

## TAX REVENUE, UNCOLLECTIBLE TAX, TAX CREDITS

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

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#### PREFACE

The main purpose of this paper is to set forth proposals for the revision of *SNA* (2008) regarding tax revenue, which need further clarification in the *SNA* (and convergence with *IPSAS*) concerning three issues, i.e. (1) the definition of tax revenue, (2) accrual recording of taxes, and (3) the recording of tax credits.<sup>1</sup>

#### The TFHPSA's Summary of Conclusion on Tax Revenue from February 11, 2004 Meeting

Issue 1: clarify the **definition of taxes** in the *SNA*

Current treatment: the *SNA* definition of taxes is a compulsory, unrequited payment to government. The terms “nothing in return” are used. This definition is broadly consistent with *GFSM* 2001 and with *IFAC-PSC*. However, clarification may be needed on borderline cases.

Possible clarification: There is no need of major change in the *SNA*. Should the wording “nothing in return” be modified alongside the idea that “nothing is obtained *directly* in *exchange*”?

Issue 2: **Accrual recording** of taxes: clarify the time of recording and the amount to be recorded

Current treatment: *Time of recording*: all three guidelines (*SNA*, *GFSM*, *ESA*) agree on the general principle “when the taxable event occurs”. However, they also all agree in giving some flexibility for income tax. This flexibility may be interpreted differently. *Amount to be recorded*: all converge on the fact that the amounts are those due but excluding tax not expected to be collected. The exact passage between amounts due and expected to be collected differs between the systems (see *IPSAS* guidelines on the tax gap issue).

Possible solutions: There is no need of major change in the *SNA*. Should the recommendation to record the tax when the taxable even occurs be reinforced, leaving however still room for flexibility? Should the way amounts not expected to be collected be harmonized? There are three options proposed by the new *ESA* (assessed amounts adjusted by a coefficient, time adjusted cash, capital transfer<sup>1</sup>). Should they be limited to the first two?

Issue 3: **Tax credits**: there are no guidelines on tax credits in the *SNA*. Guidelines would be useful

Other guidelines: *GFSM* and *OECD* revenue statistics converge on the recommendation that the tax credit is to be deducted from the tax value, but that any amount exceeding that tax liability and paid by general government should be classified as expenditure. The *IFAC-PSC* tries to distinguish more “tax expenditures” and “expenses paid through the tax system” which should be expensed.

Possible solution: Should the principle stated by *GFSM* and *OECD* Revenue statistics be adopted in the *SNA*? Should this principle be augmented by a definition of what is a tax credit? Does the recording of personal tax credits raise specific questions, compared to corporate tax credits?

1) Note the change made by the EC's Regulation No 2516/2000, which made the assessment of the capital transfer based on coefficient (see section A.2.2).

<sup>1</sup> The text-box includes the TFHPSA's Summary of Conclusion on Tax Revenue from February 11, 2004 Meeting.

## MAIN PROPOSALS

### (1) Definition of taxes

No important change in substance seems to be necessary. The wording “nothing in return” can be replaced by “nothing in exchange”, consistently with the IFAC-PSC reflections on “non-exchange revenue”. See further proposals on page 4.

### (2) Accrual recording

There is no need for major change in SNA.

Regarding *time of recording*, some flexibility should be permitted concerning taxes on income and parallel economy. The right time to record taxes in these two cases is not the time when they accrued, but the time when the taxes were known as due to be paid with sufficient certainty.

On *amounts to be recorded* regarding uncollectible taxes, the general recommendation is (a) to adjust the assessed amount by a coefficient to eliminate uncollectible taxes (adjustment made on the revenue side), or (b) to time-adjust the cashed amounts (to the time they were accrued, or due), or (c) a combination of a and b with some flexibility (Annex 1). See further proposals on pages 10-11.

### (3) Tax credits (proposals for discussion – see further pages 13-14)

- a. “non-wastable tax credits”: tax credit is to be deducted from tax value, but that any amount exceeding the tax liability and paid by general government should be classified as expenditure.
- b. Any tax credits paid to the taxpayers (non-wastable tax credits), and any tax credits not assessed on basis of the underlying tax source (base)<sup>2</sup>, should be classified as expenditure.
- c. Any tax credits not assessed on basis of the underlying tax source (base), and any tax credits that discriminate between taxpayers of same type, should be classified as expenditure.

