries, company income tax is levied under a separate tax law from individual income tax, and there is no cross-reference between these laws for the determination of the tax base.¹⁶ A second model has company income tax levied in a law separate from that imposing tax on the income of individuals, but the rules for calculating the tax base are based on the rules in the individual income tax law,¹⁷ or vice versa.¹⁸ A third model has separate regimes for individuals and companies contained within a single act, with the company tax rules cross-referenced to the individual tax base rules so that the company tax rules in effect "piggyback" on those applicable to individuals.¹⁹ A variation of this approach uses the same legislation and the same basic rules for determining the company and individual tax bases, but includes supplementary provisions with special rules applicable to companies or individuals.²⁰

From a technical perspective, it is equally acceptable to use separate company and individual income tax laws or a single law, and both alternatives are compatible with either classical or imputation company and shareholder tax systems (these are described in chapter 19). It seems preferable, however, to abstain from separately setting forth the rules for individuals and companies, which would lead to duplication, complexity, and the risk of establishing divergent rules. More important than the form of the legislation is its substance. It is important that the tax base (and rates) of the company tax and the individual tax on business income be similar to simplify administration and discourage taxpayers from using a possibly less efficient business

¹⁴ Schedular systems may even have separate laws for different categories of income. This was more common in the past, but currently applies in Romania, for example, although it is proposed to consolidate these laws.

¹⁵ In addition to the basic structural alternatives described, a look at the Bibliography of Tax Laws, *infra*, shows that many countries have, besides the basic individual and corporate income tax laws, other tax laws that contain rules related to income tax. Some of the Scandinavian countries provide examples of this. The resultant structure contributes to the complexity of the system, although it must be said in fairness that other countries (such as the United States) have managed to achieve a comparable if not greater complexity even though they have only one tax law.

¹⁶ This is, for example, the case in Latvia, Romania, and Russia. Japan also has separate laws for individuals and corporations, with independent rules for determining income. In Hungary, the individual income tax law contains its own rules for measuring business income and expenses; the corporate income tax law refers to the amount determined for financial accounting purposes in the case of taxpayers keeping double-entry books. See HUN CTDT § 6. The tax code of the Kyrgyz Republic contains separate rules for individuals and companies, repeating most of the income-determination rules.

¹⁷ See AUT KStG § 7(2); DEU KStG § 8(1); NLD Vpb § 8. Technically, the German company tax is not an income tax, but a tax on profits, the concept of income being reserved for the taxation of individuals.—L.M.

¹⁸ See ESP IRPF § 42.

¹⁹ See FRA CGI § 209.

²⁰ E.g., AUS ITAA; CAN ITA; COL TC; GBR ICTA; SWE SIL; USA IRC.

form only to secure tax savings arising from differences between the company and individual tax systems.

C. Charging Provision and Basic Terminology

The personal income tax is, as its name implies, a tax on persons, not on transactions or things. The charging provision in the income tax law should therefore impose the tax on persons. The tax is not imposed on all persons; rather, it is imposed only on those persons who have taxable income²¹ for the relevant tax period.²² Some countries impose the income tax on the taxable income of persons, rather than on persons having taxable income.²³ A charging provision of this type needs to be supported by a provision that imposes a liability to pay the tax on the person having the taxable income. The administrative provisions of the legislation will specify the due date for payment of the tax and include mechanisms for the collection and recovery of the tax due.

The charging provision sets out four central concepts underpinning the income tax. First, it identifies the *person* liable for tax, namely, any person who has taxable income for the tax period. The issues relating to identifying the taxpayer are discussed in section IX, below. Second, the charging provision imposes the income tax by reference to the *tax period*. This means that the taxable income of any person must be calculated separately for each tax period. Generally, the tax period for the income tax is a specific period of 12 months, commonly the calendar year or financial year of the relevant country. The periodic nature of the income tax means that it is necessary to provide accounting rules for allocating income and expenses to particular tax periods for the purpose of calculating a person's taxable income for the period. These rules are discussed briefly in section VIII, below, and in more detail in chapter 16.

Third, the concept of *taxable income* defines the tax base. Taxable income is a net concept determined by reference to the tax period. All income tax systems, whether global or schedular, generally seek to impose taxation on a net amount because this amount properly reflects a person's increase in economic capacity for the tax period.²⁴ The taxable income of a

²¹ The term "taxable income" is used in this chapter to refer to the amount against which the rates of tax are applied. An alternative term used in some countries is "chargeable income." See LSO ITA § 13; SGP ITA § 38.

²² E.g., LSO ITA § 4(1).

²³ E.g., USA IRC §§ 1, 11. Until recently, the income tax law in Australia followed this pattern; however, as part of the progressive rewriting of that law, the income tax is now imposed on entities (which is defined to include individuals): see AUS ITAA (1997) § 4-1.

²⁴ There are exceptions to this general rule, the most important being withholding taxes that are imposed on gross receipts. However, there is often little or no expense involved in deriving some kinds of income commonly subject to withholding tax, such as interest income. Also, withholding tax rates are commonly lower than ordinary tax rates, the difference being in part attributable to the fact that expenses are not taken into account when withholding taxes are imposed on gross receipts. The application of a lower rate against income that commonly involves few deductions means that the withholding tax is effectively a proxy for tax on a net basis.

person for a tax period is therefore commonly defined as the gross income²⁵ of the person for the period less the total deductions allowed to the person for the period. A schedular income tax nets gross income and related deductible expenses on a schedule-by-schedule basis, while a global income tax nets gross income against total deductible expenses. The specification of the tax base is discussed in sections III–VII, below. Fourth, the charging provision should provide for the calculation of the amount of *tax payable*. In the ordinary case, this involves applying the relevant tax rates to the taxable income of the taxpayer and then subtracting any tax offsets that may be available to the taxpayer. Tax offsets are reductions in the amount of tax otherwise payable.²⁶ They are allowed primarily to reflect tax already paid through a special collection regime or as a concession to achieve certain social or economic objectives. Design issues relevant to tax rates are discussed in section X, below, and tax offsets are discussed in section XI, below.

By clearly specifying the central concepts, the charging provision will ensure that there is consistency in the use of terminology, thereby providing a coherent structure for the substantive provisions of the legislation. It is preferable that the charging provision be included at the commencement of the legislation so that the substantive provisions can then be developed as an elaboration of the central concepts specified in the provision. The importance of consistency cannot be emphasized too strongly. At best, failure to provide a coherent structure will lead to a confused application of the tax law; at worst, it will make the law unworkable. For example, it must be clear that charging provisions apply to taxable income and not to gross income.²⁷ Similarly, it must be made clear whether supplementary definition provisions include amounts in gross income or in taxable income.

III. Taxable Income

The concept of taxable income effectively defines the income tax base. It was stated above that the taxable income of a person for a tax period is commonly defined as the gross income of the person for the period less the total deductions allowed to the person for the period.²⁸ The gross income of a person for a tax period is the total of amounts derived²⁹ by the person during the period that are subject to tax. The gross income of a person, therefore, will not include amounts that are exempt from tax. The total deductions of a person for a tax period are

²⁵ Also sometimes called "assessable income." See AUS ITAA (1997) § 4-15.

²⁶ Tax offsets are known by a variety of technical labels, including tax credits, tax rebates, and deductions of tax. For a discussion of the terminology used in various countries to describe tax offsets, see *infra* note 205.

²⁷ Unless, of course, it is gross income on which the tax is levied as with withholding taxes. It must be clearly stated when tax is imposed on taxable income and when it is imposed on gross income.

²⁸ *E.g.*, AUS ITAA (1997) § 4-15 (1), ("taxable income = assessable income-deductions"); CAN ITA § 2(2) (taxable income defined as income plus certain additions and minus certain deductions); USA IRC § 63(a) (taxable income defined as gross income minus deductions).

²⁹ The word "derived" is used in this chapter to refer to the allocation of an amount to a particular tax period according to the application of tax accounting rules. See *infra* sec. VIII.

the total of expenses incurred by the person during the period in deriving amounts subject to tax plus any capital allowances and other amounts allowed as a deduction on a concessional basis (e.g., charitable donations). Consequently, there are three key elements in the definition of the tax base: first, the inclusion of amounts in gross income; second, the identification of amounts that are exempt income; and third, the allowance of amounts as deductions.

The definition of key concepts related to the determination of taxable income, drawing on commonly accepted understandings and notions in the jurisdiction, will depend in part on the structure of the income tax system to be adopted and in part on existing structures and concepts. Even when general definitions are used, they are inevitably supplemented by specific definitions, inclusion rules, exclusion rules, rules allowing deductions, and rules denying certain deductions. Thus, any consideration of general definitions must be made in the context of plans for specific rules.

A. Gross Income

Supplementary definition and inclusion provisions applying to the determination of gross income have proved increasingly important for the implementation of global tax systems. There are three reasons for this. The first is the circular definition of income that characterizes many global systems. As stated above, taxable income is normally defined as gross income less allowable deductions. But the definition of gross income may provide little guidance to the income concept, often including the term that it purports to define.³⁰ Second, and related to the first point, supplementary definition and inclusion provisions may be needed to overcome the otherwise restrictive concept of income that would be applied by courts, particularly in Commonwealth or former Commonwealth countries, where courts rely on U.K. judicial doctrines.³¹ Third, supplementary definition and inclusion provisions may be required in response to the growing complexity and variation of legal forms and transactions.³²

Consequently, even under a global income tax, the inclusion of amounts in gross income will often be specified by reference to particular categories of income. For this purpose, income is commonly divided into employment, business, and investment income. There are often supplementary definitions of each category of income and, in the case of investment income, definitions of amounts included in investment income (e.g. dividends, interest, rent, and royalties).

³⁰ E.g., AUS ITAA (1997) § 6-1(1) (“assessable income consists of ordinary income and statutory income”); CAN ITA § 3 (income defined as “the total of all amounts each of which is the taxpayer’s income”); EST ITL § 9 (“the income of a resident taxpayer is all income derived...”); USA IRC § 61(a) (gross income defined as “all income from whatever source derived”).

³¹ See *supra* note 8.

³² For example, special definitional provisions may be needed to define as interest income certain types of gain realized on financial transactions. See *infra* ch.16.

However, not all amounts derived by a taxpayer will fit neatly into one of these categories.³³ An issue arises, therefore, as to the specification of other amounts to be included in gross income. This is commonly done by separately listing out those amounts. As stated above, such a definitional structure means that any amount that does not come within one of the listed inclusions will not be included in gross income. This may be overcome by including a residual category of income. The residual category may itself be a separate category.³⁴ Alternatively, the list of amounts included in gross income may be expressed to be inclusive only so that a general formula may apply for including other amounts in gross income.³⁵ Regardless of how the residual category is identified, it is important that there be some certainty in the scope of its operation. Sometimes the word “income” is used to define the residual category.³⁶ In the absence of a definition of income,³⁷ such an approach can lead to uncertainty where the word is used in a jurisdiction in which it has no established meaning.³⁸ On the other hand, where it does have an established meaning, care must be taken to ensure that the use of the word income does not unduly restrict the intended scope of the tax base. A preferable approach may be to define the residual category broadly so that it covers all gains of whatever nature and rely on the definition of exempt income to limit its scope.³⁹

The discussion of the tax base below and in chapter 16 follows an approach that divides income into four broad categories: employment, business, and investment income, and miscellaneous receipts.

B. Exempt Income

³³ See *infra* sec. VI for examples of amounts that may fall outside a classification of income into employment, business, and investment income.

³⁴ E.g., LSO ITA § 17(1)(d); SGP ITA § 10(1)(g).

³⁵ E.g., EST ITL § 9(1) (“income of a resident taxpayer is all income derived by him/her from all sources of income during the period of taxation, including” seven specified categories of income. The inclusive nature of the provision means that any other amount derived by a resident taxpayer that is “income” is taxed); IDN LCIT Art 4(1) (“the Tax Object is income, meaning any increase in economic prosperity received or accrued by a Taxpayer...that may be used for consumption or to increase the wealth of such Taxpayer, in whatever name and form, including” 11 specified categories of income. Again, the inclusive nature of the provision means that any other amount that is “income” is taxed). “Inclusive” is used here to refer to a definition that takes the form of including specified items in a general concept, as opposed to offering an exhaustive definition of that concept.

³⁶ E.g., EST ITL § 9(1); IDN LCIT Art 4(1); SGP ITA § 10(1)(g).

³⁷ IDN LCIT Art 4(1) is an example of a defined concept of income being used as a residual category. In that provision, income is defined to mean “any increase in economic prosperity.” See *supra* note 35.

³⁸ In the Anglo context, as a result of judicial decisions, for an amount to be income, it must have its source in an earning activity or exhibit the essential characteristics of an amount that has its source in an earning activity (see *supra* note 8). This is also the case in some continental European countries. In the United States, a broader notion of income has been developed by the courts, including any realized accretion to wealth.

³⁹ E.g., IDN LCIT Art 4(1) and (3); LSO ITA § 17(1)(d) and §§ 21–32.

There will be amounts that are not to be included in gross income. These amounts are usually identified as “exempt income.” In providing for the basic charging provisions, it must be made clear that amounts defined as “exempt income” are excluded from the definition of gross income and thus from the calculation of taxable income.

While many different amounts may be treated as exempt income, such amounts can be classified into several broad categories. First, an amount or an entity may be exempt for social compassion reasons. Examples of amounts that may be exempt on this basis are welfare payments, scholarships, and compensation payments.⁴⁰ Examples of entities that may be exempt on this basis are religious, charitable, or education institutions of a public character.⁴¹

Second, an amount may be exempt as a result of international convention, agreement, or practice. For example, a country that is a signatory of the Vienna Convention on Diplomatic Relations is obliged to exempt from tax the official employment income and foreign-source income of a foreign diplomatic officer, consular officer, administrative or technical employee of a diplomatic mission or consulate, consular employee, member of the service staff of a diplomatic mission or consulate, or a private servant of a diplomatic mission.⁴² The exemption also extends to the foreign-source income of family members and consular staff. As a matter of practice (sometimes only on a reciprocal basis), a similar exemption may be extended to other foreign government representatives working in the country.

Third, an amount may be exempt for structural reasons. This is primarily to prevent double taxation under the income tax or other tax legislation. For example, some amounts (e.g., interest) may be subject to withholding of tax at source as a final tax on the income. It is necessary to exempt such amounts from inclusion in gross income so as to avoid double counting. Another example is gifts, which may be subject to gift duties or capital transfer taxes. While such amounts need to be excluded from gross income, whether they are treated as exempt income for all the purposes of the income tax legislation will depend on the circumstances in which the concept of exempt income is relevant under the legislation.⁴³

Fourth, an amount may be exempt for political or administrative reasons. An example of such an amount is a windfall gain.⁴⁴ Finally, an amount may be exempt as an incentive to

⁴⁰ See *infra* sec. VI.

⁴¹ See *infra* ch. 19. The exemption may not apply to all income of the entity. For example, business income derived by such an entity from carrying on activities that are not related to the entity’s religious, charitable, or educational purpose may be taxable.

⁴² Vienna Convention on Diplomatic Relations (1961) Art. 34 (500 UNTS 95).

⁴³ For example, it is a feature (albeit unusual) of the Australian income tax that the amount of a loss carried forward for a particular tax period is reduced by the net exempt income of the taxpayer for that period, with the balance applied first against the net exempt income of the following tax period (AUS ITAA (1997) § 36-15). With such a feature, it is important that amounts treated as exempt income to prevent double counting be excluded from the calculation of net exempt income. Australian tax law has not always been consistent in this regard.

⁴⁴ See *infra* sec. VI.

encourage a particular activity. For example, the income of a retirement fund may be exempt from tax to encourage retirement savings. As indicated above, the concept of exempt income may be relevant for other purposes of the income tax law. For example, it is important in applying rules that deny deductions for expenditures incurred to derive exempt income.

C. Deductions

The third element in the determination of the tax base is the allowance of amounts as a deduction. The usual structure for allowing amounts as a deduction is to provide a general rule followed by supplementary definition and allowance provisions. The general rule commonly allows a deduction for expenses to the extent to which they are incurred in deriving amounts included in gross income. Consequently, the specification of amounts included in gross income also defines the basic parameters for the claiming of deductions. Supplemental provisions allow deductions for capital allowances (such as depreciation and amortization provisions) and as a tax incentive (such as charitable donations and retirement fund contributions).

D. General Principles

In specifying the basic structural rules of the income tax, there are some general principles for which provision may need to be made.

1. Apportionment

The categorization of income (including the treatment of some income as exempt) gives rise to the need for apportionment rules, particularly for deductions. It is possible that a particular expense (such as interest) may be incurred to derive more than one category of income. Where different rules apply to different categories of income (e.g., expenses incurred in deriving investment income may be deductible only against that income), it is necessary to apportion such expenses between the different categories of income. It is generally sufficient for the law to state a principle that deductions are to be apportioned reasonably among the categories of income to which they relate.⁴⁵ If necessary in a particular class of case, more detailed rules can be provided by way of regulation or administrative practice. As stated above, some deductions may be allowed as a tax concession to encourage a particular activity (such as the making of charitable donations or contributions to retirement funds) and, therefore, do not relate to the derivation of any income. It may be necessary to make special provision for the apportionment of such deductions. Such a rule could provide for the apportionment of such deductions ratably among each class of income derived by the taxpayer.⁴⁶

It may also be necessary to have an apportionment rule for income, although the derivation of composite amounts is probably less likely to arise than the incurrance of expenses to earn more than one class of income. One type of composite amount that is likely to be derived

⁴⁵ *E.g.*, LSO ITA § 46(1).

⁴⁶ *E.g.*, LSO ITA § 46(2).

is a compensation receipt. It is possible, for example, in the personal injury context, that an undissected lump sum amount may be paid as damages for several losses, such as loss of earnings, physical impairment, and pain and suffering. In this example, to the extent that the amount is for loss of earnings, it should be included in gross income. A general rule of apportionment will achieve this result. In the absence of such an express rule, the courts may be willing to apply such a rule as a matter of general principle.⁴⁷ Alternatively, the courts may apply a single characterization to the whole amount.⁴⁸

2. Recouped Deductions

Another example of an amount that may require a general inclusion rule is a recouped deduction (i.e., an expenditure or loss for which a deduction has been allowed that is subsequently recouped in whole or in part). It is common to find such rules in specific contexts, such as the recovery of amounts written off as bad debts or capital allowances recovered on disposal of the relevant asset; however, it is preferable that a general principle be stated to ensure that all possible situations are covered. Such a rule would provide that any expenditure or loss (including a bad debt) that has been allowed as a deduction in one tax period but is recovered by the taxpayer in whole or in part in a later tax period is included in the gross income in that later period to the extent of the amount recovered. It should also be stated that the recouped amount takes the character of the income to which it relates. For example, the recovery of a previously deducted bad debt incurred in carrying on a business should be treated as business income. In the absence of such an express rule, the courts in some countries may be willing to apply such a rule as a matter of general principle,⁴⁹ but this may not always be the case.⁵⁰

3. Valuation

It will be necessary in some cases to take into account for tax purposes an amount in kind. This is most commonly the case where income is derived as a benefit in kind (e.g., an employee fringe benefit). However, there are other contexts under the income tax where this will also be the case. For example, a deductible outgoing may be paid in kind, or an asset may be acquired or disposed of for consideration given in kind. In each case, the in-kind item must be valued for the purposes of determining the amount to be taken into account for tax purposes.

