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Taxation of Income from Business and Investment

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Lobbyists know that a 0 percent tax rate on capital income is not, in fact, the lowest possible rate.
—Joel Achenbach

I. Introduction

This chapter addresses the design and drafting of the income tax law as it applies to business and investment income.

While employment is an activity exclusively engaged in by individuals, business and investment activities may be engaged in by individuals or legal persons. Consequently, the rules for taxing income from business and investment cut across the taxation of individuals and legal persons. Countries with separate tax laws for individuals and legal persons need to coordinate the rules for taxing business and investment income, even though these may not always be uniform.

Regardless of the overall design of the income tax,[1] it is common to provide special rules for taxing business or investment income. These rules primarily relate to the tax base, timing of the recognition of income and deductions, and collection of tax. By far the most important are the timing rules. Particularly in the business context, these rules must negotiate the difficult terrain that bridges financial accounting and taxation. While uniformity between tax and financial accounting may seem desirable, countries have adopted quite different approaches: some countries have achieved substantial uniformity; in others, tax and financial accounting are substantially independent.

Note: Contributions to this chapter were made by Frans Vanistendael. The appendix is by Victor Thuronyi, with contributions by David Williams.

[1]Global, schedular, or composite; and single or separate tax laws for individuals and legal persons. *See supra* ch.14, sec. II.

II. Business Income

The characterization of an amount as business income is important in both schedular and global income tax systems.[2] Under a schedular system, it is common for separate taxes to be imposed on employment, business, and investment income. Consequently, the characterization of an item of income determines which tax regime applies to it. Under a global system, there is often a notional schedular breakdown of income types under which business income is specifically mentioned as a type of income that is included in gross income. Even if the notion of income is completely global, special rules, particularly tax accounting rules, may apply to business income. Other types of income derived by individuals may be calculated using different rules.

The starting point in determining whether an item of income is business income is to determine whether the activity giving rise to the income is properly characterized as a business. This issue is considered first below, followed by a discussion of inclusion rules related to business income. The third topic covered in this section is deductions for business expenses.

A. Definition of Business

In the absence of a definition in the income tax law, the term “business” will have its ordinary meaning.[3] In broad terms, a business is a commercial or industrial activity of an independent nature undertaken for profit.[4] The concept of a business may overlap with the notion of employment for tax purposes.[5] Whether this is the case will depend on the definition of employment that is included in the law. For administrative reasons, employment should be defined for income tax purposes to include all continuing service relationships where most or a significant part of the service provider’s income is derived from one customer and that income essentially represents remuneration for the service provider’s labor.[6] This will include some independent contractor relationships (i.e., relationships that are within the ordinary meaning of business). Where employment is defined in these broad terms, the definition must be coordinated with the definition of business so that the same economic activity is not characterized as both a

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[2]*See also supra* ch. 14, sec V.

[3]While the word business is commonly used in income tax laws, some countries use other expressions, such as “entrepreneurship”, to identify independent economic activity. *See, e.g.,* EST IT § 9(1) (income derived from entrepreneurship).

[4]Some systems have distinguished a trade from a profession or vocation. *See, e.g.,* GBR ICTA § 18 (sched. D, case I (trade) and case II (profession or vocation)). *See also supra* ch. 14, sec V. As discussed in ch. 14, it is preferable not to draw such a distinction. Therefore, business should be defined to include both trade and professional activities. *E.g.,* AUS ITAA (1997) § 995-1; CAN ITA § 248; IND ITA § 2(13); KEN ITA § 2; ZMB ITA § 2.

[5]In the United States, employment is considered to be a business, but other systems generally do not follow this approach. This is in any case largely a semantic point in the United States, which distinguishes the business of employment from other businesses.

[6]*See supra* ch. 14, sec. IV(A).

business and an employment for income tax purposes. This could be achieved by providing that a business does not include an employment.[7]

B. Definition of Business Income

The definition of business income may serve a number of purposes in a global or schedular income tax system, for example, to identify a category of income for which special deduction or timing rules apply. It may also be used to characterize a particular item of income as business income where the income may otherwise be characterized as investment income. An important purpose of the definition in jurisdictions with a less than comprehensive judicial concept of income (e.g., those that rely on U.K. jurisprudence) is to broaden the tax base.

The relationship between income characterization and timing rules is an important factor in the design of the income tax rules applicable to business income. In turn, the timing rules depend on the relationship between tax and financial accounting rules. Because of the importance of this latter relationship in determining business income for tax purposes, this relationship is discussed first below. There then follows a discussion of specific inclusion rules relating to business income.