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<sup>2</sup> In other words, the tax credits are determined arbitrarily or in fixed amount (e.g. allowances per child), but not as a function (percentage) of the underlying tax base (f.ex. taxable income).

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

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

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

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

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

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

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

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

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

### **2. GFSM 2001**

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

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

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

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

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

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

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

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

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

#### ► Proposals for the new SNA

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

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

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

## II. ACCRUAL RECORDING OF TAXES

### A. Current systems

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

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

##### Time of recording:

###### *General principle:*

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

###### *Practical principle:*

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

Amounts to be recorded:*Parallel economy:*

- When economic activities “escape the attention of the tax authorities” (...) “the amounts of taxes to be recorded in the System are determined by the amounts due for payment only when evidenced by tax assessments, declarations or other instruments (...) which create liabilities in the form of clear obligations to pay”. (§7,59)

*Cash basis and uncollectible taxes:*

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

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

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

**A.2.1 ESA 1995 – Initial version**

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

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

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

In a context where the net borrowing/net lending of general government was serving as a critical criterion to assess government finance sustainability (and to allow Euro-Area membership), Eurostat and member states felt necessary to develop supplementary provisions and to amend ESA 1995 by way of Parliament and Council Regulation n° 2516/2000 of 7 November 2000 and Commission Regulation (EC) No 995/2001 of May 22, 2001. The rationale of the regulations is that “the impact on general government net lending/net borrowing of taxes and social contributions recorded in the system on an accrual basis shall be equivalent over a reasonable amount of time to the corresponding amounts actually received.”

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

#### *Time of recording:*

##### *General and practical principles:*

- “This is when the activity *took place* which generated the tax liability or, in the case of some income taxes, when the amount of tax due *is determined* with certainty by the government”<sup>3</sup>

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

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

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

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

- “If cash receipts are used, they shall be time-adjusted so that the cash is attributed to the period when the activity took place to generate the tax liability (or when the amount of tax was determined, in the case of some income taxes) (2.1). This adjustment may be based on average time difference between the activity (or the determination of the amount of tax) and cash tax receipt (2.2).”<sup>4</sup>

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

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

#### *Time of recording:*

##### *General principle:*

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

##### *Practical principle:*

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

#### *Amounts to be recorded:*

- Due to uncertainties related to economic activities, “only those taxes and social security contributions that are evidenced by tax assessments and declarations (...) are considered to create revenue for government units.” (§3.56)
- “It would be inappropriate to accrue revenue for an amount that the government unit does not realistically expect to collect. Thus, the difference between assessments and expected collections represents a claim that has no real value and should not be recorded as revenue. The amount of taxes and social security contributions that is recorded as revenue should be the amount that is realistically expected to be collected.” (§3.57)

<sup>3</sup> See ESA95 Manual on government deficit and debt, chapter III.1 (interpretation of ESA95 §1.57 and 4.26).

<sup>4</sup> See Regulation (EC) No 2516/2000 of 7 November, 2000 of the European Parliament and Council.

It can be concluded from this wording, that the GFS Manual 2001 supports the change to the ESA 1995, and arguably reinforces it, and at the same time expresses a strong preference for the ESA 1995 recording (1.1)<sup>5</sup>.

#### A.4 IFAC – PSC

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

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

Two approaches are mentioned to accounting for the tax gap:

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

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

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

Several paragraphs are dedicated to the analysis of taxes as assets to the extent that the inflow of resources “embodies future economic benefits or service potential”.<sup>6</sup>

§7 The Steering Committee view is that:

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

- a) the taxable event occurs, that is the past event that gives rise to the control of the resources;
- b) it is probable that the future economic benefits or service potential will flow to the entity; and
- c) the fair value of the economic benefits or service potential flowing to the entity can be measured reliably.”

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

<sup>5</sup> A draft discussion paper by Johann Bjorgvinsson (IMF), entitled “Recording of taxes and other revenues in the GFSM 2001 System”, submitted to the Steering group on Revenue Statistics (OECD Working Party N°2 on Tax Policy Analysis and Tax Statistics, held on 18 November 2003) confirmed that “Option 1.1 and option 2 above are more in line with the spirit of the GFS 2001 Manual and its recording principles.” For certain types of taxes (income taxes on individuals), a combination of the two options was recommended.