It is common for detailed valuation rules to be provided in the income tax law for the valuation of employee fringe benefits. However, as indicated above, the derivation of an

⁴⁷ See, e.g., *Tilley v. Wales* [1943] A.C. 386 (U.K. courts).

⁴⁸ See, e.g., *McLaurin v. FC of T* (1961) 104 CLR 381 (Australian courts have characterized such an amount as wholly capital).

⁴⁹ This is the position in the United States under the judicially developed tax benefit principle. See *Hillsboro Nat'l Bank v. C.I.R.* 460 U.S. 370 (1983); see generally *Bittker & Kanner, The Tax Benefit Rule*, 26 U.C.L.A. L.Rev. 265 (1978).

⁵⁰ See, e.g., *FC of T v. Rowe* (97 ATC 4317) (Australia).

employee fringe benefit is not the only circumstance in which an in-kind item will have to be valued for tax purposes. It is suggested, therefore, that a general valuation rule be included in the income tax law.⁵¹ It is important that such a rule be of general operation so that it can apply in all circumstances where it is necessary to value an in-kind item. In other words, the rule should not be confined to the valuation of benefits as income. It is also important that the general valuation rule be subordinate to any specific valuation rule or rules that may apply in a particular context (such as those that may apply for the valuation of employee fringe benefits).

It is suggested that the basis of valuation under the general rule should be fair market value.⁵² Where consideration is given in kind, valuation will ordinarily be necessary for both sides of the transaction. For example, if a person pays a deductible expense in kind, then the in-kind item will need to be valued for the purposes of determining both the deductible amount to the payer and the income inclusion amount of the payee.⁵³ Similarly, if a person acquires an asset providing consideration in kind, the tax cost of the asset acquired should reflect the value of the consideration given.

Special rules may need to be applied to the derivation of nonconvertible benefits. In jurisdictions relying on U.K. doctrines, the derivation of a nonconvertible benefit raises two issues. The first is the characterization of the benefit as income and the second is the valuation of the benefit to determine the amount of income derived. For other jurisdictions, only the valuation issue arises.

The characterization issue arises in those jurisdictions relying on old U.K. doctrines because the judicial concept of income under those doctrines excludes benefits in kind that cannot be converted to cash.⁵⁴ In these jurisdictions, specific statutory inclusion provisions are necessary to bring nonconvertible benefits into the gross income of the recipient. While nonconvertible benefits are most commonly provided in the employment context, they may be provided in other contexts, and the nonconvertible benefit rule applies equally in those other

⁵¹ Countries with a tax code may specify such a rule as part of the general provisions applicable to other taxes as well (such as value-added tax (VAT)). *E.g.*, Germany has a separate tax law known as the Valuation Law (DEU BewG).

⁵² *E.g.*, LSO ITA § 65(1).

⁵³ The in-kind payment may also involve the disposal of an asset (such as inventory) of the payer. Consequently, the valuation rule will need to apply also for the purpose of calculating any gain or loss on disposal of the asset by the payer. Similarly, the receipt of the in-kind item may also amount to the acquisition of an asset by the payee and the valuation rule will need to apply for the purpose of determining the tax cost of the asset. For example, suppose that *A* owes *B* \$100 for rent of business premises. Instead of paying cash, *A* transfers to *B* inventory with a market value of \$100 and that cost *A* \$80. Under a fair market value rule, *A* will be required to recognize a gain of \$20 on disposal of the inventory and will be allowed to claim a deduction of \$100 for rental expense. This means that *A* is in the same position as if he or she had disposed of the inventory for cash that was then used to pay the rent. Under the fair market value rule, *B* would be required to recognize \$100 as rental income and as the cost of the inventory acquired.

⁵⁴ This is a consequence of the doctrine from the decision of the House of Lords in *Tennant v. Smith* [1892] A.C. 150, where the taxpayer received free use of premises that he could not assign or let.

contexts.⁵⁵ Consequently, any statutory income inclusion rule applicable to nonconvertible benefits must be of general application and must not be confined to employee fringe benefits.

Where a nonconvertible benefit is characterized as income under either general principles or a statutory income-inclusion rule, the value of the benefit (and hence the amount of income derived) must be determined. In particular, the issue is whether there should be any discount for the nonconvertibility of the benefit. On the grounds of equity and neutrality, the fair market value rule should apply equally to nonconvertible benefits. That is, there should be no discount for any restriction on the transfer of the benefit to another person or to the fact that the benefit is not otherwise convertible to cash.

IV. Employment Income

The main category of income derived by an individual is employment income. A number of technical and administrative issues arise in the taxation of employment income. The technical issues are discussed below, and the administration issues are discussed in section XII.

A. Definition of Employment and Employment Income

The notion of employment is important in both schedular and global income tax systems. Under a schedular system, it is common for separate taxes to be imposed on income from employment and income from business, trade, or professional activities.⁵⁶ The rate of tax and the method of collection will generally differ depending on which tax regime applies. Consequently, the notion of employment under a schedular system is fundamental to the determination of the tax regime that is to apply to particular income derived. Under a global system, as stated above, there is often a schedular notion of income under which employment income is specifically included in gross income.⁵⁷ Even when there is a completely global notion of income, it is usual for there to be special rules applicable to employment income, particularly in relation to the collection of tax on such income.

In the absence of a tax law definition of employment, general law notions will apply. In civil law countries, employment will take the definition in the civil code or in a labor code.⁵⁸ In common law countries, employment will be defined by reference to tort jurisprudence applicable to determining an employer's vicarious liability. Neither type of definition will necessarily be appropriate for income tax purposes, where the objects of the legislation are quite different from those underlying the code or common law doctrines. For example, for income tax purposes

⁵⁵ See *FC of T v. Cooke & Sherden* 80 ATC 4140 (nonconvertible benefit provided in the business context); and *Dawson v. Comm'r of IR (NZ)* 78 ATC 6012 (nonconvertible benefit provided as the return for an investment).

⁵⁶ *E.g.*, ERI ITP arts. 7 and 20.

⁵⁷ LSO ITA § 17(1)(a); SGP ITA § 10(1)(b).

⁵⁸ DEU BGB (Civil Code) § 611 *et seq.*; ESP Código Civil § 1544; ITA Codice civile § 2096 *et seq.*

(particularly the collection of tax), it is preferable to treat as employment relationships all service relationships where the remuneration paid is essentially for the labor of the service provider. This is the case regardless of the legal characterization of the relationship as that of officeholder or customer-client. These are relationships where the service provider incurs few deductible expenses in providing his or her labor and, therefore, should be subject to the collection regime applicable to income from employment.⁵⁹ Generally, nontax definitions will not be broad enough to cover all relationships that should be covered by the notion of employment for tax purposes and, therefore, a special definition for tax purposes should be provided.⁶⁰

As noted above, even under a global system, employment income may be expressly included in gross income. In this case, it is necessary also to have a definition of employment income. Again, in the absence of such a definition, nontax definitions may apply in determining what employment income is, and these definitions may not be appropriate for tax purposes.^{1_ornote}
¹See, e.g., FRA Code du travail § 140-2 (definition of salary). For example, nontax definitions of “salary” or “wages” may not include many employment-related receipts that should be treated as employment income for income tax purposes.

The definition of employment income may serve a number of purposes in a global or schedular income tax system, and the appropriate definition may differ depending on the use to which it is put. The definition may be used, for example, to identify a category of income for which special deduction rules apply. It may also be used to establish the base for withholding of tax at source by employers.⁶¹ An important purpose of the definition in jurisdictions with a less than comprehensive judicial concept of income is to broaden the tax base. This is particularly the case in those jurisdictions that rely upon U.K. jurisprudence. As noted earlier, the income concept developed by U.K. courts was a narrow one. In the context of income from employment, the tests required a strict nexus between the provision of services and the receipt of consideration for the services so it could be said that the receipt was a product or an ordinary incident of the provision of services.

Thus, many gains that would be considered employment income in other jurisdictions were excluded from the U.K. judicial concept of employment income and, consequently, from the global concepts of income used in jurisdictions adopting U.K. jurisprudence. Examples

⁵⁹ See *infra* sec. XII.

⁶⁰ E.g., FRA CGI §§ 80–80 *ter*; HUN PIT § 24 (nonindependent activities include those of employment, legislative service, participation in association, and office holding, and activities of contributing family members); USA IRC § 3121(d). There have been substantial difficulties in the United States in the classification of workers as employees or independent contractors. Rev. Rul. 87-41, 1987-1 C.B. 296, sets forth 20 factors in applying the common law test for an employment relationship. See also Revenue Act of 1978, § 530, Pub. L. No. 95-600, which imposed a moratorium on the issuance of regulations on this issue. See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, at 300–05 (1979).

⁶¹ The withholding system applied to employment income is commonly called a pay-as-you-earn or PAYE system. See *infra* sec. XII; ch. 15. However, where employer withholding is a final tax on employment income, there should be complete identity between the definition of employment income for the purposes of the charge to tax and for the purposes of collection of tax.

include receipts that are characterized as being in the nature of a gift or "personal tribute" rather than as a product of the employee's labor and receipts that are characterized as being in return for some consideration other than actual performance of labor, such as the giving up of valuable rights under an employment contract. Alternatively, the receipts may be characterized as capital amounts, paid to secure "negative covenants" from a past, present, or future employee not to compete with the employer or to divulge the employer's confidential information. Particularly in jurisdictions that rely on U.K. jurisprudence, therefore, the definition of employment income will need to be broad to avoid these interpretations.

The basic definition of employment income should include any compensation directly or indirectly related to the employment relationship. Depending on the drafting style used, it may be appropriate to enumerate for further certainty specific amounts,⁶² including the following:

- salary, wages, or other remuneration provided to the employee, including leave pay, overtime payments, bonuses, commissions, and work condition supplements, such as payments for unpleasant or dangerous working conditions;
- fringe benefits;⁶³
- any allowance provided by the employer for the benefit of an employee or in respect of any member of the employee's family, including a cost of living, subsistence, rent, utilities, education, entertainment, or travel allowance;
- any discharge or reimbursement by an employer of expenditure incurred by an employee other than expenditure incurred in the performance of duties of employment;
- consideration provided by an employer in respect of the employee's agreement to any conditions of employment or to any changes in the conditions of employment;
- any payment provided by an employer in respect of redundancy, any payment for loss of employment or termination of employment, and similar payments;
- any compensation received for a total or partial loss of employment income;
- retirement pensions and pension supplements;
- any consideration paid to secure a negative covenant from a past, present, or future employee; and

⁶² Many income tax laws contain a nonexhaustive enumeration of various elements of income derived from employment. *See* AUT EStG § 25; BEL CIR §§ 31–32; DEU EStG § 19; ESP IRPF §§ 24–26.

⁶³ *See infra* sec. IV(C).

- gifts provided by an employer to a past, present, or prospective employee in the course of or by virtue of employment.

The definition of employment income can exclude certain fringe benefits and social benefits provided to employees that do not represent net economic gains or that are to be exempted from the tax base in order to achieve certain social policy objectives.⁶⁴

B. Employee Expenses

Because taxable income consists of net amounts, recognition of expenses incurred to derive gross employment income is as important to the definition of taxable income as are the inclusions outlined above. The rules regarding the deductibility of expenses incurred to derive employment income are relevant not only to the determination of net gains, but also to the design of the pay-as-you-earn (PAYE) withholding system applied to employment income. Recognition of employee expenses inevitably complicates the withholding system, making it difficult or impossible to use PAYE withholding as a final tax. Indeed, this is an example where tax policy may be dictated by decisions as to administrative design. If it is decided to make PAYE withholding a final tax for a majority of individual taxpayers, then it will be necessary to have either a standard deduction or a denial of employee deductions (perhaps compensated by rate adjustments)—see the discussion of this issue in section XII, below, and in chapter 15.

There are significant differences from jurisdiction to jurisdiction in the treatment of employee expenses. The trend, however, is to restrict employment-related deductions, given that they cause a number of significant administrative complications. First, as noted above, they make it difficult to apply withholding tax as a final tax on employment income. Also, they raise a number of difficult borderline questions—common trouble areas include expenses for education, commuting, travel, clothing, child care, and entertainment. Finally, given the large number of employees in any jurisdiction, it is inevitable that there will be many disputes over employment-related deductions—disputes that can tie up a disproportionate amount of administrative resources.

One solution that has been tried in some jurisdictions is simply to deny deductions for employee expenses⁶⁵ or to allow a flat deduction.⁶⁶ The impact of such rules will depend in part

⁶⁴ See *infra* sec. IV(C)(3).

⁶⁵ For example, in Canada, ITA § 8(1)(a) formerly allowed a standard deduction for employee expenses of 20 percent of employment income, to a maximum of Can\$500. This provision was repealed in 1988, so that now there is no deduction for expenses incurred to derive employment income, except for very special categories of employment such as artists, clergy, and truck drivers. A similar position applies in New Zealand where no deductions are allowed for any expenditure or loss incurred in gaining or producing employment income (ITA § 105).

⁶⁶ See ESP IRPF § 28(2) (standard deduction of 5 percent with a cap of Ptas. 250.000 (approximately US\$2,250) and a special standard deduction for handicapped employees; there is no provision for an itemized deduction).

on the relative bargaining strength of employees and employers and thus on whether the additional tax payable by an employee faced with a deduction denial or restriction is actually borne by the employee or can be shifted to employers who are required to gross up wages to offset the additional tax burden or assume responsibility for paying for the expenses formerly borne by the employee. If the employee bears all or some of the tax burden, two potential problems may arise. First, denying or restricting deductions for employee expenses may lead to inequities for some taxpayers, particularly those incurring large employment expenses. Second, it may open a significant distinction between employees who are not able to fully recognize employment expenses and self-employed persons and contractors who are. The latter phenomenon may result in a significant restructuring of employment contracts as employers seek to have their relationships with employees recharacterized as independent contractor arrangements.⁶⁷

A compromise approach is to allow taxpayers to choose between a standard deduction for employment expenses and a deduction for actual documented expenses when the latter exceed a specified threshold.⁶⁸ This is the solution most OECD countries follow.⁶⁹ It does not solve the problem, however, of the temptation of many taxpayers to opt for itemized and substantiated expenses, particularly when the standard deductions are set at a low level,⁷⁰ resulting in an inordinate volume of work for the tax administration. Therefore, if a system allowing taxpayers to choose between a standard deduction and the optional deduction of itemized and substantiated expenses is adopted, there are advantages to be realized by setting the maximum limits for

⁶⁷ The incentive to convert an employment relationship into an independent contractor relationship will depend on the scope of the definition of employment that applies for this purpose. As stated above, a broad definition of employment will include independent contractor relationships where the remuneration paid is essentially for the labor of the service provider.

⁶⁸ Jurisdictions that allow employees to choose between a standard deduction and an option to claim a deduction for itemized and substantiated expenses include Austria: AUT EStG § 16(3), which provides a flat deduction of S 1800 (approx. US\$180); Belgium: CIR § 51, which establishes a declining standard deduction of employment expenses ranging from 20 percent of employment income below BF 150,000 (approx. US\$5,000) to 3 percent of employment income exceeding BF 500,000 (approx. US\$16,500), subject to a maximum deduction of BF 100,000 (approx. US\$3,300); France: CGI § 83 /3, which provides an ordinary deduction of 10 percent of employment income, to a maximum indexed deduction (F72,250 in 1993) and an additional standard deduction for specific forms of employment (artists, journalists, miners, construction workers, and traveling salesmen), which varies from 10 percent to 30 percent of employment income, also subject to a maximum limit; Germany: EStG § 9a (flat amount of DM 2,000 (approx. US\$1,400)); the Netherlands: NLD WIB § 37, which provides a standard deduction of 8 percent of employment income, subject to a fixed minimum and maximum deduction and a special standard deduction for sailors; and the United States: USA IRC § 63, which provides a combination of standard deductions. A special feature of the U.S. employment income deductions is the adoption of a floor on deductions for certain itemized expenses, set at 2 percent of "adjusted gross income." See USA IRC § 67. A U.S. employee opting for the standard deduction in lieu of itemized deductions also gives up the right to itemized deductions that are not connected with employment.

⁶⁹ I.e. countries that are members of the Organization for Economic Cooperation and Development. Two exceptions to this general rule are Australia and Canada. Australia permits deductions only for substantiated expenses and, as noted earlier, Canada does not allow any deduction for employment expenses.

⁷⁰ Examples of jurisdictions with relatively low standard deduction thresholds include Austria and the Netherlands.

standard deductions at levels that are high enough to dissuade all but a few employees from claiming deductions for itemized expenses.

A conceptually distinct problem is that of the so-called borderline expenses that have elements of both employment expenses and personal consumption. A number of legislative techniques have been used to minimize the problem, although none has eliminated it. To begin with, it is common for the general deduction rules to require a direct nexus between a deductible expense and the derivation of income.⁷¹ This construction implies a distinction between expenses incurred to put a person in a position to derive income (e.g., commuting,⁷² child care, and education), which are not deductible, and expenses incurred directly in the income-earning process, which are deductible. General rules of this sort are often also drafted to prohibit explicitly or implicitly deductions for personal expenses.⁷³ The general rules may be supplemented by specific ones addressing particular types of expenses.

Many jurisdictions have taken the position that social support is appropriate for some quasi-personal expenses such as child care or commuting expenses. At the same time, it is generally recognized that deductions for quasi-personal expenses will lead to an upside-down subsidy.⁷⁴ For this reason, some jurisdictions that wish to provide support through the tax system for quasi-personal expenses prefer tax offsets to deductions.⁷⁵

An alternative approach for some quasi-personal expenses is to prorate the outgoings and allow a deduction for only a portion of the expenditure. This approach is taken, for example, with business entertainment expenses in some jurisdictions.⁷⁶ The proration approach has been criticized because of the administrative difficulties involved in substantiating entertainment expenses as legitimate business outgoings and because of equity concerns. Equity concerns are based on the indisputably high personal consumption value of the expenditure to the person incurring the cost, the fact that other persons benefiting from the expenditure will not be assessed on the value of the consumption benefit they receive, and the fact that the expenditures are

⁷¹ E.g., AUS ITAA (1997) § 8-1; AUT EStG § 16(1); BEL CIR § 49; DEU EStG § 9(1); ESP IRPF § 41.

⁷² Commuting expenses may be regarded either as travel to and from work (deductible) or travel to and from home (nondeductible living expenses).—L.M. For a theoretical discussion, see William Klein, *Income Taxation and Commuting Expenses*, 54 Cornell L. Rev. 871 (1969).

⁷³ E.g., AUS ITAA (1997) § 8-1(2)(b) prohibits deductions for expenses of a "private or domestic nature"; FRA CGI § 83/3 limits deductions to expenses "inherent to the office or employment"; GBR ICTA § 198 allows "the holder of an office or employment" a deduction for expenses incurred "exclusively and necessarily in the performance of those duties" [of the office or employment]; IDN LCIT Art 9(1)(h) denies a deduction for "costs incurred for the personal needs of the Taxpayer and his dependents"; USA IRC § 262 denies deductions for "personal, living, or family expenses."

⁷⁴ See *infra* sec. VII.

⁷⁵ See USA IRC § 21.