1. Financial Accounting and Business Income Taxation

Two basic models are used to determine the taxable income arising from business activities (referred to as "taxable business income") of a taxpayer[8] for a tax period: the receipts-and-outgoings system and the balance-sheet system. Under the receipts-and- outgoings system, generally used in common law countries, the determination of taxable business income is based on the calculation of all recognized income amounts derived by a taxpayer in the tax period and all deductible expenses incurred by the taxpayer in the tax period. Under the balance-sheet method, common in many European civil law jurisdictions, taxable business income is calculated by comparing the value of the net assets in the balance sheet of the taxpayer at the end of the year plus dividends distributed by the taxpayer during the year with the value of the net assets in the balance sheet of the taxpayer at the end of the previous year.[9] A positive difference constitutes taxable business income, while a negative difference is a business loss.

While the two models may sound quite different, in practice, they are similar in many respects. In theory, the starting point for the balance-sheet method is the taxpayer's financial accounts, while the receipts-and-outgoings system starts with gains and expenses that are recognized for tax purposes. In practice, however, most taxpayers in receipts-and-outgoings regimes use accounting records of commercial profits and losses as a starting point to show gross

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[7]*E.g.,* AUS ITAA (1997) § 995-1; CAN ITA § 248; KEN ITA § 2.

[8]In this discussion, the reference to "taxpayer" is intended to include a partnership, although, generally, a partnership is not a separate taxpaying entity. However, it is usual to calculate the taxable income (or the gross income and deductions) arising from the partnership's activities as if the partnership were a separate taxpayer in respect of that income for the purpose of determining the tax liability of the partners. *See generally infra* ch. 21.

[9]*See infra* appendix.

income and expenses. The recorded income and outgoings are then adjusted as necessary to reflect the differences between tax and commercial accounting rules. Similarly, while the balance-sheet method explicitly commences with commercial accounting records, these must be adjusted to reflect differences between tax law and commercial accounting practice. In some circumstances, the two systems may yield the same determination of taxable business income.

Not all business taxpayers are required to compile comprehensive accounting records that include balance sheets. Accordingly, in jurisdictions that use the balance-sheet method to calculate taxable business income, smaller businesses operated by sole traders and self-employed persons (particularly those that account on a cash basis)[10] may be allowed to calculate income as the difference between taxable receipts and deductible expenses.[11]

The relationship between the determination of business income for tax purposes and financial accounting rules is analyzed in detail in the appendix to this chapter. Those materials note that the principal purpose of financial accounting is to provide an accurate analysis of the profitability of an entity to the managers and owners of an entity, as well as to creditors and potential outside investors. Income tax, in contrast, is concerned with the measurement of the net economic gain of a taxpayer in a fixed period for the purpose of collecting a portion of the gain as tax. These differences explain why classifications used in one system may not be relevant to the other. For example, because financial accounting is concerned with presenting owners, creditors, and investors with an accurate reflection of the ongoing profitability of an entity, it places some emphasis on classifying gains by reference to their regularity.[12] Distinctions of this sort that are drawn for accounting purposes are generally not carried over for tax purposes in jurisdictions that use the balance-sheet method of calculating taxable income.[13] The accounting distinctions are, however, relevant in some jurisdictions that use the receipts-and-outgoings method of determining taxable income.[14]

[10] *See infra* sec. IV(B)(1) for a discussion of cash-basis accounting.

[11] *See, e.g.,* DEU EStG § 4(3) (taxpayers who are not required under commercial law to keep double-entry books and do not keep such books).

[12] For example, financial accounting may distinguish between ordinary gains and extraordinary gains (which often equate to "capital gains" in income tax concepts) to ensure that readers of the accounts are not misled into thinking that extraordinary gains will be regularly received by the business. Often, extraordinary gains realized upon disposal of an asset have accrued over many years. *See* Financial Accounting Standards Board (USA), General Standards I17.106 and I17.107 for an example of the criteria used in financial accounting to identify extraordinary gains. The key criteria in U.S. financial accounting standards are the "unusual nature" of the transaction yielding the gain (I17.108) and the "infrequency of occurrence" of the transaction (I17.109).

[13] However, several countries draw a distinction between capital gains and other business income. *See infra* ch. 20, sec. III(A).