<sup>6</sup> However, §3.30 and 31 discuss the issue of considering the “right to tax” as an intangible asset of the government. It finally states that « the right to tax cannot be recognised as an asset because it is not possible to establish the cost or fair value of the asset; therefore it fails the criteria for recognition of an asset.”

## **B. Assessment**

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

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

There is broad agreement in principle; the coverage of the parallel economy is troubling.

One issue is the reference to past events, that SNA may be interested to pick up.

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

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

Also, there should be limited room or none at all for recording write-off of accrued taxes (bad debt) through other changes in volume.

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

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

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

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

It is clear that 1.1 and 1.2 make use of a *coefficient*, but how should such coefficient be measured? And how should a difference that might appear between the assessed amount (adjusted by a coefficient) and the actual (realised) amount collected be tackled?. Part II.C deals with these issues.

A use of a *coefficient* to reflect the assessments never collected, as described in Part II.C, will make the ESA95 part (a) in paragraphs 4.27 and 4.82 unnecessary regarding unpaid taxes (see A.2.1), if regular revisions of the coefficients are allowed to smooth out uncollectible taxes over longer period.



### B.3 Time of recording.

With reference to the role of the GFS as a fiscal analytical instrument for measuring the government's impact on the economy, it is seen as vital that both the *accuracy and reliability* of the accrual recording and the *timeliness* of revenue data are adequate for this role. The recommendation on rules for revenue recording should take account of this requirement and the need for *optimizing the trade-off* between the quality of accrual recording and the timeliness of the data. A combination of possibility (1.1) (assessment adjusted by a coefficient) and possibility (2) (time-adjusted cash amounts) should be considered for the future SNA recommendation. A numerical example on such combination (recording rules), showing the possible trade-off, is described in [Annex 1](#) by using two examples on how to record personal and corporate income tax.

## C. The Coefficient

### C.1 The Coefficient concept

The coefficient should capture the amounts of uncollectible taxes, i.e. the amounts that were assessed or declared (accrued), but will not be paid due to various events, such as bankruptcies, corrections, etc. For a given year of income or event being taxed, the uncollectible amount will be known far after the event.

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

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

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

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

### C.2 Measure of the coefficient

Since the coefficient will not be known exactly until after a few years (assuming a tax reporting system capturing the year of income to which each tax payment relates), some estimates of the coefficient will be needed for provisional or final accounts. The calculation can of course be repeated for more years, and the average results (even weighted by recent trend-changes) will be used to estimate the coefficient. Over longer period the coefficient will, of course, need regular revisions due to e.g. changes in tax collection methods or the economic prosperity. It is therefore necessary to have floating assessment (more recent years) of the coefficient, which takes account of the recent trend-changes (even weighted). By doing these adjustments, the amounts of uncollectible taxes will be smoothed out over longer period. This will mean that uncollectible taxes will be corrected through *revenue recording*.

### **C.3 Treatment of a difference that appear between the assessed amount (adjusted) and the actual amount**

It is implausible that GFS compilers (users) would agree to perpetually revise taxes of previous years, as the actual cash flows allow finer and finer estimates of the actual coefficient for each year of income. Instead, it is likely that the estimated coefficient will be fixed for a year, perhaps at first estimate, or after few revisions. The question then arise what should be done if a difference appears between the actual amounts and the assessed amount (adjusted by coefficient)?

There are two classes of answers:

- (1) Correcting (delete/create) the difference in question in the books of government, at the time the difference is established, through:
  - (1.1) other change in volume
  - (1.2) capital transfers (tax revenue)
  - (1.3) a tax revenue negative (positive)
- (2) do nothing (just revise the coefficient).

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

Option (2) is to simply do nothing other than revising the coefficient so the difference between the actual and the estimated amounts can be smoothen out (corrected) over longer period. This option does not involve immediate deleting (or adding) of the difference appearing in the other accounts receivable due to inaccuracy in the estimate of the coefficient. Since it is likely that the accumulated “wrong” other accounts receivable will be small, particularly in comparison with the total tax amount adjusted by the coefficient, it is recommended that nothing will be done.

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

#### **► Proposals for the new SNA**

To replace §7.59-60 and 8.49-50:

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

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

- the time of recording
- the amounts to be recorded

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

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

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

- **Taxes on income:** in some cases the liability to pay income taxes can only be determined in a later accounting period than that in which the income accrues. This is the case when amounts due are evidenced and known with sufficient certainty only through tax assessments, declarations etc.