⁷⁶ See CAN ITA § 67.1; LSO ITA § 35; USA IRC § 274(n).

incurred disproportionately by higher-income taxpayers. These concerns explain the prohibition on deductions for entertainment expenses in several jurisdictions.⁷⁷

Full or partial denial of a deduction for entertainment expenses requires this category of expense to be defined. The concept covers all expenses incurred for the purpose of socializing with business associates, such as for meals, drinks, theater tickets, hunting, and yachting. In some countries, the concept of “representation” or “protocol” expenses is more meaningful.⁷⁸ These may include, in addition to entertainment, transportation and lodging expenses for one’s own employees or for the employees of another company (e.g., a potential customer). Expenses for lodging and transportation should be treated in the same manner as business trip expenses, rather than as entertainment expenses. Thus, if a company pays for representatives of a potential customer to visit its headquarters, the costs of transportation and lodging should be deductible, while expenses for meals and entertainment should not be deductible if a deduction for entertainment expenses is generally denied.

⁷⁷ AUS ITAA (1997) § 32-5; GBR ICTA § 577(1)(a); for a review of deductibility of entertainment expenses in several jurisdictions, *see* Hugh Ault et al., *Comparative Income Taxation: A Structural Analysis* 216–19 (1997).

⁷⁸ *E.g.*, GEO TC § 49(2) (representation); ROM PT § 6(2) (protocol).

C. Employee Fringe Benefits

1. Introduction

A "fringe benefit" is any monetary or nonmonetary benefit derived from employment that does not constitute cash salary or wages. Common examples of fringe benefits are employer-provided housing, the use of an employer-provided car for personal purposes, and the provision of discounted goods to employees.

The theoretical case for full inclusion of fringe benefits in the tax base is noncontroversial. Full taxation is a prerequisite to horizontal equity between taxpayers who are wholly remunerated in cash and taxpayers remunerated partly through fringe benefits. It is also a prerequisite to vertical equity because the incidence of fringe benefits tends to rise with taxpayers' economic incomes and employment status. Full taxation of fringe benefits is also a precondition to achieving an economically efficient tax system. It ensures that the tax system will be neutral between those employers able to provide fringe benefits and those not able to do so and removes the distortion in favor of providing goods and services that are not taxed. Finally, taxation of fringe benefits is important to protect the revenue base.

The overwhelming theoretical case in favor of fringe benefits taxation is countered by a number of conceptual and political problems. A fundamental problem is that many taxpayers, and for that matter some tax administrators, do not perceive benefits in kind to be income with the same economic capacity as cash wages or salaries.⁷⁹ Subsidiary problems arise from the definition of fringe benefits, the difficulty in allocating general benefits among employees, and the difficulty in distinguishing genuine benefits from benefits that are consumed in the course of employment or that are a necessary condition of employment. The conceptual difficulties that arise with the income taxation of fringe benefits have often resulted in low levels of taxpayer compliance with, and administrative enforcement of, the tax law applying to these benefits. This in turn has led to a "tax culture" in some countries that regards fringe benefits as tax-free remuneration so that attempts to expressly bring the value of fringe benefits within the tax base are subject to political resistance.

2. Choice of Tax Method

Three methods have been used to tax fringe benefits. The first, and by far the most common, is to include the value of fringe benefits in employees' assessable income.⁸⁰ In civil code jurisdictions, the definition of salaries in the labor codes will usually include fringe benefits, and this definition will in principle be applied for income tax purposes.⁸¹ Similarly,

⁷⁹ This is particularly the case with nontransferable benefits of a kind or quantity that the taxpayer would not have been interested in buying with his or her own money. An individual estimate of when this is the case is, however, too much for a mass procedure such as income tax assessment.—L.M.

⁸⁰ *E.g.*, AUT EStG § 25(1)1a; BEL CIR § 31(2); DEU EStG § 19(1)1; FRA CGI art. 82; ESP IRPF §§ 24(2), 26; USA IRC § 61(a)(1).

⁸¹ *See* International Fiscal Association, *The Taxation of Employee Fringe Benefits* 18–19 (1995).

fringe benefits will automatically be incorporated into income from labor in common law jurisdictions where the judicial concept of "income" is broad enough to encompass all net gains. In common law jurisdictions that rely on U.K. precedents, the judicial concept of income excludes benefits in kind that cannot be converted to cash⁸² and values benefits that can be converted by reference to their value as secondhand goods or services.⁸³ In these jurisdictions, specific statutory inclusion provisions and valuation rules are needed to include the full market value of nonconvertible fringe benefits into the gross income of employees.

A second method of taxing fringe benefits is to impose a surrogate tax on the benefits by denying employers a deduction for the cost of providing them. This method is used in a number of countries for selected benefits, especially those benefits that are difficult to allocate to particular employees, but is not used as a general method for taxing fringe benefits in any jurisdiction.⁸⁴ The principal disadvantage of denying deductions to the employer as a method of taxing fringe benefits is that it effectively taxes the benefit at the employer's marginal rate, which, for public sector employers or employers in tax loss positions, is nil. A deduction denial is equivalent to taxing the employee only if the same tax rate is imposed on employers and employees. Even then, equivalence is achieved only if the cost of providing a benefit is equal to its market value. Often, this will not be the case; some benefits, such as transportation on public transit vehicles operated by the employer, have little or no cost to the employer. The design of the company and shareholder tax system may also cause problems by "washing out" the effect of the deduction denial.⁸⁵

A third method of taxing fringe benefits is to impose a separate tax (usually referred to as a "fringe benefits tax") on the employer, based on the value of benefits provided to employees. This method may be used as a basis for taxing specific benefits or as a general method of taxing fringe benefits. New Zealand was the first country to use a fringe benefits tax as a general method of taxing fringe benefits. The fringe benefits tax was adopted in New Zealand for political reasons in the context of a reform agenda based on a tax mix change.⁸⁶ The political

⁸² See *supra* note 54.

⁸³ *Wilkins v Rogerson* [1961] 1 Ch. 133 (an employee was provided with a suit worth £30, but was taxed only on its secondhand value of £7).

⁸⁴ It is used, for example, in Canada (ITA § 18 (1)(b)) and the United States (IRC § 274), to tax some entertainment and recreational benefits provided to employees. In Belgium, art. 53/14 CIR denies a deduction for certain fringe benefits that are exempt in the hands of the employees on the basis of art. 38/11, because: (1) the beneficiaries of such benefits cannot be easily identified; (2) they cannot be considered as effective remuneration; or (3) they are small gifts and benefits at the occasion of weddings, birthdays, and other personal occasions.

⁸⁵ This is the case in Australia, for example. The deduction denial will cause the company to incur higher taxes, which in turn generates tax offsets (commonly referred to as "imputation credits") under an imputation system that shareholders may use to shelter tax-exempt income derived by the company. For a general explanation of "washout," see Charles McLure, *Must Corporate Income Be Taxed Twice?* 94–95 (1979).

⁸⁶ The concept of a fringe benefits tax has its genesis in the Report of the Task Force on Tax Reform 154–56 (1992) prepared by the McCaw Committee in New Zealand.

authorities had concluded that the fringe benefits tax would be more viable politically than reform measures that included all benefits in employees' incomes. Similar considerations led to the adoption of a fringe benefits tax in Australia and to the adoption of separate fringe benefits taxes in some developing and transition countries.⁸⁷

The fringe benefits tax imposed on employers as a general policy instrument for dealing with fringe benefits has been criticized.⁸⁸ It is particularly vulnerable to criticism that it undermines the measurement of employee income. While the employer-based fringe benefits tax might ensure that the benefits are subject to income tax, noninclusion in the employee's gross (and therefore taxable) income may allow the benefits to escape other taxes and contributions based on taxable income, particularly social security taxes. Also, employees' taxable incomes will be understated for the purpose of measuring eligibility for various means-tested benefits such as health benefits and education benefits. The understatement may also affect obligations based on taxable income such as support payments.

A separate problem with employer-based fringe benefits taxation is its inability to impose tax at the appropriate marginal rate for each employee.⁸⁹ A single rate must be applied to all fringe benefits, and this is usually the highest personal marginal tax rate on the assumption that most benefits are derived by persons in the highest marginal rate bracket. This approach presumes that employers will "cash out" benefits provided to employees in lower tax brackets, an approach that discourages the provision of benefits that might be provided more efficiently through employers. An example is medical insurance, which is less expensive when acquired through an employer-sponsored plan because of the discounts available to large group enrollments.⁹⁰

There are two options as to the basic design of a fringe benefits tax. The first option is to design the fringe benefits tax independently of the income tax system, with no attempt to coordinate it. The second option is to carefully coordinate the income tax system to achieve the exact same overall tax burden on any given fringe benefit as would be the case if the employer paid cash to the employee instead of providing the fringe benefit. It is suggested that the second approach is preferable because it will ensure that the fringe benefits tax operates fairly and in a neutral fashion between those employees paid in cash and those paid in fringe benefits. If the tax burden is not the same for cash and fringe benefits, remuneration packages will be altered to

⁸⁷ See, e.g., EST ITL § 33; LSO ITA §§ 115–127; MWI §§ 94A–94D.

⁸⁸ See Richard J. Vann, *Some Lessons from Hussey and Lubick*, 7 Tax Notes Int'l 268, 268–70 (1993); Richard K. Gordon, *Some Comments on the Basic World Tax Code and Commentary*, 7 Tax Notes Int'l 279, 280–81 (1993).

⁸⁹ This is only a problem where, as is usually the case, a progressive marginal rate structure applies to individuals. Estonia is the only country that imposes a fringe benefits tax to also apply a flat rate of tax on individuals. In Estonia, the fringe benefits tax rate is aligned to the individual rate of tax, which is currently 26 percent (EST ITL § 7).

⁹⁰ For this reason, if a fringe benefits tax is used, it may be desirable to exempt benefits of this sort. See LSO ITA § 124(3). Safeguards could be provided to prevent abuse (e.g., the Lesotho exemption applies only when the benefit is available to "all non-casual employees on equal terms").

achieve the best tax result, thereby giving rise to economic distortions and revenue losses resulting from the tax-driven alteration.

Fringe benefit taxes are usually imposed at a flat rate. For those countries with a progressive marginal rate structure, the setting of the rate is designed (at least initially) to achieve parity in terms of the final tax burden between the fringe benefits tax and the tax that would have been paid had the benefit been taxed in the hands of an employee subject to the highest personal marginal rate. Parity may be achieved under a system in which the employer is allowed an income tax deduction for the cost of the fringe benefit, but not for the fringe benefits tax imposed on the benefit⁹¹ or under a system in which the employer is allowed an income tax deduction for both the cost of the fringe benefit provided and the fringe benefits tax payable thereon.⁹² In the latter case, adjustments must be made to offset the value to the employer of the income tax deduction for the amount of fringe benefits tax paid. This can be done in one of two ways. First, the value of the benefit can be grossed up before the fringe benefits tax rate is applied,⁹³ or, second, the actual value of the benefit can be used and a higher rate of fringe benefits tax (i.e., the maximum marginal rate grossed up by an appropriate formula to achieve the desired parity) imposed on that value.⁹⁴

One potential drawback with the flat-rate employer-based fringe benefits tax is that parity between a fringe benefits tax and the alternative of taxing employees on the value of fringe benefits received can be achieved only with respect to one tax rate. That is, whichever system described above is used (nondeductible fringe benefits tax or deductible tax but subject to a gross-up of the value or rate), the parity formula is calculated to achieve parity with one tax rate only, usually the highest personal marginal tax rate for reasons explained above. If the employees receiving the benefits are subject to lower tax rates, the tax burden may be too high.

Another problem with an employer-based fringe benefits tax is its potential incompatibility with prevailing unilateral and bilateral international tax rules. If an individual from one country goes to work as an employee in a second country, both the country where the work is performed and the country where the employee is resident may claim taxing rights over the salary and fringe benefits derived by the employee. International tax rules to prevent double taxation have been devised on the assumption that fringe benefits are taxed to the employee in the country where the work is performed. If the employee's country of residence also seeks to tax the employee's remuneration, it will normally provide an offset⁹⁵ against the tax otherwise payable on employment remuneration (including fringe benefits) for any taxes imposed on salary

⁹¹ This is the method that applies in Estonia and Malawi. It is also the method that originally applied in Australia and New Zealand.

⁹² This is the method that applies in Australia, Lesotho, and New Zealand.

⁹³ This is the method that applies in Australia (FBTAA § 136AA) and Lesotho (ITA § 117).

⁹⁴ This is the method used in New Zealand.

⁹⁵ Generally, referred to as a "foreign tax credit"; *see infra* ch. 18.

and fringe benefits by the country where the work is carried out. However if the country where the work is carried out imposes a fringe benefits tax on the individual's employer and the employee's country of residence seeks to tax the employee on the value of the fringe benefits received, the employee may not be able to obtain any double tax relief for the tax already levied by the other country on the same fringe benefits. This is because the country of residence may not recognize the fringe benefits tax imposed on an employer in another country as an income tax paid by the employee. Since offsets are normally available only for foreign income tax actually paid by the employee, double taxation will result.⁹⁶ Similar difficulties arise in other cases where different countries assess different taxpayers for the same type of benefit.⁹⁷ Special treaty measures or unilateral rules can be devised to ameliorate the problem, although to date these problems have been largely ignored in those countries that impose a fringe benefits tax.⁹⁸ The international aspects of employer-based fringe benefits taxation are discussed further in chapter 18.

Another international law problem with an employer-based fringe benefits tax is that of imposing the tax on such employers as diplomatic and consular missions and certain public international organizations that are exempt from tax under a convention or other international agreement. It may be necessary to include a parallel regime for taxing employees of such organizations or entities; otherwise, the benefits provided to these employees may go untaxed.⁹⁹ The existence of parallel regimes for taxing fringe benefits means that the effective rate of tax on the benefits may differ depending on which regime applies. For developing countries with a significant presence by public international organizations that employ local staff, the need for parallel regimes may substantially detract from the advantages of the fringe benefits tax.

Notwithstanding these problems, a fringe benefits tax imposed on the employer does have the significant advantage of being more achievable politically in jurisdictions in which fringe benefits are not commonly perceived to be income that should be taxed in the hands of employees in the same manner as cash salaries. It may also be easier to implement in jurisdictions where cash salaries are low and employees would face liquidity problems if the cash

⁹⁶ The same problem can arise where the employee's country of residence provides relief from international double taxation by exempting foreign income from tax. This is because it is usually a condition of such relief that the employee has paid foreign tax on the foreign income.

⁹⁷ A leading example is in the area of pensions paid from pension or retirement funds, as the pensions may be double taxed if derived by a beneficiary in a country that taxes pension recipients from a country that taxes pension or retirement funds.

⁹⁸ One exception to this is the renegotiated Australia-New Zealand double tax agreement (signed Jan. 27, 1995), which was adopted in part to better coordinate the application of those countries' employer-based fringe benefits tax systems.

⁹⁹ Such taxation should, of course, apply only to those employees (typically, local staff) who are taxed on their employment income as a general matter. Another example of an employer who is generally excluded from a fringe benefits tax is a private individual who employs domestic staff (e.g., housekeeper, gardener, or chauffeur). However, in most developing and transition countries, the remuneration paid to such staff will generally be below the threshold for income taxation.

remuneration were reduced by tax on both the cash payment and the benefits received. This may also facilitate the making of PAYE withholding a final tax on employment income. The choice of a fringe benefits tax system is thus likely to turn on political considerations as much as on technical tax ones. If an employee-based fringe benefits tax system appears to be difficult to attain in the short term for political reasons, an employer-based tax may be considered as an interim solution. It may, however, be difficult to subsequently change to an employee-based tax. The New Zealand fringe benefits tax was originally recommended as a transitional tax, establishing the political acceptability of fully taxing fringe benefits, that would be phased out when taxation was shifted directly to employees.¹⁰⁰ The government did not accept the transitional aspects of the proposal, however, and there is no sign of an imminent or long-term future shift in approach in that jurisdiction.

One technical issue that may influence the choice of fringe benefits tax system is the difficulty of collecting the tax if fringe benefits are included in employees' assessable income. In theory, the tax may be collected on an assessment basis when the taxpayer's final liability for tax for the year is determined, or on a regular basis throughout the year by including fringe benefits in remuneration subject to PAYE collection. The effective administration of either method requires the employer to provide tax authorities with information on the value of fringe benefits provided. Thus, from a compliance perspective, an employer-based tax is often less costly than one in which the tax is imposed on employees, since in the former case the employer can consolidate the value of benefits provided and does not have to report the separate value for each employee's benefits.

The choice among the three methods of taxing fringe benefits need not be resolved the same way for all benefits. All three methods can be used at once for different kinds of fringe benefits. Thus, fringe benefits can generally be taxed to employees, subject to exceptions for those benefits that may be excluded from employees' income for administrative reasons (an example might be *de minimis* benefits) or because of the difficulty in valuing the benefit derived by a particular taxpayer (e.g., recreational facilities that are available to all employees). Such excluded benefits may be taxed by way of deduction denial to the employer or under a fringe benefits tax.

3. *Identification, Valuation, and Exclusions*

Assuming a policy decision is made to tax fringe benefits fully, one might be tempted to recommend simply a general provision that all benefits in kind are taxable to the employee and that their value for income tax purposes is the fair market value of the benefit at the time it is derived by the employee. Experience in many countries shows that this strategy is not likely to be successful. Even if a taxable benefit is identified, requiring taxpayers to determine fair market value without providing further guidance on calculating that value will be a serious problem in many cases. A more fruitful strategy has proved to be to deal with different types of fringe benefits one by one, with explicit rules distinguishing taxable benefits from those that are excluded from tax, and to provide easily applicable rules for the valuation of those benefits that

¹⁰⁰ See Report of the Task Force on Tax Reform, *supra* note 87.

are taxed. Valuation rules need not necessarily be in the statute, but could be provided in regulations. If most benefits are dealt with in this manner, then a residual catchall provision can provide for the taxation of benefits other than those specifically mentioned and further provide for their valuation at fair market value.

The first question to be resolved in the context of fringe benefits taxation by means of either an employee-based tax or an employer-based tax is whether the person receiving a benefit is an employee. In many cases, there will be an incentive for employers and employees to recharacterize the relationship as one of business and independent contractor.¹⁰¹ Where fringe benefits are taxed at the employee level, characterization of the beneficiary as an independent contractor can take the person out of the PAYE system with respect to the benefits and enable the beneficiary to defer, and possibly reduce or avoid, tax payable on the benefit. Where fringe benefits are taxed at the employer level, characterization of the beneficiary as an independent contractor can defer tax and possibly reduce the rate if the beneficiary's marginal rate is less than the marginal rate used for fringe benefits tax purposes.

If fringe benefits are subject to a separate fringe benefits tax, either within the income tax legislation or as a separate tax, it is important that the definition of employee be used consistently throughout the legislation to ensure that there is neither overlap nor gaps between the tax applicable to other remuneration and that imposed on fringe benefits. Once it is determined that a person is an employee, it is necessary to see whether the person also enjoys another relationship with the employer (such as that of a shareholder of the employer, a friend of the employer, or a creditor of the employer) and whether the benefit is received in consequence of that person's employment or the other capacity.

A second issue to be addressed is the characterization of benefits, particularly cash benefits, as salary or wages or fringe benefits. The benefit that most often gives rise to difficulty is the payment of cash "allowances" or "bonuses." If these payments are considered salary, they will be subject to PAYE withholding. However, if they are treated as fringe benefits, they may not be subject to PAYE withholding if benefits are taxed at the employee level¹⁰² and certainly will be exempt from PAYE withholding if benefits are taxed at the employer level. Specific rules will be needed to coordinate the tax imposed on cash benefits of this sort with any offsetting deductions that might be available to an employee as a result of the application of the amount received.