[14] For example, in common law countries, gains that are characterized as extraordinary gains for accounting purposes are commonly treated as capital gains for tax purposes, where the tax system provides different treatment for capital gains and ordinary income gains.

A second area in which financial and tax accounting rules differ is the treatment of income to which a future liability may attach or income that is related to goods or services to be provided in future years. This difference is relevant to both methods of determining taxable business income. Financial accounting uses a variety of means to ensure that the calculation of income does not present a distorted view of true long-term profitability when a taxpayer's right to retain income is contingent on the provision of goods or services in the future or is otherwise associated with potential future liabilities.[15] Income tax rules, by way of contrast, are not as concerned with qualifying or deferring recognition of income for the purpose of noting the taxpayer's future obligations. Instead, they tend to recognize income when the taxpayer has command over the gain, while deferring recognition of the consequent obligation until it is actually satisfied.[16]

The relationship between tax and financial accounting is important in the design of income tax rules in developing and transition countries. These two types of jurisdictions differ from each other in key respects in terms of their financial accounting systems, and both types of jurisdictions differ again from industrial countries.

Most developing countries have relatively comprehensive financial accounting rules, usually based on the systems of one or more of the member countries of the Organization for Economic Cooperation and Development (OECD). In many cases, however, local accounting rules have not evolved in line with changes in industrial countries that were adopted to reflect changes in commercial practice. A different situation exists in most transition countries, where financial accounting rules were designed for application in a centrally planned economy and are now undergoing or have undergone reform. The adoption or reform of accounting laws has ameliorated the problem, but the accounting laws alone are not sufficient for income tax purposes. In many cases, statutory regimes are not supported by developed commercial accounting practice or judicial precedents that can be used to fill in the gaps in accounting statutes. Accordingly, it may be necessary for income tax laws of developing and transition countries to include characterization and timing rules, instead of relying on financial accounting. Tax accounting issues that should be addressed in income tax laws are reviewed below in section IV(B).

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[15]In some cases, this is done by recognizing receipts as income but then appropriating part of the amount received to a "reserve" to indicate that it is not actually available for use or distribution, but is being held for eventual application to satisfy a contingent or potential liability. Alternatively, an amount received may be treated as unfettered profits but be subject to a notation to the accounts indicating that it is subject to a contingent or potential liability and may not, therefore, reflect actual gain. This might be done, for example, where goods are sold subject to the purchaser's right to rescind the contract within a fixed period. A receipt related to the provision of future goods or services is likely not to be treated as income at all for financial accounting purposes. Instead, it will probably be credited to a "prepaid revenue account," which is a liability of the company (offset by an increase in cash). As the goods or services are provided, the liability will be diminished and amounts will move from the prepaid revenue account to the income account. Income tax treatment of advance payments may accord with the accounting treatment or may require inclusion of the payment in income. *See infra* sec. IV(C)(1).

[16]*See infra* sec. IV.

2. Specific Inclusions

It was stated above that a key purpose of the definition of business income is to broaden the income tax base, particularly in jurisdictions that rely on U.K. law or precedents. Jurisdictions that use U.K. concepts[17] measure taxable business income using the profit-and- loss method, based on taxable receipts and allowable deductions. In these jurisdictions, only receipts recognized as business income under judicial precedents or specific rules in the statute are included in gross income from business.[18] The judicial concept of business income in U.K. law characterizes gains as income from business if the receipt is a product or an ordinary incident of the carrying on of a business. Judicial precedents for determining whether gains satisfy this test emphasize the characteristics of the receipt, such as periodicity, and the subjective intention of the taxpayer with respect to the derivation of the gain.

A gain may thus be income from business if it arose from a transaction that was entered into by the taxpayer with a business or profit-making intention.[19] Such a gain is said to arise from an adventure or concern in the nature of trade.[20] Under this approach, gains from "one-off" or isolated transactions such as immovable property sales and speculative financial transactions are particularly difficult to imbue with an income character, and the disputes concerning the characterization of gains from such transactions account for a high percentage of taxation cases in jurisdictions relying on U.K. judicial concepts. In these jurisdictions, gains from transactions that fall outside the business income concept are likely to be considered capital gains and hence outside the judicial concept of income. Rather than define business income expansively to overcome this problem, many common law jurisdictions have simply accepted the judicial characterization and grafted capital gains tax regimes on to the basic income tax system[21] or adopted a separate capital gains tax.[22]

In jurisdictions that use the balance-sheet method to calculate taxable income, the business income concept is typically formulated to encompass both gains from ongoing

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[17]The U.S. courts have taken a broadly similar approach to the issues discussed in this paragraph, although there are some differences in the approach of the case law--hardly surprising given the extensive amount of litigation on these issues.