- **Parallel economy:** some activities, transactions or events escape the attention of the tax authorities. The liability to pay taxes cannot be related to the underlying economic event, but only to the time when the tax assessment is made.

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

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

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

The general recommendation on *amounts to be recorded* regarding uncollectible taxes is

- (a) to adjust the assessed amount on by a coefficient to eliminate uncollectible taxes. The adjustment should be made on the revenue side.<sup>7</sup> Regular revision of the coefficients is recommended to smooth out uncollectible taxes over longer period
- (b) to adjust the cashed amounts (but at the time they were accrued, or due)
- (c) a combination of a and b with some flexibility (see Annex 1)

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

### **A. Current Systems**

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

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

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

Chapter 5 (Revenue) states in §5.23:

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

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

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

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<sup>7</sup> Regarding the expense side recording, see argument under section B.2.

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

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

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

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

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

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

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

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

### **A.4 IFAC – PSC**

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

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

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

## B. Assessments

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

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

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

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

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

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

### b) Borderline with social benefits and subsidies

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

The recording of tax credits should meet some criteria:

- The tax credit measure must appear as part of the tax law, the tax code and on tax statements. To that extent, could only be deducted from a given tax, amounts that are calculated on the same base as the tax (usually the income), and over the same period of time. Thus, possible VAT reimbursement to specific categories of the population cannot be deducted from the tax on income.

- The amount recorded as tax credit – deducted from tax due – cannot exceed the amount of tax due by beneficiaries. This element in excess is an expenditure of government.

- Individual information should be available through the tax statement of households or other entities benefiting from the measure.

Further discussion points:

- (a) Any tax credits paid to the taxpayers (non-wastable tax credits), and any tax credits not assessed on basis of the underlying tax source (base)<sup>8</sup>, should be classified as expenditure.<sup>9</sup>**
- (b) Any tax credits not assessed on basis of the underlying tax source (base), and any tax credits that discriminate between taxpayers of same type, should be classified as expenditure.<sup>10</sup>**

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<sup>8</sup> In other words, the tax credits are determined arbitrarily or in fixed amount (e.g. allowances per child), but not as a function (percentage) of the underlying tax base (for example taxable income).

<sup>9</sup> This means that all unpaid tax credits like child allowances or interest (housing) allowances, which are not directly related to the underlying tax base, should be classified as expenditure (or clearly specified on the revenue side).

<sup>10</sup> All unpaid tax credits not directly related to the underlying tax base, should be classified as expenditure (or clearly specified on the revenue side). All tax credits to a certain class of taxpayers (of same type), like disabled people, certain welfare institutions (NPI), or certain corporations (certain activities) within particular industry, should be classified as expenditure (or clearly specified on the revenue side).

## ANNEX 1. Examples of how recording principles could be applied

### Example 1 Personal Income Tax.

Taxes have to be recorded best at time the economic activity occurred, which may impair timeliness needs. An alternative method may give quicker final accounts. It involves using time-adjusted cash recording (cash is attributed to the period when the activity (...) took place that generated the liability) with recording of *final tax liability* in the period in which it is determined.

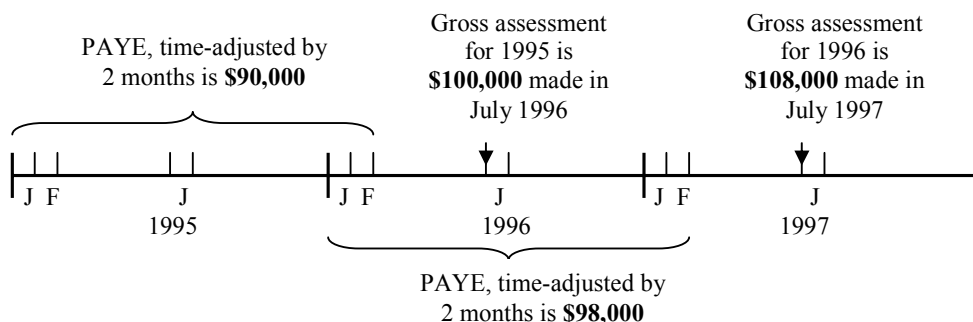
The alternative method (applied in Iceland):

- (1) record all income taxes *deducted at source* (PAYE) related to the recording year when deducted,
- (2) *time-adjust* those taxes related to the recording year, but paid in following year, on the based of the due for payment principle.<sup>11</sup>
- (3) record the *final tax liability* in the period in which the liability is determined. When deciding the final tax liability, the gross tax assessment is adjusted by a coefficient reflecting the assessments that will never be collectable, and as well by the tax amount that has already be paid (i.e. by provisions (1) and (2)).