The third issue to be resolved is that of the value to be assigned to taxable fringe benefits. In theory, the preferable value for the taxation of a fringe benefit is the value of the benefit to the employee, because this is the cash or economic equivalent for the taxpayer. It is, however, impossible to levy a tax on the basis of the subjective valuation by a taxpayer, and so a surrogate must be used. The most appropriate value in this case is the market value of the benefit. It is

¹⁰¹ See generally sec. IV(A).

¹⁰² Where PAYE withholding is not a final tax, the value of fringe benefits provided may be excluded from the PAYE tax base, with the result that tax is deferred until assessment.

logical to assume that for most taxpayers the value of benefits derived equals the amount other persons would pay for those benefits in a market transaction. Valuation based on market value best achieves the equity and efficiency objectives of fringe benefits taxation.

Determining the market value for common benefits can be a costly and administratively complicated procedure for employees and employers. Accordingly, it is common for tax systems to provide rules of thumb for determining market value for most common benefits. Depending on the legislative structure of the tax regime, valuation rules may be set out in legislation, regulations, or rulings. They may be provided in the form of valuation formulas or specific values for particular benefits.¹⁰³ The major categories of fringe benefits that are usually subject to specific valuation formulas include cars, housing, low-interest loans, debt waivers, expense allowances, shares acquired under an employee share scheme, and subsidized goods and services. Residual valuation rules may apply to other benefits.

In some cases, the valuation rules set out presumptive values that are lower than market values where the market value could impose an unreasonable burden on a taxpayer. An example is the provision of accommodation in a remote work site. If the value of this benefit were calculated as a reasonable rental value based on the cost of providing accommodation, the value of accommodation in, say, a remote jungle, a desert camp, or an offshore oil drilling platform would be very high. But the value to the taxpayer is the amount the taxpayer is saving by not paying for accommodation in an ordinary setting where the taxpayer would be if not for the job. The same is true of board. The cost of meals in a remote location could be high, but the saving to the taxpayer is the cost of meals where the taxpayer would live if not for the employment. Thus, in this situation, the value of accommodation and board is likely to be set at a figure based on the market value of the benefit had it been provided at a nonremote location rather than on its actual market value.¹⁰⁴

Finally, special valuation rules may be needed in jurisdictions where it is difficult to allocate among employees such benefits as a subsidized cafeteria or employer-provided recreational facilities. Where benefits are taxed by means of a fringe benefits tax imposed on the employer, a surrogate value based on total usage may be used,¹⁰⁵ but where benefits are taxed at the employee level, some formula must be adopted to allocate the benefit to individual users. The employer could be required to keep strict track of actual usage by individual beneficiaries, but this may be an administratively expensive procedure. An alternative is to consider the benefit provided to be the right to use the subsidized facility rather than its actual usage and to assess employees on the notional value of that right. This approach poses two difficulties—valuation of rights that might not be used and imposition of a tax on persons who may not have wanted to be

¹⁰³ For example, the value of automobile benefits may be determined by a formula that takes into account the cost of the vehicle, its age, and the distance traveled in the year.

¹⁰⁴ Some jurisdictions offer a range of exemptions for particular benefits for political reasons or to subsidize certain activities, particularly in remote areas. These exemptions take the form of indirect spending programs and, accordingly, are not considered in the context of devising a fringe benefits tax system.

¹⁰⁵ *E.g.*, AUS FBTA §§ 37A–37CF.

offered the right. An exclusion for socially desirable benefits provided to all employees on a nondiscriminatory basis (see immediately below) may avoid the problem in the cases of some benefits, but the difficulty will remain with others. It is a problem inherent in the employee-based tax.

Fringe benefits tax regimes may contain a range of exemptions. A common exemption is one for *de minimis* benefits, the value of which, after taking into account the frequency with which the employer provides similar benefits, is so small as to make accounting for them unreasonable or administratively impracticable.¹⁰⁶ Exemptions are also provided for benefits taxed under an alternative regime (deduction denial to the employer or fringe benefit tax). Sometimes exemptions are provided for socially desirable benefits such as subsidized meals, medical benefits, or child care facilities that are provided on a nondiscriminatory basis to all employees. Finally, an exemption is usually provided for benefits that would have been deductible to the employee had the employee incurred the cost of acquiring the benefit directly.¹⁰⁷ An example is the provision of work equipment to employees. Similarly, that portion of an allowance for which the employee has provided receipts or other proof of payment of expenses that are in the nature of business expenses for the employer should also be excluded.¹⁰⁸

V. Business and Investment Income

Most of the fundamental issues concerning the taxation of business and investment income (inclusion of gains, allowable deductions, calculation and remittance systems for tax collection, and tax accounting rules) are equally relevant to such income derived by individuals and to that derived through partnerships, companies, and other entities or relationships such as common law trusts. Accordingly, the examination of these issues in chapter 16 applies equally to the calculation of business and investment income derived by individuals.

As the discussion in chapter 16 points out, some particular issues raised in the context of business income can be of particular importance to individuals. For example, in jurisdictions that have adopted U.K. judicial doctrines, the judicial concept of business income is very narrow, and legislative base broadening in this area is necessary. Courts in these jurisdictions are often more likely to apply narrower concepts of income to individuals than to legal persons, so the statutory extensions can have a slightly greater impact on individuals than on companies. Similarly, some restrictions on deductions, particularly restrictions on personal and quasi-personal expenses, are sometimes more relevant to individuals than to incorporated entities, although these issues tend to be equally relevant to partnerships and, in many cases, to trusts. And finally, it is not uncommon to apply different tax accounting rules to small businesses, including most businesses

¹⁰⁶ For examples of exemptions on this basis, see LSO ITA § 118 and USA IRC § 132.

¹⁰⁷ See USA IRC § 132(d). For purposes of applying such a rule, any special rules denying all or a portion of employee expenses (see, e.g., US IRC § 67) should be ignored.

¹⁰⁸ See USA IRC § 62(a)(2)(A).

operated by individuals, than are applied to large businesses, particularly companies and larger partnerships. These exceptions aside, the basic rules setting out measurement of business income apply to all taxpayers deriving business income, and, accordingly, these issues are not discussed separately for individuals here. For more information on these issues, see chapter 16.

One important issue relevant only to individuals is the characterization of income from a trade or profession. Some countries make a distinction between income from commercial trading activities on the one hand and income from professions and vocations on the other.¹⁰⁹ These distinctions reflect older divisions in civil law countries between commercial traders and members of the liberal professions; these may linger on in some areas of law, such as ethical rules and rules of professional organization.¹¹⁰

The definitions of business income in common law jurisdictions generally include income from professional activities,¹¹¹ and the distinction between business and professional income has not been maintained in all civil law countries.¹¹² There are no persuasive tax policy reasons for the distinction, which developed out of historical, nontax rationale; from a tax administration perspective, it is much simpler to have a single set of rules dealing with all business and professional activities. If necessary, targeted rules such as tax accounting rules for work in progress can be applied to professions without the need for a completely separate regime for professional income.

VI. Miscellaneous Receipts

The discussion above has centred around a schedularization of income into three categories: employment, business, and investment income. As stated above, not all amounts derived by a taxpayer fit neatly into one of these categories, and, therefore, an issue arises as to the specification of other amounts to be included in gross income. The legislative method by which this may be achieved is discussed in section III(A), above. The discussion below considers the treatment of some amounts that do not come within the categories of income discussed above.

¹⁰⁹ E.g., DEU EStG §§ 15 (*Gewerbebetrieb*); 18 (*Selbständige Arbeit*); FRA CGI §§ 34 (*Bénéfices industriels et commerciaux*), 92 (*Bénéfices des professions non commerciales*).

¹¹⁰ See Klaus Tipke & Joachim Lang, *Steuerrecht* 334 (13th ed. 1991). The former were supposed to trade for a profit, while the latter performed their services without profit motive, for only an "honorary fee."

¹¹¹ AUS ITAA (1997) § 995-1: "Business includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee"; CAN ITA § 248(1); GBR ICTA § 18, sched. D, cases I and II.

¹¹² See, e.g., ESP IRPF § 40 (both including professional income together with business income); NLD WIB § 6/2.

A. Windfalls

Windfalls constitute unexpected accretions to wealth. While windfalls may constitute income under a comprehensive judicial conception of income,¹¹³ they are not included in gross income in many jurisdictions. In most jurisdictions with schedular definitions of income, windfalls simply fall between the categories of income included in gross income. They similarly fall outside the judicial concept of income in jurisdictions that rely upon U.K. judicial precedents (as they do not have the necessary connection to an earning activity) and have usually been excluded from the coverage of later base-broadening legislation in those jurisdictions.

Although there are no persuasive tax policy grounds for excluding windfalls from the income tax base, political considerations and practical difficulties in assessing these gains most often explain their continued noninclusion in gross income in many jurisdictions. At the same time, their noninclusion in the income tax base does raise some administrative issues. The most problematic exclusion is gambling and lottery winnings. It is common practice for taxpayers facing assessment on the basis of a surrogate income measurement test such as an assets betterment test (a test that presumes a taxpayer has derived enough income to explain the taxpayer's assets)¹¹⁴ to claim their assets were acquired with nonassessable windfalls such as betting winnings rather than with unreported assessable amounts. While the assessment and enforcement rules may place the onus on the taxpayer to prove that gains are not taxable, the nonassessability of windfall gains does complicate the task of the administrators.¹¹⁵ Other problems arise with taxpayers whose primary source of income is derived from gambling or betting activities, because tax administrators must then prove that taxpayers have crossed the threshold from persons who derive windfall gains from these activities to persons who carry out these activities as a business, thus generating assessable income.

The administrative solution to these difficulties in the case of gambling winnings may be to assess the gains but to collect the tax on most such winnings by imposing a final withholding tax at an intermediate rate.

A separate type of windfall payment is a prize or an award. Generally, tax systems distinguish between prizes and awards that are won by a taxpayer in a purely personal capacity, which are usually not taxable, and prizes and awards given in recognition of a taxpayer's business or employment activities, which are usually taxable. Thus, for example, the prize won by an architect who submitted a design to an architecture contest or a "player of the match" award won by a sportsperson would be assessable. The former is connected with an activity that is an integral part of the taxpayer's business (architects often enter design contests to achieve

¹¹³ See *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969) (cash found in used piano is taxable).

¹¹⁴ See vol. 1, ch. 12.

¹¹⁵ A taxpayer may, for example, produce evidence of substantial winnings while omitting evidence of amounts lost. The latter may be difficult or impossible for the tax authorities to reconstruct.

recognition and hence new clients), and the latter is an example of an award that enjoys a direct nexus with the taxpayer's employment responsibilities.¹¹⁶

B. Gifts

Although some have argued that gifts or bequests should be taxed,¹¹⁷ they are generally not taxed as income. They may, however, be subject to gift or estate duties or capital transfer taxes.¹¹⁸ Depending on the structure of the definition of income, it may not be necessary to provide an explicit exclusion for gifts. If the definition is schedular, gifts will likely fall under none of the schedules. If, however, there is a broad residual schedule ("any other income"), then providing an explicit exclusion for gifts bolsters a broad reading of this residual category.

If an explicit exclusion is provided for gifts, it should be limited.¹¹⁹ It should not apply to the income from property that is transferred as a gift, unless the income is attributed to the transferor, as happens in some antishifting rules.¹²⁰ Also, an exclusion should not apply to a gift or bequest of an income stream, such as, for example, a gift of an annuity or of the right to a royalty unless (once again) the income is attributed to the transferor for income tax purposes as a result of the application of antishifting rules. In addition, an amount transferred by or for an employer to, or for the benefit of, an employee should not qualify as a gift but should be considered employment income. A similar rule could be provided for gifts made in a business context other than to an employee. Under such a rule, a gift made to a business associate would be treated as business income to the recipient.

¹¹⁶ In 1986, the United States, which had previously made distinctions such as those outlined above, adopted a rule under which prizes and awards would be generally taxable. *See* USA IRC § 74.

¹¹⁷ *See, e.g.,* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978).

¹¹⁸ *See* vol. 1, ch. 10.

¹¹⁹ *See* LSO ITA § 31. Where the statute has excluded gifts without any statutory limitation, the courts have had difficulty determining whether certain transfers, particularly those occurring in a business context, qualified as excludable gifts. *See* Commissioner v. Duberstein, 363 U.S. 278 (1960).

¹²⁰ This is the case, for example, in AUS ITAA (1936) § 102B and CAN ITA § 74(1), where attributed income is excluded from the recipient's attributable income.

C. Scholarships

Scholarships are another type of income treated inconsistently in different jurisdictions. In some jurisdictions they are generally taxable¹²¹ and in others they are exempt from assessment, perhaps subject to limitations.¹²² Once again, there are no persuasive tax policy reasons for excluding these gains from assessable income. Where scholarships are assessable and a taxpayer derives only scholarship income, much of the scholarship may be lightly taxed or exempt under the ordinary progressive income tax rate scale. Where a taxpayer derives significant income in addition to a scholarship, the exclusion of the scholarship from assessable income can seriously undermine vertical equity. Excluding scholarships can also lead to administrative problems, as employers can seek to characterize employment income as scholarships. This has affected, for example, graduate students working for the university where they are studying and employees asked to complete higher degrees directly relevant to their work.

If scholarships are to be taxed, they may have to be specifically listed if the definition of income is a schedular one, because they would not fall into the usual general categories of income. They will in any event have to be specifically mentioned if it is desired to exclude certain scholarships.

D. Damages

The tax treatment of damages (compensation awarded in a legal action) and settlement payments (paid to settle a legal action) will depend on the nature of the damages. The character of the compensation depends on what is being compensated.¹²³ For example, compensation for loss of a capital asset should be treated in the same manner as the proceeds on a disposition of the asset, subject to any rules allowing deferral of recognition of such gain. On the one hand, damages (other than for personal injury) intended to compensate a taxpayer for loss of employment or business income are usually assessable as direct substitutes for assessable gains. Damages for personal injury, on the other hand, are usually exempt from taxation on the basis that they represent no real gain to the taxpayer—they are merely compensatory for mental or physical losses of, or suffering by, the taxpayer.

In some cases, damages for personal injury are exempt from taxation because they fall outside general or judicial concepts of income and are not caught by any base-broadening statutory provisions. Where base-broadening statutory provisions would include damages for personal injury, it may be necessary to explicitly exempt these receipts where this result is desired.

¹²¹ See CAN ITA § 56(1)(n).

¹²² See AUS ITAA (1936) § 23(ya), (z), and ITAA (1997) § 51-10; USA IRC § 117.

¹²³ A specific rule to this effect can be included in the law. *E.g.*, LSO ITA § 70 ("compensation received takes the character of the thing that is compensated").

One type of damage or settlement payment that gives rise to difficulty in many jurisdictions is compensation for the loss of a taxpayer's ability to earn income in the future. If a payment is made for the loss of income-earning capacity because of physical injury occasioned by negligence, it may be characterized as nonassessable compensation, even when the amount of damages is determined in part to be compensation for loss of future earnings. However, when a payment is clearly made in contemplation of lost income (without a physical injury), such as a payment for premature termination of employment, the amount should be treated as an assessable receipt. Drawing the line in this area is difficult, and no fully acceptable solution exists.

E. Social Welfare and Analogous Benefits and Expenses

The tax treatment of social welfare payments and expenses differs markedly from jurisdiction to jurisdiction. It is an issue that can be evaluated only in the context of the jurisdiction's social payment system, because the tax treatment of benefits and expenses is an integral element of the overall social welfare system.

The development of theoretical tax positions is complicated by the different models for social welfare payments adopted by different jurisdictions. Some benefits are targeted to lower-income persons through means testing of income and assets. Others are provided on a near-universal basis. Some are funded from general revenues. Others are paid for from earmarked taxes or levies or from a combination of earmarked levies and general revenues. And in some jurisdictions, key elements of the social benefit system such as health are largely privatized and services are paid for either directly by the user or by private insurance.

Some broad generalizations for possible tax treatment can be made. To the extent that benefits are tightly means tested, it may be appropriate to exempt them from taxation, because the recipients are quite likely to fall below the minimum tax threshold. Thus, means-tested welfare payments, unemployment payments, old-age pensions, and similar payments will normally be exempt from tax. This result is also consistent with considerations of tax administration.

In the case of other benefits funded through earmarked taxes or levies, parallel treatment of costs and benefits will provide for a generally neutral tax regime. For example, if unemployment insurance levies are imposed on taxpayers and these are deductible for income tax purposes, benefits received under the program should be taxable.¹²⁴ If the levies are not deductible, it may be appropriate to exempt the benefit from tax. In many cases, where contributions are not deductible, the benefit will be means tested and, therefore, would be excluded from income under the first principle, above.

In some cases, deviation from this general rule may be appropriate. One such case is when taxpayers make nondeductible contributions to an income support plan, but the benefits

¹²⁴ See, e.g., CAN ITA § 56(1)(a) (unemployment insurance benefits are included in computing the income of the taxpayer).

include an investment income component. An example of this arrangement is where taxpayers are required to make nondeductible contributions to a national old-age pension scheme. The benefits paid to members in this case in theory include investment income derived from the investment of the contributions. The most appropriate treatment of these benefits is as private annuity or pension payments, with the payments being fully taxed, subject to a deduction or exclusion for a pro rata return of the taxpayer's original nondeductible contribution.

Similar issues arise in the context of universally provided social benefits, such as free or subsidized public education, health services, higher education, and so forth. When the provision of these benefits is means tested, the preferable policy is to exclude the benefits from the income tax base, because benefits will accrue to lower-income taxpayers who are likely to be exempt from taxation. Exempting means-tested benefits will reinforce the vertical equity of the income tax system.

The appropriate treatment of such benefits as health care, public education, or higher education that are provided on a universal (i.e., non-means-tested) basis will depend on whether these are viewed as a social good, comparable to the provision of defense or police, or as social benefits intended to further the redistributive objective of taxation and expenditure. If they are viewed as social benefits provided in the context of redistributive objectives, including the value of the benefit in the income tax base can reinforce the progressivity of the income tax. Imposing a tax on the value of benefits effectively claws back the subsidy for middle- and higher-income earners that is inherent in the benefits. For a number of reasons, however, it is not efficient to use the income tax system to achieve or reinforce vertical equity in respect of these benefits. Most of these relate to the administrative difficulties in assessing benefits. These include problems of valuation (should the value of benefits be measured net of income tax previously paid?) and problems of attribution (is the value of, say, higher education a benefit to the student or the parents, and, if the latter, how should it be apportioned between the parents?). If the provision of these benefits is regarded as an element of the state's redistributive program, a far more effective and efficient solution to the problem of vertical equity is to means test the provision of benefits in the first place rather than to seek to claw back subsidies after the fact through the income tax system.

In terms of drafting technique, schedular definitions of income often do not include social welfare benefits, and their characterization also varies in jurisdictions that use global definitions.¹²⁵ When income is defined globally or with a broad catchall, and when an exclusion for some or all social welfare benefits is desired, it would be preferable to provide for such an exclusion explicitly in order to preserve a broad reading of the catchall, as suggested above for gifts.

F. Loans and Cancellation of Indebtedness

¹²⁵ The basis for their nontaxation in some global systems is sometimes obscure. The United States is an example of a jurisdiction where the rationale for exclusion is not articulated. *See* I.T. 3447, 1941-1 C.B. 191 (USA) (holding that social security benefits are not taxed, but no reason given).

While the receipt of loan funds does not give rise to a taxable event (there being no gain because of the corresponding liability to repay), cancellation of indebtedness may give rise to the derivation of income. Upon cancellation of a debt, the taxpayer is immediately better off to the extent that he or she is relieved of an obligation, even though the taxpayer may not have been in a financial position to satisfy the debt had it not been canceled.

While cancellation of a debt increases the taxpayer's net worth, whether this constitutes income depends on the nature of the transaction. If, for example, the transaction is a private one, where cancellation is analogous to a gift, cancellation will not give rise to income to the relieved debtor, assuming that gifts are generally nontaxable.¹²⁶ Cancellation of loans made in an employment context usually gives rise to a taxable fringe benefit to the employee. Cancellation of loans made in a business situation generally gives rise to a gain that is included in business income, subject to any applicable special rules that defer or exempt such income in certain cases.¹²⁷

G. Imputed Income from Owner-Occupied Housing

Only a few countries tax imputed income from owner-occupied housing.¹²⁸ In principle, this could be an important revenue source and an important element in supplying progressivity to the income tax. However, practicalities suggest that this is generally not a feasible element for taxation for developing and transition countries because of administrative and valuation difficulties. This does not mean housing should be ignored. The provision of housing to employees should be taxed as a fringe benefit. Moreover, deductions should not be allowed for mortgage interest or other housing expenses. Finally, if preferential treatment is to be provided in respect of gains realized on disposal of a private residence, the preference should be narrowly circumscribed and subject to strict caps.

H. Illegal Income

It is likely that, as a matter of general principle, income from illegal activities would fall within the general inclusion provision under a global system or, in the case of a schedular system, one of the schedules.¹²⁹ However, if this is not the case, then it should be stipulated that income derived from illegal activities is still subject to tax. Where illegal income is taxed, a deduction should be allowed for amounts subsequently returned. In part, the possibility for taxing illegal income provides a tool for prosecution of crimes having nothing to do with

¹²⁶ For example, cancellation of private debts (incurred in a nonbusiness or nonemployment context) does not result in the derivation of income in Australia, Canada, France, Germany, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. See Ault et al., *supra* note 78, at 182–85. It may, however, be subject to gift taxation.

¹²⁷ See *infra* ch. 16.

¹²⁸ See Ault et al., *supra* note 78, at 172–75.

¹²⁹ See Ault et al., *supra* note 78, at 186–87.

taxation. Because criminals typically fail to declare their illegal income on tax returns, they can often be successfully prosecuted for tax evasion even when there is no specific proof as to how they got the money.

VII. Tax Relief for Personal Expenses

Under a comprehensive income tax, the taxable income of a taxpayer is the measure of the increase in the taxpayer's economic capacity during the relevant tax period. The way in which the taxpayer exercises the economic power resulting from an increase in economic capacity is irrelevant for the purposes of calculating the taxpayer's taxable income. In other words, the income tax is indifferent to the manner in which a taxpayer chooses to spend money provided the outlay was not incurred to derive gross income¹³⁰ and, therefore, a taxpayer's taxable income should be the same regardless of whether the taxpayer saves the income derived, consumes it, or gives it to someone else to save or consume.

In addition to tax policy arguments, tax administration considerations also argue against allowing any tax relief for personal expenses, particularly in developing and transition countries. As discussed in section XII below, allowing such relief is inconsistent with a PAYE system under which most employees (and therefore most income taxpayers) pay tax through final withholding and do not file returns.

However, a number of countries do use the income tax system to provide relief for certain personal expenses. The main examples of such expenses are charitable contributions, interest, life insurance premiums, retirement fund contributions, and medical expenses. Tax relief for interest expense is discussed in chapter 16. The special nature of tax relief for charitable contributions warrants further consideration below.

Many countries wish to encourage the development of charitable organizations to fulfill various functions that are considered socially important. Some countries have chosen to do this through the tax system. While, as indicated above, strong arguments can be made that the tax system is not the appropriate means for granting such a subsidy, this is ultimately a political question that each country's legislature must address.¹³¹ If tax relief is provided, then it may be provided in the form of either a tax deduction or a tax offset based on the amount of the contribution. Because a tax deduction is a subtraction from income, under a progressive tax system, the higher the individual's income, the greater the value of the relief. In other words, a tax deduction provides what is known as "upside-down" relief because the value of the deduction increases with the donor's income. In other words, the deduction is of greater value to those on higher marginal rates.

¹³⁰ If an outlay is incurred to derive gross income, then it may be a deductible expense (*see* sec. IV(B), above).

¹³¹ *See, generally*, Richard Krever, *Tax Deductions for Charitable Donations: A Tax Expenditure Analysis* in Richard Krever & Gretchen Kewley eds., *Charities and Philanthropic Organisations: Reforming the Tax Subsidy and Regulatory Regimes* (1991).

This has important implications for the subsidy given by the government for the contribution because the benefit of the tax savings resulting from the deduction does not flow exclusively to the taxpayer; rather it flows to another party, namely the charitable institution. Consider, for example, a taxpayer on the highest marginal rate (say, 50 percent) who donates \$100 to a charity. The taxpayer is entitled to a deduction of \$100, which at the 50 percent rate results in a tax saving of \$50 for the taxpayer. This tax saving lowers the cost of the gift to the taxpayer by \$50, yet the charity received \$100 from the taxpayer. In effect, the government gave \$50 and the taxpayer gave \$50. The upside-down nature of the tax deduction means that the government's contribution increases with the taxpayer's income and, hence, with the taxpayer's marginal tax rate. It also means that the government is making a smaller contribution to those charities chosen by taxpayers facing lower marginal rates.¹³²

To avoid these problems, some countries have moved recently from a tax deduction system to a tax offset system for charitable contributions. Under a tax offset system, the making of a charitable contribution would not affect the determination of a taxpayer's taxable income, but rather would directly reduce the tax payable on that taxable income. The amount of the offset could be set at any level;¹³³ once established, however, it would be the same for taxpayers in all tax brackets (i.e., the ratio of the government's contribution to that of the taxpayer would remain constant whatever the taxpayer's level of income). It is suggested that, if it is decided to provide tax relief for charitable contributions, then the relief be provided through a tax offset rather than through a tax deduction.

Whatever form of tax relief is chosen, certain limitations and restrictions should be considered so as to limit the administration problems that are likely to arise with such relief. First, a threshold can be provided below which charitable contributions are not deductible. The threshold, if set high enough, can prevent many returns from being filed while still encouraging individuals who make substantial gifts. Second, a cap should be placed on the amount of the relief available in any one year.¹³⁴ Third, in the case of contributions of property, it is important that the donation of the property be treated as a taxable disposal for market value so that the donor realizes for tax purposes all the gain for which a deduction or tax offset is sought. Otherwise the relief would be a vehicle for avoiding the capital gains tax and, moreover, can become a source of abuse by providing an incentive for overvaluation of property. If donations of property are not treated as taxable disposals for market value, the basis for the relief should be limited to the donor's tax cost of the property. Fourth, any scheme that allows relief for

¹³² The experience in Australia is that about one-third of deductible gifts are made to private schools with a consequent benefit to the donor (Krever, *supra* note 132, at 20–21).

¹³³ *E.g.*, CAN ITA § 118.1 (amount of the tax offset is 17 percent of the first \$250 of the gift and 29 percent of the excess above \$250 subject to a maximum deduction of 20 percent of the taxpayer's total income for the tax period); NZL ITA § 56A (amount of the tax offset is 33 1/3 percent of the gift, subject to a maximum deduction of \$500).

¹³⁴ *See supra* note 134.

charitable contributions must define qualifying charities,¹³⁵ probably with a registration and approval requirement and with limitations on what qualifying charities may do (e.g., they may not provide benefits to any person other than as part of the exercise of charitable programs). It is also important to limit permissible distributees upon liquidation (i.e., only other charities or government bodies).

¹³⁵ It is important that an organization qualify as a charitable organization only if it applies all or substantially all income and donations derived for charitable purposes so as to prevent individuals from using the exemption to build up a tax-free fund. In the United States, such a requirement is applied to private foundations, but not to all charities.

VIII. Timing Issues

A. Tax Period

As stated above, the income tax is imposed on a periodic basis. It is necessary for the legislation to specify the tax period, generally a period of 12 months, often set to coincide with the government's budgetary year or with the calendar year.¹³⁶ Some taxpayers may be permitted to use a substituted accounting period in particular circumstances. This is mostly relevant to business taxpayers and is discussed in chapter 16.

B. Persons Entering and Exiting the Tax System

Taxpayers may enter or exit the tax system during a tax period. Examples include persons immigrating or emigrating during a tax year, taxpayers leaving education for full-time employment, and taxpayers retiring from employment. Aspects of the tax system, such as tax concessions for the support of dependents (see section IX(D), below) and tax-free bands or progressive rate structures (see section X(A), below), are usually calculated on the basis of a taxpayer's total income over the tax period. When a person is effectively within the tax system for only part of the tax period, application of tax features such as concessions and tax-free zones to the taxpayer's income as if it were a full year's income can produce anomalous or inappropriate results. Accordingly, all structural aspects of the personal income tax should be reviewed and, if appropriate, adjusted so that a prorated formula will apply to taxpayers entering or exiting from the tax system in a tax period.¹³⁷

C. Method of Accounting

The periodic imposition of the income tax requires a separate calculation of the taxable income of a taxpayer for each tax period. For this purpose, it is necessary to provide rules (referred to as tax accounting rules) for allocating income and expenses to tax periods. These rules identify the tax period in which income and expenses are to be taken into account in calculating the taxable income of the taxpayer for the tax period.

It is unlikely that a single tax accounting rule will apply to all taxpayers in respect of all items of income or deductible expense. Different rules will apply depending on the circumstances.¹³⁸ In general terms, income or expenses may be accounted for on a cash or an

¹³⁶ Various tax systems refer to the tax year in terms such as the "fiscal year," "year of assessment," "taxable year," and so forth. In composite systems, there may be more than one taxable period. For example, in Chile the tax on wages is collected monthly, while the taxable period for the global complementary tax is the calendar year. See CHL IR §§ 43, 52.

¹³⁷ *E.g.*, AUS ITRA 1986 §§ 16–20 (proration of tax-free threshold); CAN ITA § 118.91 (proration of certain deductions); CZE ITA §15(7) (proration of tax allowances); FRA CGI §§ 166, 167 (treatment of income before establishment of residency and after departure); JPN ITL §102 9 (computation of tax where a nonresident becomes a resident in the course of the taxable year).

¹³⁸ The rules of tax accounting are discussed in greater detail in ch. 16, *infra*.

accrual basis. Ordinarily, salary and wage earners account for income and deductions on a cash basis, and business taxpayers above a certain size account for income and deductions on an accrual basis. Under the cash method, income is derived in the tax period in which it is actually received by, made available to, or, in the case of a benefit, provided to the taxpayer. Similarly, expenses are treated as incurred in the tax period in which the taxpayer actually pays them. Under the accrual method, income is derived in the tax period in which the right to receive the income arises and expenses are accounted for in the tax period in which the obligation to pay arises. Further, special rules may apply in particular cases (e.g., for long-term contracts or prepayments).

As different tax accounting rules may apply to the same type of income or expense depending on the nature of the taxpayer or to different types of income or expense of the same taxpayer, it is important that the charging and deduction provisions use generic terms to refer to the relevant tax accounting rules so as to properly accommodate all possibilities. The terms commonly used for this purpose are “derived” and “incurred.” An amount is included in the gross income of a taxpayer in the tax period in which it is derived by the taxpayer. Similarly, an expense is allowed as a deduction of a taxpayer in the tax period in which it is incurred by the taxpayer.¹³⁹ The terminology therefore implicitly refers to the tax accounting rules, and which rule applies in a particular case depends on the circumstances. There should be consistency in the use of generic terminology in the charging and deduction provisions. For example, a situation where some charging provisions use the word derived while other provisions use other terminology such as “received” or “accrued” should be avoided because it may raise uncertainty as to whether all terms used are intended to be generic or are stating different tax accounting rules for different items of income. This is not intended to prevent use of specific tax accounting rules in particular cases; rather, specific rules should be provided for in the tax accounting rules and not in the charging provisions.

When an item of income is to be accounted for on a cash basis, it is important that the concept of “receipt” include a constructive receipt. This ensures that an amount that indirectly benefits the taxpayer or that is dealt with on the taxpayer’s behalf or as the taxpayer directs is taken into account in calculating the taxpayer’s income, provided the amount would be income of the taxpayer if it had been actually received directly by the taxpayer. Examples of situations that should be covered by a constructive receipt rule are an employer directly paying the school fees of an employee’s child, the payment of part of an employee’s salary or wages to the spouse of an employee, and the payment of part of an employee’s salary or wages to a third party in discharge of a debt owed by the taxpayer to the third party. In each case, the application of a constructive receipt rule avoids the argument that, because the taxpayer does not actually receive the payment, there is no derivation of income by the taxpayer.¹⁴⁰

¹³⁹ In the United States, the term used for deductions is “paid or accrued.” *E.g.*, USA IRC § 162(a).

¹⁴⁰ There may be a derivation of an amount by some person other than the taxpayer, but the circumstances may be such that the amount derived does not have the character of income in the hands of that other person. For example, if part of an employee’s salary is paid to his or her spouse, the amount derived by the spouse will not be employment income of the spouse because the spouse provided no services to the payer. This amount would constitute a gift.

IX. The Taxpayer

The charging provision in the income tax law identifies the person liable for tax. A separate issue to be addressed in the case of individuals (as opposed to legal persons) is what individuals should comprise the appropriate tax unit. This section deals primarily with this issue. Initially, though there are questions of terminology that must be resolved.

A. Terminology

Taxation law imposes different obligations on different categories of persons. These include the obligation to provide information to tax authorities about a person's own or another person's affairs, the obligation to file a tax return, the obligation to pay tax, and the obligation to withhold tax from payments to other persons.

Clear terminology should be used consistently throughout the tax legislation to refer to persons with tax obligations. Tax laws often refer to "person" or "taxpayer," but there is sometimes uncertainty about what these terms refer to in certain situations.¹⁴¹ For example, the term "taxpayer" need not connote a person obliged to pay tax in a particular year.¹⁴² A taxpayer may be required to file a return and provide other information to tax authorities even though the person did not have any taxable income for the year (as would be the case, e.g., if the taxpayer's deductions exceeded his or her gross income) or is not required to pay tax upon his or her taxable income (as would be the case, e.g., if the taxpayer's taxable income fell below a tax-free threshold). A broad definition of taxpayer as a person deriving an amount included in gross income would be more appropriate in these circumstances. Even that will not cover the case, albeit rare, of a person who only incurs deductible expenses. To be all-inclusive, the definition of taxpayer could be drafted to include any person who has incurred a tax loss for the tax period.

Similarly, a person other than a taxpayer may be required to satisfy that taxpayer's tax liability. This is the case, for example, where a tax liability is met by withholding at source. If the payer of gross income who is obliged to collect withholding tax from the payment is not the taxpayer in respect of that income, then alternative appropriate terminology should be used to apply to that person (such as "withholding agent" or "representative taxpayer"). Another possibility is that the taxable income of a person may include the income and deductions of another person. However, both persons may be treated as taxpayers for the purposes of collecting the tax on the taxable income.¹⁴³

¹⁴¹ See, e.g., 1 William McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 9.01[10] (3rd ed. 1997) (discussing whether reference to person or taxpayer includes a partnership).

¹⁴² See also vol. 1, ch. 4, sec. II(B).

¹⁴³ This can occur, for example, under a system where a wife's income and deductions are included in the calculation of the taxable income of her husband, but the tax owed by the husband on the wife's income can be collected from both the husband and the wife (see ZMB ITA §§ 19(1), 85).

Given that taxable income is an algebraic concept determined periodically, it is appropriate to use a term such as “has” to describe the required relationship between a person and a taxable income. Terms such as “derived,” “earned,” “accrued,” or “received” are not appropriate for this purpose because they describe the required relationship between a person and individual items of gross income.

B. Individual, Spousal, or Family Units

The tax unit is the basis on which a person’s taxable income is calculated.¹⁴⁴ Although a wide range of tax units is used in different jurisdictions for imposing tax on individuals,¹⁴⁵ the main possibilities are to treat as the tax unit individuals, married couples, or families. If couples or families (however defined) are treated as the tax unit, then taxable income is calculated by reference to the income and deductions of all persons included in the tax unit. While many tax theorists contend that the individual is the most appropriate tax unit for a benchmark income tax system, there is no consensus on the issue. The range of units used is largely the result of historical and political considerations.

The question of tax unit is closely tied to that of the tax rate structure. When individual tax rates are relatively flat, the differences between income aggregation and income splitting are minimal. However, large tax-free zones at the bottom end of the rate scale or significant low-rate bands exacerbate the differences in tax burdens between aggregation, splitting, and separate unit systems, described below.

The earliest income tax laws, such as the U.K. Act of 1799,¹⁴⁶ treated unmarried individuals and married couples as equivalent tax units because at the time married women were not recognized as separate individuals for most legal purposes.¹⁴⁷ The Australian, Canadian, New Zealand, Swedish, and U.S. income tax laws, adopted more than a century later, recognized the individual, whether married or not, as the tax unit. The U.S. courts later allowed married persons in community property states to divide their income for tax purposes, and the U.S. Congress

¹⁴⁴A different meaning of tax unit refers to the person or persons against whom tax is assessed, that is, the legal taxpayer. The two need not necessarily be the same. For example, in some systems the taxpayer is the individual, but the tax is calculated on the basis of the joint incomes. This was previously the system in Sweden. See Martin Norr, Frank J. Duffy, & Harry Sterner, *Taxation in Sweden* 83 (Harvard Law School, International Tax Program 1959).

¹⁴⁵See generally Brian Arnold et al., *Materials on Canadian Income Tax* 39–44 (1993); John Head & Richard Krever eds., *Tax Units and the Tax Rate Scale* (1996).

¹⁴⁶39 Geo. 3, c. 13 (repealed).

¹⁴⁷For a historical review of family unit taxation and a comprehensive survey of the literature see Neil Brooks, *The Irrelevance of Conjugal Relationships in Assessing Tax Liability*, in Head & Krever, *supra* note 146, at 35. While the United Kingdom finally adopted the individual as the tax unit in 1990, some of its former colonies still provide the aggregation of a wife’s income with that of her husband. See KEN ITA § 45 and ZMB ITA § 19 (1).

eventually extended to all married persons the right to divide income for tax purposes.¹⁴⁸ Equal splitting in the United States was eventually modified by the adoption of a special "joint filing" tax scale imposed on the combined spousal income.¹⁴⁹ The effect of this rate scale is that a married couple pays less tax than they would pay if their income were not combined, provided that their incomes are sufficiently unequal. If their incomes are relatively close together, then the couple pays more tax than they would pay if they were unmarried with the same incomes.¹⁵⁰ Married persons in the United States also have the option of filing separately rather than jointly, but the rate scale for married persons filing separately makes this option unattractive in almost all cases.¹⁵¹

Over the past few decades several members of the OECD that formerly used spousal units have moved toward compulsory or optional separate unit taxation for married persons. This shift has been made largely in recognition of social and legal changes granting equal rights to husbands and wives. In some jurisdictions, optional individual unit filing is available only for "earned" income, while investment income continues to be aggregated and taxed in the hands of the higher-income spouse.¹⁵² In others, such as Germany, spousal incomes can be based on the individual unit¹⁵³ or on the couple,¹⁵⁴ with the rate scale applicable to joint filers yielding a tax burden similar to that which would ensue if incomes were equally divided for the purpose of applying the individual rate scales. The United Kingdom has an individual filing unit with a limited deduction that provides relief to married couples.¹⁵⁵

¹⁴⁸ Each state of the United States has its own system of private law, including property and family law. In community property states, the income of a married couple is treated for property law purposes as if it accrued to each spouse, whatever the actual derivation pattern.