Consider the following example:

- The recording year is 1996.
- The (1) PAYE and (2) time-adjusted income tax, related to 1996, is \$ 98,000.<sup>12</sup> The adjustment period (due for payment period) is two months,<sup>13</sup> i.e. January and February. The corresponding figure for 1995 is \$ 90,000.
- The gross income tax assessment related to 1996 is \$ 108,000 made in July 1997, and the corresponding gross assessment for 1995 is \$ 100,000 made in July 1996.
- A coefficient is used to adjust the gross assessed income tax to determine the tax assessment that will never be collectable. The coefficient is based on calculation from previous years' experiences and is in this example 4%.
- Under the usual accrual principle the amount to record in 1996 is \$ **103,680** ( $\$108000 \cdot 0.96$ ), and will be known in August 1997 (T+8 months).
- The alternative method yields quicker results: by March 1997 (T+3 months). The personal income tax recorded in 1996 is \$ **104,000**, i.e

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



<sup>11</sup> Due for payment recording shows transactions at the latest times that the corresponding payments can be made without additional charges or penalties.

<sup>12</sup> Only cash payments related to the income year 1996 are recorded.

<sup>13</sup> This period can, of course, be of different length (due for payment period), and it can be based on average time difference between the activity and cash tax receipt.

**Example 2 Corporate Income Tax**

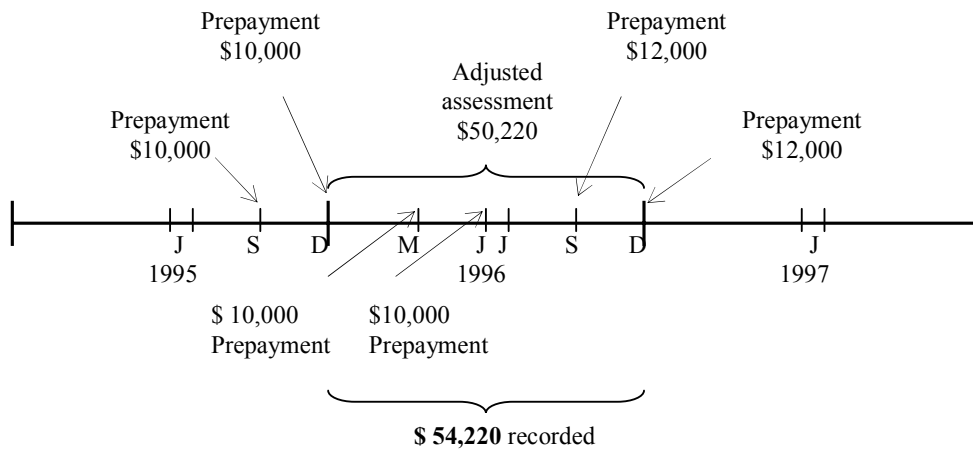
**Taxes have to be recorded best at time the economic activity occurred, which may impair timeliness needs. An alternative method may give quicker final accounts. It involves using time-adjusted cash recording (cash is attributed to the period when the activity (...) took place that generated the liability) with recording of final tax liability in the period in which it is determined.**

The levy of corporate income tax is normally based on income (profits) declarations provided by the corporations.<sup>14</sup> An alternative method, can be applied as follows: The tax liabilities, usually related to the previous year, are recorded in the period in which they are determined, and adjusted by a coefficient reflecting the assessments that will never be collectable and by the amount that has been prepaid.<sup>15</sup>

Consider the following example:

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

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



<sup>14</sup> These taxes are usually assessed on the total incomes of corporations from all sources and not simply profits generated by production (see *SNA 1993*, paragraph 8.52)

<sup>15</sup> As a practical deviation from general principle, regular prepayments of income taxes may be recorded in the periods in which they are paid (See *section V*).