¹⁴⁹ See USA IRC § 1(a).

¹⁵⁰ This is because the rate bands for an unmarried individual are broader than one-half as wide as the rate bands of a married couple filing jointly. See IRC § 1(c).

¹⁵¹ This is because the brackets of the rate schedule for married persons filing separately (as opposed to unmarried individuals) are one-half as wide as the brackets for joint returns (see IRC § 1(d)), so that the tax would normally be higher in all cases except when the incomes are evenly split, in which case the tax would be the same. However, this rate scale can be advantageous in certain cases where limitations on certain deductions based on a percentage of income would otherwise apply (e.g., when one spouse has a low income but high medical expenses, the latter being subject to a floor of 7.5 percent of adjusted gross income).

¹⁵² For example, in Belgium and the Netherlands. See Sommerhalder, *The Taxation of Families and Individuals in Europe*, in Head & Krever, *supra* note 146, at 163, 166–79. Both Belgium and the Netherlands have hybrid systems that tax married couples separately for earned income, but also provide tax relief for couples. See also COG CGI §§ 89–95; CMR CGI §§ 117–23.

¹⁵³ See DEU EStG § 26a.

¹⁵⁴ See DEU EStG § 26b.

¹⁵⁵ GBR ICTA § 257A. The relief is referred to as the married couple's allowance and is provided to the husband, although under § 257BA the wife can elect to claim one-half of the relief. See Sommerhalder, *supra* note 153, at 186–92.

The most radical position in terms of family aggregation is expressed in the *quotient familial* of the French income tax. In this system, all family income is aggregated and subject to progressive rates.¹⁵⁶ Before these rates are applied, however, the total family income is divided by a denominator of 2 or more. The basic denominator of 2 applies to a couple without children, and this figure is increased by 0.5 for each child (up to 2 children) and by 1 for each additional child thereafter.¹⁵⁷ The progressive rate scale is then applied to the resulting fraction of total income, and this liability is multiplied by the denominator figure to determine the tax liability imposed on the total income. The amount of tax reduction under this scheme is, however, limited to a specified amount for each dependant.¹⁵⁸ One obvious effect of the French system, often cited as its intended purpose, is to bestow tax benefits on larger families.

If the married couple is the tax unit, then it is necessary to define whether the taxpayer is married.¹⁵⁹ A broad range of domestic circumstances can be identified. A taxpayer's civil law status may not always be clear. For example, two people may consider themselves married without entering into legal formalities, and they may or may not be considered married under the civil law of the jurisdiction where they live. A couple may also undergo a marriage ceremony without legal validity (e.g., if one of them is already married) or with questionable legal validity (if a divorce from a prior marriage of one of the parties has been obtained, but the validity of that divorce is uncertain). Two people may also marry, separate (without formal proceedings), and consider themselves no longer married, even if they are still married as a matter of law. Generally, where the married couple is the tax unit, the tax law relies on civil law rules for determining marital status. This means that couples (including same-sex couples) in marriage-like relationships not recognized under civil law are not treated as married for the purposes of determining the appropriate tax unit to be allowed to the couple.¹⁶⁰ The approach taken to married individuals who are separated but not divorced varies. For example, in the United States, such persons are treated as married individuals,¹⁶¹ whereas in Germany the election for joint filing applies only to married individuals living together. In Kenya and Zambia, the aggregation of a

¹⁵⁶ See FRA CGI § 156.

¹⁵⁷ See FRA CGI § 194.

¹⁵⁸ See FRA CGI § 197(2).

¹⁵⁹ See generally Toni Robinson & Mary Moers Wenig, *Marry in Haste, Repent at Tax Time*, 8 Va. Tax. Rev. 773 (1989).

¹⁶⁰ For some purposes, some income tax laws also treat persons living in a partnership without being married in the same way that they treat a married couple. See AUT EStG § 33(4)(1); NLD NLD WIB § 56. Rules based on whether two people live together can, however, be criticized on grounds of invasion of privacy.

¹⁶¹ There is an exception to this for a married individual who has primary responsibility for the maintenance of a child (USA IRC §§ 2(c), 7703 (b)). This exception applies only when the individual elects to file separately and ensures that the rates of tax for unmarried individuals apply rather than those for married individuals electing to file separately.

wife's income with that of her husband does not apply when the spouses are separated and the separation is likely to be permanent.¹⁶²

Marriage, separation, and divorce occurring during the taxable year must also be dealt with (e.g., the status of a person could be determined as of the end of the year¹⁶³ or prorated for changes in status during the year). The complexity and confusion that can result from situations such as these argue against designating the married couple as the tax unit. A further consideration may be constitutional restrictions on discrimination on the basis of marital status.¹⁶⁴

Even when the individual is the tax unit, it may be necessary to know the marital status of the individual. Marital status may be relevant to personal reliefs (see below) or to the definition of “associate” (which may apply, e.g., to prevent income shifting).

As indicated above, many countries have adopted separate taxation of persons, regardless of marital status—an approach that developed largely in response to the recognition of equal legal status for married and unmarried individuals. A secondary consideration that has proved of key importance in many jurisdictions is the disincentive effect of aggregate or joint filing on nonworking spouses seeking to enter the workforce. If spouses' incomes are aggregated, the tax rate imposed on the income derived by a spouse entering the workforce is based on the highest marginal rate of the principal earner. It has been argued that this effect discourages women in particular from entering or reentering the workforce following a period of child-rearing, and this concern has been a prime factor behind the move from aggregated or joint filing to individual units in many jurisdictions. Finally, administrative considerations are an important factor in favor of an individual tax unit. It is much easier, for example, to design a system of final withholding for employment income if the spouse's income does not need to be taken into account.

C. Divorced and Separated Persons

The family law of many jurisdictions may require a higher-income spouse who formerly supported a lower-income spouse to provide support to the lower-income person for a period following separation or marriage dissolution. In many jurisdictions that use the individual as the tax unit, the payments are ignored for tax purposes—that is, the payer is not allowed to deduct the payment and the recipient is not taxed on it.¹⁶⁵ In effect, the payments are treated in the same manner as payments made within a marriage. Among other things, this rule ensures that there is

¹⁶² KEN ITA § 45(2) and (3); ZMB ITA § 3(1)(b).

¹⁶³ See USA IRC § 7703 (applies only to certain sections of the Code).

¹⁶⁴ See vol. 1, at 28.

¹⁶⁵ Ordinarily, support payments are not a deductible expense of the payer because they are not incurred in deriving income subject to tax. Consequently, it is usually not necessary to expressly provide for the denial of a deduction for such payments. In some jurisdictions, though, the receipt of support payments may constitute the derivation of income because of the periodic nature of the payments. It may be necessary, therefore, to expressly exempt such amounts from tax. *E.g.*, AUS ITAA (1997) § 51–50.

no tax advantage to be gained from separation or divorce. Moreover, it is a simple rule to administer.

The treatment of support differs in jurisdictions that use spousal units and those that rely on joint filing. Systems that allow some splitting of income during marriage may continue to allow splitting following separation by allowing the payer a deduction for payments and including the amounts in the recipient's taxable income. In some cases, income shifting in this manner is allowed after divorce even though it is not permitted during marriage.¹⁶⁶ This approach is most often seen as a way of subsidizing support obligations with the object of providing a higher income for dependent spouses, particularly those with children. In recent years, this rule has been subject to strong criticism and many judicial challenges in jurisdictions that allow shifting of tax liability on support payments.

¹⁶⁶ *E.g.*, USA IRC §§ 71, 215; ZMB ITA §§ 17 (h), 40. Full or partial deductions for alimony are allowed in Belgium, Canada, France, Germany, the Netherlands, and Sweden, and a limited tax offset is provided in the United Kingdom on the same basis as that for married couples. *See* Ault et al., *supra* note 78, at 276–80; Sommerhalder, *supra* note 153.

D. Recognition of Support for Dependents

Many tax theorists argue that, in the context of an income tax levied on the basis of ability to pay, expenses incurred to support dependents should be disregarded for tax purposes. Rather, it is argued that relief for the cost of supporting dependents is best provided through direct government assistance to families and not through the tax system.¹⁶⁷ Despite these arguments, most income tax systems provide some relief for the cost of supporting dependents. While the various tax relief systems adopted have been criticized as inefficient, inequitable, and administratively complicated, few jurisdictions have moved to replace income-tax-based relief systems entirely with direct grants or expenditure programs.¹⁶⁸ However, in most industrial countries, it is now common for tax support programs to be combined with direct expenditure programs (sometimes means-tested, sometimes universal) to ameliorate some of the drawbacks of tax-based support systems.¹⁶⁹ Relief for dependents through the income tax should be structured to take into account the existence of such programs and the level of benefits they provide.

Tax relief may be provided through income splitting with dependents, deductions for the support of dependents, or refundable or nonrefundable tax offsets for the support of dependents.¹⁷⁰

To some extent, income tax systems recognizing spousal units (other than systems that simply combine the income of the spouses and tax it as if it were derived by one individual)¹⁷¹ in effect use income shifting as a means of providing tax support for dependents. Only France extends this system of relief to the support of children through its *quotient familial* system.¹⁷² This system provides upside-down relief as the tax saving from shifting income through the *quotient familial* system increases with the principal earner's income. That is, the greater the

¹⁶⁷ A contrary argument is that relief for dependents is a way of implementing a policy whereby income is split among family members: "each family member should be taxed on items he actually consumes or accumulates, regardless of source." Michael McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 Harv. L. Rev. 1573, 1576 (1977). Under this argument, deductions for dependents should not be considered subsidies, and therefore do not suffer from the upside-down relief problem described in this section.

¹⁶⁸ Sweden now provides all support for families through direct expenditure programs. Austria has an extensive system of family subsidies and very little tax relief for dependent children. See Familienlastenausgleichsgesetz 1967; AUT EStG § 33(4), (8).

¹⁶⁹ Examples include Australia, Belgium, Canada, France, Germany, Ireland, Italy, the Netherlands, Spain, the United Kingdom, and the United States.

¹⁷⁰ Tax offsets can be provided directly or indirectly by providing an extension of the lowest or tax-free threshold to taxpayers supporting dependents.

¹⁷¹ As was the case under the earlier U.K. income tax regimes. See Brooks, *supra* note 148. This system has been largely abandoned, at least for earned income (i.e., income from employment, business, or the provision of services).

¹⁷² See *supra* note 157.

ability of the principal earner to support dependents, the greater the tax relief provided. Also, in the case of high-income earners, the relief provided by this method applies to discretionary income used for personal consumption or savings, but not for the support of dependents.

A common method of tax relief has been to allow individual taxpayers to deduct a specific amount as compensation for the support of dependents. The amount of the deduction may vary with the number of dependents. Because a tax deduction is a subtraction from income, under a progressive tax system, the higher the individual's income, the greater the value of the relief. In other words, relief through tax deduction suffers the same upside-down effect as relief through income splitting, in that relief is provided inversely with the taxpayer's need. Moreover, a deduction system fails to provide any relief for individuals with incomes below the lowest tax threshold. For these reasons, some countries have moved away from deduction-based relief systems for dependents or have phased out the deduction for higher-income taxpayers.¹⁷³

Some jurisdictions have replaced tax deductions with tax offsets as the method of relief for the support of dependents.¹⁷⁴ As with deductions, the amount of the offset may vary with the number of dependents. A tax offset is a subtraction from the tax payable by the individual (i.e., it is an amount taken into account after the rates of tax have been applied to the taxable income of the individual). A tax offset that can be applied against tax otherwise due is of the same value to all taxpayers who can use it and, therefore, avoids the upside-down effect of deductions.¹⁷⁵ However, like the deduction, it provides no support for taxpayers whose incomes are so low that they incur no tax liability under the ordinary income tax rate scale. This problem could be solved by making the offset refundable, but this solution has not generally been adopted.¹⁷⁶ Instead, reliance is placed on direct expenditure programs to assist these persons.

Tax policy in this area is likely to be influenced by administrative considerations. Particularly where relief is given outside the tax system, tax administration considerations argue in favor of relying on such relief and providing no deductions or offsets through the tax system. If it is decided to provide tax relief for the support of dependents, then the design of the relief should be kept as simple as possible. In some developing countries, the amount of the relief may

¹⁷³ *E.g.*, USA IRC § 151(d)(3) (deduction phased out by 2 percentage points for each \$2,500 by which the taxpayer's adjusted gross income exceeds the threshold amount (\$150,000 for a married couple)).

¹⁷⁴ *See* CAN ITA § 118.

¹⁷⁵ It is possible to design tax offsets that increase in value with income. For example, taxpayers in the Democratic Republic of the Congo are given a 5 percent reduction in tax otherwise payable (which is effectively a credit equal to 5 percent of the tax otherwise due) for each eligible dependent. The reduction is subject to two limitations—it is available for up to only nine dependents and a total monetary cap is imposed on the reduction: ZAR CDC § 89. Because the reduction is a percentage of total tax, which rises with total income, the benefits provided by the system increase with income.

¹⁷⁶ Exceptions include Canada and the United States. The Canadian goods and services tax credit, designed to provide relief particularly to lower-income persons for indirect taxes, is refundable: *see* CAN ITA § 122.5. In the United States, the Earned Income Tax Credit, which is partially designed to provide relief for the support of dependents, is also refundable; *see* USA IRC § 32.

vary with the number of dependents. Indeed, there may be separate reliefs depending on the nature of the dependent children, or if the dependents are handicapped or elderly persons. Administrators in some jurisdictions are concerned that taxpayers will simply claim the greatest relief possible regardless of the actual circumstances. For example, if the amount of the relief increases with the number of children up to, say, a maximum of three children, taxpayers may simply claim relief for three children regardless of the actual number of children they have to support, provided they believe the administration does not have the resources to check these claims. This issue is particularly important where it is decided to make PAYE withholding a final tax.¹⁷⁷

Those who argue for direct expenditure programs to provide financial assistance for persons supporting dependents cite a number of difficulties that apply to all tax-based relief systems. The first, and most important, is that of targeting. Whether a deduction or an offset-based relief system is used, the benefit will accrue to some taxpayers who require no assistance with support of dependents and will fail to reach some taxpayers very much in need of such assistance. Moreover, the tax system cannot provide controls to ensure that the relief is used to subsidize support. The taxpayer enjoying the relief may not be the taxpayer responsible on a day-to-day basis for supporting the dependent, for example, when tax relief is provided to a high-income taxpayer who fails to pass on the benefit of the relief to a lower-income spouse who is responsible for acquiring the necessities used to support the dependent. Depending on how it is structured, direct financial assistance may overcome this problem.¹⁷⁸ Finally, it may be more difficult from an administrative perspective to define dependents in an income tax system than in a social welfare system, because the concept of collective needs is different from the concept of ability to pay and social support authorities may have more expertise, and social support laws more flexibility, in identifying dependency. This is particularly the case in respect of unrelated persons living with a supporter or where support is provided through extended families and family support networks.

If a tax-based system to provide relief for persons supporting dependents is chosen, it should be designed to minimize the upside-down, targeting, and administrative difficulties noted above. Proposals to provide tax relief for taxpayers supporting dependents should also be considered in light of decisions concerning the design of the rate scale. Adjustment of the tax-free threshold or lower brackets can be used to provide across-the-board "basic living expenses" tax relief to all taxpayers that is sufficiently generous to those supporting dependents.

A number of difficult definitional issues must be dealt with in any scheme for dependency relief through the tax system. Particular care needs to be taken with these because they can involve difficult factual and legal issues, and they will affect the majority of taxpayers who must apply the tests, usually without professional advice. The following issues are involved:

¹⁷⁷ See *infra* sec. XII; ch. 15.

¹⁷⁸ For example, the Australian home child-care allowance is paid to the parent actually caring for the child. The Swedish child subsidy is paid to the mother, if she is in charge.

(1) Relationship. A basic issue is whether the right to claim relief for a dependent should be limited to relatives. If so, the relation must be specified, that is, just children, or also parents, or also a broader group of relatives. The argument for restricting relief to support of relatives is that otherwise too much may rest on the other possible test for dependency, namely, the amount of support provided. The level of support, particularly support in kind, may be rather complicated to determine, while relation is usually easier to determine. Some countries extend tax relief to persons living in the household of the taxpayer, even when they are not related to the taxpayer.¹⁷⁹ In countries with extended families and extensive family¹⁸⁰ support networks, this could result in serious administrative problems.

(2) Allocation of relief. Particularly in a system based on an individual filing unit, two taxpayers may often satisfy the entitlement rules with respect to a particular dependent. Only one should be allowed to claim the relief. Rules need to be provided to assign the right to the relief to one or the other spouse or for apportioning the relief between the spouses.¹⁸¹

(3) Support requirement. A decision must be made as to whether to extend entitlement to dependency relief automatically to, say, taxpayers with children or to limit automatic entitlement to cases where the taxpayer supplies the requisite amount of support. Support is a notoriously difficult concept to define and it would be best from an administrative point of view not to include it among the qualifications for dependency relief. It could be presumed, for example, that a person residing in the same household is receiving support.

(4) Income test. Dependency is often determined by reference to a dependent's personal taxable income (i.e., no recognition for dependency is allowed if the dependent's income exceeds a specific threshold). This rule is important if dependency is not restricted to those with a close family relationship, but is less critical if the relationship test is fairly narrowly defined. It raises a practical problem of administration, because it requires determining the income of one taxpayer in order to tax another. Where the test is specified, it is necessary to provide the time period for which it will apply. It is easier to apply if the dependent's income is tested for a period prior to that for which the deduction is allowed, but this may not adequately deal with changed circumstances.

(5) Period for relief. Another issue for the tax-free threshold as well as for the dependency deduction is whether they are applied annually or monthly. Some systems restrict the deduction to taxpayers who earn income in a given month. This facilitates the use of final withholding taxes. The entitlement to the deduction can be determined on a month-to-month basis, so that no need arises to adjust withholding for events taking place in prior months.

¹⁷⁹ E.g., DEU EStG § 32; WIB art. 46. These provisions include relief for foster children.

¹⁸⁰ The support networks might also be based on a clan, village, or tribe, or on other groups. In some cases, support responsibilities may be allocated by law or custom to persons other than the parents. Application of a relationship test might be inconsistent with such support networks.

¹⁸¹ For example, in Belgium and the Netherlands, the deductions for dependents are automatically allocated to the higher-income spouse. See Sommerhalder, *supra* note 153.

X. Income Tax Rate Scale

A. Progressive and Flat-Rate Scales

A key issue in the design of the income tax rate structure is the progressivity, if any, to be incorporated into the tax rate scale. A progressive rate structure is one under which the effective rate of tax—the fraction of income paid in tax—increases as the level of income increases. A progressive tax can take the form of a graduated rate scale or a flat-rate scale combined with a tax-free threshold.

While setting the rate structure is a matter of economic and budgetary policy, as well as tax policy, and will often be influenced by political considerations, there are also technical considerations. First, the flatter the rate structure applicable to individuals, the fewer the incentives for such persons to engage in income shifting.¹⁸² Second, if the rate of tax applicable to legal persons is not aligned with the maximum marginal rate for individuals, taxpayers may enter into income-diversion arrangements. For example, if the rate for legal persons is less than the maximum marginal rate for individuals, high-income earners may enter into arrangements to divert their income to entities that they own. This is discussed further below. Third, there may be administrative advantages to establishing a broad standard marginal rate into which most taxpayers with income tax liability will fall. This suggests that, apart from the zero bracket, there may be a need for no more than three or four positive rates: a standard rate, a rate below the standard rate, and one or two rates above it.¹⁸³ Even two positive rates might be adequate.

As noted in section II(A), above, some jurisdictions are moving toward imposing flatter rates of final withholding taxes on particular types of income, especially income from capital. Contrary to prima facie appearances, this trend does not necessarily undermine overall progressivity. While final withholding tax rates are usually lower than the highest personal marginal income tax rate, the effective rate of these taxes may be equal to or greater than the highest marginal tax rate, and, depending on the income bracket of taxpayers deriving income subject to flat-rate withholding, progressivity may even be enhanced by such taxes.

The effective rate of withholding taxes may exceed the highest personal marginal income tax for a number of reasons. The most important is that withholding taxes are levied on a gross basis, while the ordinary progressive rate scale is applied to net income. In the case of dividend income, in the absence of an imputation system, the effective tax rate imposed on dividends may include a substantial underlying company tax. In the case of interest income, not adjusting for inflation may mean that nominal interest far exceeds the real income a lender enjoys.

¹⁸²See *infra* sec. X(C).

¹⁸³A rate schedule with a larger number of brackets may appear to be more progressive, but in fact a schedule with three or four rates can be designed to offer a similar progression in the effective rate of tax.

A further tax rate issue to be resolved is that of a basic tax-free threshold, below which income is not taxed. Almost all tax systems provide such a tax-free threshold, either through a zero rate bracket or through tax offsets or universal deductions. The size of the tax-free zone will depend on revenue needs—including the impact of other taxes, particularly on low-income taxpayers—and on administrative considerations. Significant administrative savings can be realized if a large number of low-income persons can be excluded from the tax net by way of a generous tax-free threshold.

B. Income Averaging and Antibunching Rules

The interaction of a progressive rate structure and a system of annual assessment can lead to tax rate anomalies in four respects. The first, noted earlier in section VIII(B), arises when taxpayers enter or exit the tax system during a tax year and possibly derive an inappropriate advantage by treating partial-year income as if it were full-year income for the purposes of the progressive rate scale. The three other anomalies apply to taxpayers who have been in the tax system for several years.

The second problem is a general one that follows from taxpayers' income derivation patterns. Taxpayers' actual annual earnings over the period in which they are in the tax system may be far different from their *average* annual earnings over the same period. Typically, taxpayers' earnings vary as they change employment, as they achieve seniority, and so forth. Application of the progressive rate structure to each year separately will yield a very different, and probably higher, result than would the application of the progressive tax rate structure to the average earnings over the period.

The third problem is similar to the second, but focuses on particular classes of taxpayers who are more likely than other taxpayers to derive income unevenly from year to year over the same period. Common examples of such taxpayers are farmers, artists, authors, and inventors. A taxpayer who derives widely fluctuating amounts of income from year to year may be subject, over a number of years, to a tax burden substantially higher than that faced by a taxpayer who derives the same overall income evenly.

The fourth problem is faced by taxpayers deriving lump-sum gains, such as capital gains or lump-sum retirement payments. These taxpayers may face a higher tax burden when the whole gain is taxed in the year of realization rather than annually as the gain accrues, pushing the taxpayer into a higher tax bracket. This is referred to as a "bunching" of the gain.

The problem of unequal lifetime income patterns and unequal derivation patterns by particular classes of taxpayers may be addressed through measures to average income. However, as explained below, it is common to direct these measures only at the third type of problem. The problem of income bunching can be addressed through antibunching provisions. These are also explained below.

1. Income Averaging

General income averaging may be used to address the problem of changing income-earning patterns. In simplified terms, general income averaging typically involves ascertaining the taxpayer's average income over a specific number of years, including the current year, and applying to the current year the marginal rates applicable to the average income. This procedure results in lower rates of tax for a year in which the taxpayer's income is abnormally high. A system of general averaging may impose considerable administrative burdens on revenue authorities. It would make it very difficult to treat PAYE withholding as a final tax on employment income. It can also provide unintended benefits for taxpayers who do not deserve relief.¹⁸⁴ Quite clearly, the case for general averaging is strongest when the income tax rate scale is sharply progressive. As the rate scale is flattened, the case for averaging diminishes, particularly when the potential benefits are weighed against the resulting administrative burden. For these reasons, jurisdictions that have used general averaging systems have moved to abolish those systems as the progressivity of the rate scales has been reduced.¹⁸⁵

An alternative to general averaging is to confine income averaging to particular classes of taxpayers, notably primary producers, artists, inventors, and authors.¹⁸⁶ Averaging rules for specific types of income can be far less complicated for the tax system as a whole than general averaging rules, although they are complex for the taxpayers involved. Depending on how the rules are designed,¹⁸⁷ they may provide unintended benefits and distort taxpayer behavior as taxpayers seek to recharacterize transactions or income types to take advantage of income averaging. Unless the rate schedule is very progressive, it is best from the point of view of simplicity to eliminate any averaging rules.

2. *Antibunching Rules*

Similar concerns with distorted tax liability in the context of a progressive rate structure apply to lump-sum payments, particularly those that are attributable to gains, such as capital gains or lump-sum retirement payments, that have accrued over several tax years but that are assessable only in the year in which they are realized. In these circumstances, any increase in taxation resulting from the imposition of higher marginal tax rates on the lump sum may be seen as an appropriate, if somewhat crude, claw-back of the deferral advantage enjoyed by the taxpayer prior to realization. Nevertheless, for political reasons, some jurisdictions do provide

¹⁸⁴ For example, a young professional whose average income is depressed because he or she earned little or no income while in school.

¹⁸⁵ See CAN ITA § 118 (repealed 1980); USA IRC §§ 1301–1305 (repealed 1986).

¹⁸⁶ See AUS ITAA (1936) §§ 149–158L (farmers, artists, and authors) and §§ 159GA–159GDA (special "income equalization deposit" rules to provide further averaging for farmers); CAN ITA § 119 (farmers and fishermen).

¹⁸⁷ The design issues are similar to those for antibunching rules discussed in sec. XI(B), below, except that they involve taking into account the income of prior years.

special averaging rules for particular types of income, such as capital gains¹⁸⁸ or lump-sum retirement payments.¹⁸⁹

Again, it is best to avoid such rules, but if they are provided they should be designed so as to minimize windfalls to taxpayers. The best way to do this, known as "top-slice" averaging, is for relief to be triggered only if, in the absence of any averaging rule, the derivation of a lump sum would be subject to tax rates that would not otherwise apply to the taxpayer. Thus, if a taxpayer's taxable income, apart from extraordinary gains, was high enough to ensure that the last units were taxed at the highest marginal rate, the averaging system would not be invoked because it would make no difference to the tax rate whether the gain were derived in one year or over a number of years. Typically, a top-slice averaging system slices a lump-sum payment into fractions (by dividing the payment by a number of years, which might be based on a notional determination of the period over which the payment has accrued) and determines the tax payable on the fraction, which is then multiplied by the denominator of the fraction to determine the tax payable on the entire lump sum. The system is best illustrated with an example. If the averaging system presumed that a lump sum should be averaged over, say, five years, the rules would determine the taxpayer's tax liability on taxable income without considering the lump sum and then considering the other income plus one-fifth of the lump sum. The difference between the tax payable on the taxable income without the lump sum and taxable income including one-fifth of the lump sum is the tax actually imposed on the one-fifth of the lump sum. This figure is then multiplied by five to determine the tax to be imposed on the entire lump sum.

If the taxpayer's taxable income without the lump sum is low enough that the addition of one-fifth of the lump sum still leaves the last units of taxable income subject to lower tax rates, those lower rates will be applied to the entire lump sum. If, however, the last unit of the taxpayer's taxable income, excluding the lump sum, is subject to the highest marginal tax rates, it will make no difference whether one-fifth of the payment or the entire payment is added to the taxpayer's taxable income when derived because the same rate will apply before and after the averaging system is invoked. Even this method can result in unintended benefits, for example, when a taxpayer derives, on a steady basis, capital gains eligible for averaging.

C. Income Shifting

Under a progressive rate schedule, there is an incentive to shift income to related parties unless the type of income in question is taxed at a flat rate on a schedular basis. As a result of income shifting, income that would otherwise be derived by a single taxpayer can be derived by two or more taxpayers who are then able to use more than once the tax-free thresholds and low rates applicable to lower levels of income. The income will be subject to much lower total taxation than if it had been derived by a single person.

¹⁸⁸ *E.g.*, AUS ITRA sched. 7.

¹⁸⁹ *E.g.*, Belgium, Germany, and Netherlands.

A company tax rate that is lower than an individual's marginal tax rate may stimulate a related type of income diversion, from the individual to a company controlled by the individual or persons related to the individual.¹⁹⁰

A number of countries have adopted measures to restrict income shifting. Experience has shown that, because a variety of income-shifting techniques are available to taxpayers, multiple responses are needed. Attempts to invoke universal responses, such as reliance on general anti-avoidance provisions or tax authorities' discretions, have had limited success because they can be applied only on an ad hoc basis, following an audit. Moreover, general responses are administratively costly to apply and can often be defeated by apparent "business purpose" explanations for income-shifting arrangements.

At the heart of some countries' antishifting rules, of which the United States provides the leading example, are judicial doctrines that decline to recognize income-shifting arrangements as effective for income tax purposes, notwithstanding their validity under property law.¹⁹¹ Judicial doctrines alone have proved insufficient to address the problem of income shifting, and a range of legislative approaches have been used. Separate rules are used for shifting investment income and income from services.

The most sophisticated and, unfortunately, complex antishifting regimes are those that use attribution rules for non-arm's-length transfers of property or underlying income-generating property. Generally, these attribute to the transferor for income tax purposes income subsequently derived by the beneficiary of the transfer, whether income or property is transferred directly or through a trust.¹⁹² A broader approach to preventing shifting of investment income is to attribute all investment income derived by married persons to the higher-income spouse.¹⁹³ Several jurisdictions have global antishifting systems, which impose either the highest personal marginal tax rate or the marginal rate of the parents on investment income derived by minors

¹⁹⁰ Whether there is such an incentive to divert income depends on a number of features of the corporate and individual income tax systems. *See infra* ch. 19.

¹⁹¹ *See* *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Clifford*, 309 U.S. 331 (1940); and *Commissioner v. Harmon*, 323 U.S. 44 (1944).

¹⁹² CAN ITA §§ 74.1, 74.2 contain comprehensive attribution rules applicable to transfers to spouses and children whereby the income from property so transferred is taxed to the transferor. AUS ITAA (1936) §§ 102, 102A–102CA contain less comprehensive attribution rules when income is alienated through a trust or for less than seven years. In some cases, income is attributed directly to the transferor; in other cases, it is taxed in the hands of a trustee at the transferor's marginal rate. In addition, AUS ITAA (1936), pt. IIIA imposes a tax liability on the transferor in respect of income-producing property that has appreciated in value as well as in respect of most transfers of income streams. GBR ICTA § 660 contains a rule disregarding dispositions over short periods; § 663 provides that any income from settlements for the benefit of minor children will be taxed as income of the settlor; and § 683 provides for a tax liability of the settlor when income is payable to any person but the settlor.

¹⁹³ This approach was followed in the United Kingdom, where before 1990–91 spouses were taxed on aggregate income, but could elect to be taxed separately on earned income. *See* GBR ICTA §§ 279(1), 283 (repealed by Finance Act, 1988); *see also* John Tiley, *Butterworths U.K. Tax Guide 1990–91* ¶ 3.01 (1991). It still is the case in Belgium and the Netherlands. *See* BEL CIR § 126; WIB § 5(1).

and, in some cases, on earned income in excess of the fair market remuneration that would be paid to these persons for services they provide.¹⁹⁴ At the price of some complexity, some systems provide exceptions for investment income that was clearly not derived as the result of an income-shifting arrangement. Examples of exceptions include income from property left in a bequest and income derived from property provided as settlement of a personal injury damages claim. An alternative approach for dealing with children's income used in some jurisdictions is to aggregate children's investment income with the income of the parent who claims the child as a dependent or with both parents' income in the case of joint taxation.¹⁹⁵ Constitutional or other restrictions may prevent the application of this approach in some jurisdictions.¹⁹⁶

More sophisticated antishifting measures may be needed to deal with the various techniques used to shift business income. Excessive payments to spouses or children for "services" provided to the taxpayer may be countered with restrictions on deductions for payments to such persons.¹⁹⁷ Attribution rules can be used to counter income shifting through the use of partnerships involving related parties when one partner provides the bulk of the services from which the partnership derives its income and the other party has not provided any equivalent value.¹⁹⁸ Jurisdictions have had less success combating income shifting through service trusts or companies. These are trusts or companies that provide tax-deductible services to a taxpayer in a business context for a price much higher than the taxpayer would pay if the services were acquired directly. The beneficiaries or shareholders of the trust or company are persons related to the taxpayer. Income shifting through this device could be combated by denying taxpayers deductions to related service companies or trusts in excess of the amounts those entities pay the unrelated parties who actually provide the services acquired.

Separate measures are needed to deal with the shifting of employment income by means of interposed companies or trusts. When the highest marginal tax rate imposed on individuals is higher than the rate imposed on companies, individuals may establish a company to provide services that they would otherwise provide as an employee. Income is derived by the company and is subject to a lower rate of tax. Experience shows that these arrangements cannot be

¹⁹⁴ *E.g.*, AUS ITAA (1936) §§ 102AA–102AJ (unearned income of minor child taxed to the child at the maximum marginal rate); BEL CIR § 126 (income of children taxed together with parents' income); NLD WIB (unearned income of child, other than certain capital gains, taxed to parent with highest earned income); USA IRC § 1(g) (certain unearned income of minor child taxed at parents' rate).

¹⁹⁵ *See, e.g.*, ESP IRPF § 89(3) (when parents opt for joint taxation, all income (earned and unearned) is aggregated); FRA CGI § 6 (same).

¹⁹⁶ For example, in Germany, owing to the constitutional clause in defense of the family (GG art. 6(1)), unearned income of the children is taxed separately rather than aggregated with their parents' income. *See* Tipke & Lang, *supra* note 111, at 54.

¹⁹⁷ *See, e.g.*, AUS ITAA (1997) § 26–35.

¹⁹⁸ *See, e.g.*, AUS ITAA (1936) § 94. This provision has proved of limited efficacy because attribution follows only if it can be shown that the person to whom income would be attributed "controlled" the partnership. Tax authorities have had more success in arguing that there was no actual partnership in these cases.

combated through the use of judicial doctrines or general antiavoidance provisions alone and that specific antishifting measures are needed instead.¹⁹⁹ One approach is to impose a higher company tax rate on "personal service corporations," that is, on companies whose incomes are primarily attributable to services provided by an employee or employees who own the company or who are related to persons who own the company.²⁰⁰ An alternative approach is to attribute income derived by personal service companies to the individuals providing the services for which the company is paid.

A related problem arises from individuals using interposed private companies to derive investment income that they would otherwise derive directly and that would be subject to higher individual marginal tax rates. Once again, a number of different measures may be needed to address this problem. One technique is to deny private companies concessions, such as exemptions or tax offsets for intercorporate dividends, that are available to other companies.²⁰¹ Alternatively, or additionally, taxes may be imposed on undistributed investment income retained by private companies to encourage distributions of this income to the company owners.²⁰² And, finally, measures may be introduced to prevent companies from distributing to shareholders in a nontaxable way income that was taxed only at the lower company tax rate. For example, loans from a private company to a shareholder or related party may be deemed to be taxable distributions by the company.²⁰³

XI. Tax Offsets

It was explained earlier that two types of subtractions are relevant to the calculation of the actual tax payable by a taxpayer. First, an amount may be subtracted from gross income in the calculation of the taxable income of the taxpayer. Second, an amount may be subtracted from the tax payable. It is common for a subtraction from gross income to be referred to as an

¹⁹⁹ The Australian and U.S. experiences illustrate this point. Australian authorities first tried to combat shifting of this sort by imposing an undistributed earnings tax on private companies. (The tax was also adopted to protect the "classical" company and shareholder tax system—*see infra* ch. 19.) The undistributed profits tax was abandoned on introduction of the imputation system in 1986. At that time, company and highest individual rates were aligned. When a significant rate differential was reintroduced in 1988, authorities tried to use a general antiavoidance provision to combat shifting by means of interposed companies. That approach proved of limited efficacy, and in 1995 the government announced that new, comprehensive antishifting rules would be enacted. However, following a change in government, reform legislation was deferred indefinitely. U.S. authorities found it virtually impossible to combat income shifting by means of interposed companies. The problem was solved in that country when the company tax rate was roughly aligned with the highest personal income tax rate.

²⁰⁰ *See* CAN ITA §§ 123(1), 125.

²⁰¹ This approach is used in Australia for "unfranked" dividends (dividends paid out of profits that have not been fully taxed in the hands of the distributing company) derived by private companies. *See* AUS ITAA (1936) § 46F.

²⁰² *See* USA IRC § 541.

²⁰³ *See* AUS ITAA (1936) § 108.

"allowable deduction," and a subtraction from the tax payable, as a "tax credit." However, the term tax credit sometimes does not translate well into other languages, perhaps because credit can also mean loan.²⁰⁴ As explained in section II(C), above, the term "tax offset" has been used in this chapter to avoid these difficulties. Whatever terminology is used, it is important that the legislation clearly and consistently distinguish between these two types of subtractions because of the different tax consequences.

Four broad categories of tax offset may be allowed: (1) in recognition of tax already paid by the taxpayer (e.g., under a current payment system) or by another person on behalf of the taxpayer (e.g., by an employer through PAYE withholding, another person paying income subject to withholding, or a trustee deriving income on behalf of a beneficiary); (2) in recognition of tax paid by the taxpayer or by another person on behalf of the taxpayer (through withholding tax) to foreign tax authorities;²⁰⁵ (3) in an imputation system in recognition of tax previously paid by a company on dividends (or deemed dividends) distributed to the taxpayer;²⁰⁶ and (4) for concessional purposes to support certain activities or responsibilities of the taxpayer, such as medical expenses,²⁰⁷ child care,²⁰⁸ charitable or political contributions,²⁰⁹ support for dependents,²¹⁰ and retirement savings,²¹¹ or to provide general relief to taxpayers with low earned income.²¹² As was explained earlier, tax offsets may be used for these purposes in preference to deductions from gross income to avoid the upside-down effect of deductions, which provide greater tax savings to higher-income persons.²¹³

²⁰⁴ Cf. vol. 1, at 218 note 146 (tax credit vs deduction for VAT input tax). In France, the term *avoir fiscal* is used synonymously with *crédit d'impôt*. See FRA CGI § 158 *bis*. The draft tax code of Russia (art 135) uses the term *nalogovi kredit* (literally tax credit) to describe a postponement of the time for payment of tax, that is, in the sense of extension of a loan rather than in the sense of tax credit as it is used here. In referring to the crediting of foreign taxes, the draft tax code uses the verb *zaschitivat'* (counting toward, crediting), and uses the term "creditable amount" rather than "tax credit" (art 560). The term used in Germany (*anrechnen* or *Anrechnung*, see EStG § 36) similarly has the sense of counting toward or charging. When a translation problem exists, the solution may lie in using a verb rather than using "tax credit" as a noun. However, when the verb used is equivalent to "deduct," then the problem discussed in the text—namely, the need to distinguish between deductions from income and deductions from tax—must be addressed.

²⁰⁵ Such a tax offset is commonly referred to as a "foreign tax credit." See *infra* ch. 18.

²⁰⁶ Such a tax offset is commonly referred to as an "imputation credit." See *infra* ch. 19.

²⁰⁷ See AUS ITAA (1936) § 159P.

²⁰⁸ See USA IRC § 21.

²⁰⁹ See, e.g., CAN ITA § 118.1(3) (charitable gifts); USA IRC § 24 (political contributions—repealed).

²¹⁰ See AUS ITAA (1936) § 159J. See *supra* sec. IX(D).

²¹¹ See AUS ITAA (1936) § 159SM.

²¹² See USA IRC § 32 (earned income credit).

²¹³ See *supra* sec. VII.

Different rules apply to the recognition of tax offsets for taxes actually paid (the first three categories of tax offset noted above) and to tax offsets provided for concessional purposes. The latter have no nexus with income taxes actually paid and can be set by reference to independent criteria on the basis of the taxpayer's need for concessional support. One technique sometimes used to improve the targeting of concessional support tax offsets is to use "disappearing" tax offsets that decrease in value as a taxpayer's income increases.²¹⁴ Tax offsets that are intended to act as substitutes for direct social assistance payments may also be made refundable when they exceed the tax payable by a person entitled to the offsets.²¹⁵

The extent to which offsets for taxes actually paid are recognized will vary. Offsets for advance payments of tax by the taxpayer are usually recognized completely; any amount that exceeds the final tax levied on the taxpayer is refundable in full. In contrast, taxes paid to foreign governments are usually recognized only to the extent of local taxes imposed on the foreign income with no refund of any excess offset.²¹⁶ Tax offsets for company taxes allowed under an imputation system may or may not be refundable depending on the design of the imputation system.²¹⁷

In some cases, taxpayers may be allowed to carry forward to future years nonrefundable offsets that have not been recognized previously. Restrictions may be placed on the recognition of offsets for foreign tax and company tax paid that are carried forward, so that they may be used only to offset taxes on particular types of income. When different rules concerning refundability and carryover apply to different kinds of offsets, rules are needed to specify in which order offsets are taken.²¹⁸ These may require taxpayers to first recognize nonrefundable offsets and offsets that cannot be carried forward or transferred, so as to preserve the value of refundable offsets and offsets that can be carried forward or transferred.

²¹⁴ E.g., USA IRC § 21(1)(2) (child-care credit).

²¹⁵ See text at note 177 *supra*.

²¹⁶ Further restrictions with respect to foreign income may divide that income into different income "baskets" on the basis of income type, the jurisdiction in which it was derived, or both these criteria, and may limit recognition of offsets for taxes paid on foreign-source income in a particular basket to local tax payable on that particular basket, with no carryover to other baskets of foreign-source income. See *infra* ch. 18.

²¹⁷ See *infra* ch. 19.

²¹⁸ See, e.g., USA IRC § 38(d).

XII. Administrative Aspects of Taxing Employment Income

Almost all countries collect the income tax payable on employment income (PAYE) on a current basis by withholding at source by the employer.²¹⁹ Employers collect the PAYE withholding tax, although the employees bear the liability because, under the PAYE provisions, employees whose salaries have been subject to PAYE withholding are deemed to have received the gross (pretax) amounts of pay they are due. Administrative and collection provisions impose on employers the obligations to withhold and to remit, and parallel penalty and interest provisions will apply to nonwithholding or nonremittance.

If the employer has withheld tax but has failed to remit it to the tax authorities, it is appropriate to relieve the employee of any further tax liability (because the employee has already effectively borne the tax).²²⁰ In contrast, the provisions related to nonwithholding are usually drafted as parallel alternatives, allowing revenue authorities to collect the tax from either the employer or the employee, provided that it is collected only once.

If tax has been withheld, but the employer enters into bankruptcy or insolvency proceedings before the tax is remitted to the tax authorities, it is customary to give the government a priority interest in this fund, regardless of the general position that may be taken as to the priority given to tax debts owed by bankrupt or insolvent taxpayers. In effect, the fund is treated as being the property of the government rather than that of the employer.²²¹

To be effective, PAYE collection and remittance obligations should be imposed on as broad a range of employers as possible. The objective, particularly if PAYE is to be used as a final tax on employment income, is to apply the system to every situation where payment is made substantially for the labor of the recipient of the payment—that is, where the person receiving payment will not be entitled to substantial deductions in respect of materials, equipment, and so forth. The definition of persons subject to PAYE withholding is generally coextensive with the general definition of employee for income tax purposes, which is often broader than the labor law notion of employment.²²²

While the costs to an employer of administering PAYE collections are generally a small part of administering employee payrolls generally, PAYE obligations do impose a cost on

²¹⁹ This section elaborates on a few issues in PAYE taxation; for a full discussion, *see infra* ch. 15.

²²⁰ *E.g.*, USA IRC § 31(a) (credit allowed for the “amount withheld”).

²²¹ The New Zealand position is not atypical: revenue authorities are given priority for PAYE and withholding taxes not remitted by an employer, but stand with other creditors for the employer's basic income tax liability (*see* NZL ITA § 365). A contrasting position was taken recently in Australia, where the priority for PAYE and withholding taxes was abolished. On the same theory, the failure to pay over the tax withheld can be made a crime, as was done in Sweden, on the basis that it is analogous to embezzlement. *See* Leif Mutén, *Sweden Enacts Tax Account System*, 15 Tax Notes Int'l 905 (Sept. 22, 1997).

²²² *See supra* sec. IV(A).

employers, which is higher for small employers. In recognition of this fact and of the desirability of spreading the PAYE net as widely as possible, different remittance schedules can be applied to large and small employers, with the frequency of remittance falling with the size of employers' payrolls. Because employees are paid more often than the taxes are remitted to tax authorities, employers will obtain the benefit of the tax funds during the period between collection and remittance. This benefit can offset to some extent the costs of administering PAYE taxes, and the longer delay in remittance for smaller employers offsets in part the relatively greater costs faced by these employers. It must be recognized, however, that differential remittance dates do impose an additional administrative burden on tax authorities. When there is little or no computerization of the administration, a system of uniform remittance dates for all businesses may be easier to manage.²²³ In Russia and certain other countries of the former Soviet Union, it is typical for remittance to be required simultaneously with the payment of wages. This is a holdover from the previous system of clearance accounts. It may still be justified under current circumstances because businesses are in extremely tight cash situations and temptations not to remit should not be offered. However, this should be changed when these circumstances no longer prevail.

Notwithstanding the desirability of extending the PAYE coverage as broadly as possible, most PAYE systems contain exceptions for particular types of employment. A common exception is for employment in respect of personal services for an employer that are not part of the employer's business or occupation. This exemption would apply, for example, to a housekeeper or a home gardener.

It was suggested earlier in this chapter that there has been a trend toward designing the PAYE withholding system so as to make such withholding the taxpayer's final liability. This has the administrative advantage of excluding a large number of salary and wage earners from having to file a return, thereby freeing up scarce enforcement resources for other purposes. For PAYE withholding to be the final liability on employment income, the amount withheld must be accurate, which means the employer must be made aware of the employee's *taxable* income. This is usually done through an employment declaration, in which the taxpayer enumerates deductions, reliefs, or tax offsets that should be taken into account when determining taxable income. In some cases, the employment declaration may also provide the employer with information about other income derived by the taxpayer.

The use of employment declarations and withholding taxes as final taxes on employment income raises a number of technical and policy issues, which are discussed below.

A. Deductible Expenses

One of the main difficulties in making PAYE a final tax is the treatment of deductions. The tax is withheld from gross employment income, while in theory income tax is imposed on

²²³ There is, however, a compensating factor, namely, that the total number of transactions to be processed is smaller if small employers are required to pay less frequently. In developing countries, it is not uncommon for 75–90 percent of employers to fall into the "small employer" category, and a system that requires less frequent remittances from these employers may on balance require a smaller staff.

net gains, after recognizing deductible expenses incurred by an employee to derive the gross employment income.

It is impossible to take into account actual employment expenses when calculating PAYE withholding, because these will generally not be known at the start of the year. One possibility is to require employees to advise the employer of the incurrence of employment expenses so that they may be taken into account in subsequent withholdings. This approach has several problems. First, it may encourage employees to make inflated claims. This could be avoided by requiring the employee to produce documentary evidence to substantiate the claim to the employer. However, this requirement may impose an unreasonable and expensive compliance burden on employers. Also, the system imposes some obligation on the employer to assess whether or not the claim for a deduction is valid. Again, this may be an unreasonable and expensive burden to impose on employers.

Accordingly, if employee withholding is to be a final tax liability on employment income, a surrogate for recognition of actual expenses must be used. The alternatives of allowing a standard deduction or eliminating the deduction for employee expenses are discussed in section IV(B), above. Another option is to take no employment-related deductions into account in determining PAYE withholding, but to give employees an option to file a return if they wish to claim such deductions (in excess of any applicable threshold). The choice between these alternatives will be based on a balancing of equity objectives and administrative resources in the jurisdiction.

B. Personal Reliefs

Where it is decided to make PAYE withholding a final tax, it is necessary to keep the design of personal reliefs as simple as possible.²²⁴ If dependent spouse support is to be offered through the tax system, from an administrative point of view, the best option is to have a single relief that is intended to compensate notionally for the support of a spouse, children, and other dependents. It is then available to all resident individual taxpayers. While this relief may represent a windfall advantage to those taxpayers with no dependents, many such taxpayers are likely to claim relief in any case if the administration does not have the resources to check such claims. For taxpayers with dependents, it avoids arguments as to who is a dependent (particularly where there is an extended notion of the family) as well as the problems that arise with a change of tax status during the tax period (see below).

If tax relief is to be provided for dependents through deductions or tax offsets related to the actual number of dependents, relevant information on an employee's dependents must be provided on the employment declaration form. The declaration forms should be filed annually if a taxpayer is claiming such relief and should contain enough information (full name, birth date, and so forth) to enable auditors to detect fraud by comparing declarations for different years. Allowing a taxpayer to claim a deduction for a dependent only if the dependent has obtained a taxpayer identification number has proved effective in combating fraud because this makes it

²²⁴ See *supra* sec. IX(D).

possible to confirm both the existence of the dependents and their dependent status.²²⁵ Also, the form should provide the taxpayer's spouse's taxpayer identification number if the spouse is not a dependent to enable auditors to determine when two persons are claiming the same dependents (if individuals are used as the tax unit).

One technical and policy problem raised by recognition of relief for dependents is a change of status during a year—a taxpayer may marry or separate, have a child or lose a child (or the child may cross an age threshold during the year), or a dependent may enter (or reenter) or depart from the household. The simplest approach for handling additions to dependency relief is to place the onus on the employee to provide information on increased support obligations by submitting an amended employee declaration at the time the increase occurs. Additional relief can then be taken into account for future tax withholding. This incentive does not apply to employees who lose a support obligation or an entitlement to relief during the year. Nevertheless, an employee could be obliged to provide information on changes in personal relief entitlement, and the information could be checked against the following year's initial employment declaration form. This process may be administratively onerous. The simplest alternative is to allow taxpayers to enjoy dependency relief for the entire year, even if their entitlement changes during the year (concomitantly, a taxpayer would not become entitled to dependency relief until the new year).

C. Multiple Employment and Changes in Employee Status

An employee's status may change during a year in a variety of ways relevant to her or his tax liability. For example, an employee may become a resident or cease to be a resident during an income year. Similarly, an employee may enter full-time employment or retire from full-time employment during this period. The employee may also change employment or accept positions with more than one employer. The PAYE system must be designed to cope easily with these types of events.

Changes in residency or entering or leaving the workforce are relevant only if benefits are prorated for persons changing status in these ways. Proration is sometimes used to prevent exploitation of benefits or the tax-free thresholds that are intended for persons enjoying a particular status for the entire tax year.²²⁶ Only some types of proration can be handled in the context of a PAYE withholding system. It is in theory possible to take into account changes when a person commences employment (e.g., when a person leaves full-time education or becomes a resident), but impossible to take account retrospectively of changes when a person ceases employment (e.g., upon retirement or emigration). Recognizing changes of status poses a number of practical problems, of which the most significant is calculating withholding amounts. One key attribute of a PAYE system is the use of withholding liability charts that enable the employer to determine easily the exact amount of tax to be withheld from each salary payment.

²²⁵ USA IRC § 151(c)(3)(D)(I).

²²⁶For example, Australia prorates the tax-free threshold for persons becoming or ceasing to be a resident and for persons ceasing full-time education. See AUS ITRA §§ 16–20.

The charts are based on different levels of taxable income and are designed so that employers can take into account with relative ease such entitlements as personal allowances for dependent support. However, they cannot deal easily with a range of individual circumstances, such as variable tax-free thresholds. As a result, jurisdictions using these systems do not treat PAYE withholding as the final tax liability for employment income.

Problems also arise when an employee has more than one source of employment income. In this case, the total amount withheld will be accurate only if at least one employer knows the details of the employment income paid by others. While in some cases this may be possible, an employee may not wish to disclose the existence of other employment to his or her primary employer. In light of these problems, the system for final PAYE withholding for employees with more than one job is not likely to be fully satisfactory.²²⁷ One option is to require persons with more than one job to file a return so that their final tax liability can be determined.

A related problem area is that of taxpayers changing employment during the year. If the taxpayer's salary level is relatively unchanged following a change of employment, unobtrusive administrative procedures can ensure a continuity of appropriate PAYE withholding. If the former employer is required to provide the employee with a statement of his or her PAYE position at the date of leaving, the information can be provided to the new employer, who can use it as the basis for withholding to ensure accuracy for the year. This system will not work when the salary level changes following a change of employment. While the new employer will know the taxpayer's total expected employment income for the year, the PAYE withholding charts will not show how withholding should be adjusted to compensate for the relative under- or overwithholding at the first place of employment (in terms of the changed total expected employment income). As a result, PAYE withholding cannot accurately be used as a final tax liability in this situation, and it may be necessary to require employees who change employment to file returns unless their salary level has not changed or income rate bands are so broad (or so flat) that a taxpayer's proportionate liability would not change with the change in income.²²⁸

D. Fringe Benefits

The taxation of fringe benefits in the hands of employees poses particular problems if employee taxation is to be based on a PAYE withholding tax that is intended to represent the taxpayer's final employment tax liability. From an administrative perspective, there is relatively little difference to an employer between the alternative fringe benefits tax systems—whether fringe benefits are taxed in the hands of employers or employees, it is common to require the employer to monitor and value all fringe benefits, although valuation is clearly much simpler when the employer can report total benefits and does not have to allocate those benefits to individual employees.²²⁹ The principal difference is the impact of the tax on employee liquidity.

²²⁷ See *infra* ch. 15, sec. III(C).

²²⁸ This problem could be taken care of if withholding were computerized instead of being based on charts, or if withholding were in any event done on a cumulative basis (see *infra* ch. 15), but this will be beyond administrative capacity in most developing and transition countries.

²²⁹ See *supra* sec. IV(C)(3).

Because withholding cannot be extracted from a benefit in kind, the tax on fringe benefits must be withheld from an employee's wages or salary, in addition to the tax payable on the wages or salary. As mentioned earlier, in the context of fringe benefits taxation, this process may have a significant effect on the employee's cash flow when the value of taxable benefits is quite high relative to the value of cash remuneration. Thus, one effect of imposing a final PAYE withholding tax on employee fringe benefits in such a situation may be to cause employees to "cash out" the benefits and restructure their remuneration packages to receive wages or salaries in preference to benefits in kind, even those that are most efficiently provided through employers because of the availability of group discounts, such as medical and dental insurance.²³⁰ This possibility must be balanced against the obvious administrative advantages of using PAYE withholding tax as a final tax on all employment income and benefits derived by taxpayers.

If the cash-flow problems resulting from the introduction of PAYE withholding on fringe benefits are seen as transitional and the value of fringe benefits is not high compared with cash salaries, employers may be able to meet the initial cost of the PAYE deductions, recovering the funds over time from salaries as selected benefits are cashed out. The effect of this process is to transfer the cash-flow problem from employees to employers temporarily and to impose a real cost on employers. Whether this would occur depends on the relative bargaining powers of employers and employees.

A different problem arises with respect to the application of PAYE withholding to benefits that the employer may pay for once a year but that have the effect of providing a benefit to the employee continuously throughout the year. For example, an employer may provide employees with a health plan for which the employer accounts only once a year for the costs of operating the plan. Similarly, the valuation formula for a car fringe benefit will yield a single value for the year or perhaps a few values at the end of each mileage recording period if the formula takes mileage into account. In cases like these, it will be necessary to allocate part of the cost or benefit to each pay period of the employee. Rules of thumb will have to be devised to do this from the beginning of the year when the exact cost for the year will not be known until later.

One advantage of the fringe benefits tax discussed earlier is that taxation at the employer level facilitates the use of PAYE as a final tax and avoids the cash-flow problem noted above.

E. Other Income Sources

Unless the income tax rate scale is completely flat, PAYE withholding tax can operate as a final tax liability only for taxpayers deriving income solely from employment. In many developing and transition countries, this may be the case for a majority of employees. To the extent that employees do derive business or investment income, it is likely to be a *de minimis* amount for most employees relative to their employment income. Failure to reconcile the PAYE tax liability and the tax liability employees should incur if their complete employment and other income is taken into account will accordingly not seriously undermine the progressive tax system in most cases. The most likely scenario for an individual is that she or he will have a single job

²³⁰ See text at note 91 *supra*.

with her or his only other income being interest on a bank account. In this situation, it is possible to make PAYE withholding a final tax by taking steps to ensure the accuracy of PAYE withholding (as discussed above) and imposing a final withholding tax on interest income. Alternatively, PAYE can be used as a final tax on incomes up to a nominated threshold, on the assumption that persons above the threshold are likely to have income other than bank interest.

In some cases, failure to combine employment income and other income when determining final tax liability can prima facie violate the objectives of the progressive income tax. The extent to which treatment of the PAYE withholding tax as a final tax liability on employment income defeats overall progressivity depends on both the structure of the income tax rate scale (and in particular the degree of graduation) and the treatment of other income. In theory, the imposition of separate tax liabilities on business and investment income reduces the overall progressivity of the tax system, although in practice this may not prove to be true. In many cases, global taxation has in fact reduced progressivity because taxpayers have exploited shortcomings in the provisions by which income from capital is taxed to defer recognition of gains and to use deductions for investment income expenses to reduce their taxable income from employment. Unless the provisions for measuring business and investment income are well drafted and contain special rules for quarantining expenses incurred to derive those types of incomes (for further detail, see ch. 16), overall progressivity may be threatened.

The choice between using the PAYE withholding tax as a final tax liability in all cases or only when taxpayers do not also derive business or investment income will thus depend on a variety of factors, in particular the type of taxes imposed on business and investment income and the sophistication of the rules protecting the integrity of the business and investment tax systems.