[18]Also sometimes called “assessable income.” *See supra* ch. 14 note 25.

[19]*See* Rutledge v. Commissioner, 14 T.C. 490 (1929); Martin v. Lowry [1927] A.C. 312.

[20]Some income tax systems derivative of U.K. principles include an “adventure or concern in the nature of trade” in the definition of business. *E.g.,* KEN ITA § 2; CAN ITA § 248; IND ITA § 2(13); ZMB ITA § 2. This has its source in U.K. tax law in which trade is defined to include “every trade, manufacture, adventure or concern in the nature of trade” (GBR ICTA § 832).

[21]For example, the inclusion of capital gains in AUS ITAA (1936) §§ 160AX–160ZZU and CAN ITA §§ 38–55.

[22]*E.g.,* GBR TCGA.

commercial activities and gains on the disposal of business assets, including immovable property and machinery.[23]

A broad definition of business income can also be helpful in transition jurisdictions that use evolving accounting standards and accounting codes as the basis for calculating taxable income. It can achieve certainty and simplicity in the income tax base and avoid the application of significant administrative and judicial resources to issues arising from the uncertain boundaries of business income. Choice of an appropriate drafting technique to accomplish this objective will depend upon the drafting norms followed in the jurisdiction.

A wide inclusion provision should treat as business income any gains arising on the disposal of business assets.[24] It should be made clear that the inclusion rule applies to all assets of a business and not just those used in the normal operations of the business. Thus, the concept of business asset should include not only assets physically used in, or held by, the business, but also investment assets related to a business activity. For example, a person carrying on a construction business may make short-term investments with advance payments received, and these investments should be considered business assets and not investment property. For companies and partnerships this effect can be achieve by a rule that treats all assets of such entities as business assets. For individuals conducting business activities, that may be achieved through a broad definition of business asset that includes all assets used, ready for use, or held for the purposes of a business. As a practical matter, it may be difficult to draw the line between the business and investment activities of an individual. Nevertheless, making the distinction will be necessary if gains on the disposal of investment assets may be either untaxed or subject to some form of tax concession.[25]

The inclusion in business income of gains arising on the disposal of business assets needs to be coordinated with any special regimes applying to specific types of assets, particularly inventory and depreciable or amortizable assets, as such regimes may have their own inclusion rules. Even if these regimes do have their own inclusion rules, it still should be made clear that the amount included under those rules is characterized as business income. This should also be the case for amounts included in gross income as recapture of excess depreciation or amortization.[26]

The business income inclusion rule should also cover any gain arising in relation to a business debt.[27] Ordinarily, if a person receives money with an obligation to repay, the receipt of

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[23]The following definitions of business income for commercial and industrial enterprises are based on a net-increment-of-assets theory (*théorie du bilan*) and include all gains on assets used for business purposes: AUT EStG § 4 ; BEL CIR § 24; FRA CGI §§ 34, 36, and 38/1 and 2; DEU EStG §§ 4 and 5; CHE LIFD § 16; ESP IRPF § 41. NLD WIB § 7 taxes any advantage, whatever the name or the form, derived from an undertaking.

[24]*See infra* sec. V for a discussion of the timing and calculation rules relating to gains on the disposal of assets.

[25]*See infra* sec. VI(B).

[26]These amounts may also be referred to as balancing charges or as claw-back. *See infra* ch. 17, notes 170–71.

[27]*See generally supra* ch. 14 sec. VI(F).

the money is not regarded as income because of the offsetting liability to repay the amount received. However, if a debtor is able to discharge a business liability for less than the face value of the liability,[28] there needs to be some adjustment to the debtor's tax position to reflect the increase in the debtor's net worth. The simplest way of making this adjustment is to include the difference between the face value of the liability and the discharged amount in the business income of the debtor in the tax year in which the debt is discharged.[29] If the discharge has come about because the debtor is in financial difficulties, it may be appropriate to defer recognition of the gain by applying it to reduce the debtor's loss carryovers or asset costs, rather than including it in income.[30] Applying the gain in this way will reduce the debtor's deductions or cost recognitions in later tax years, thereby increasing the debtor's taxable income in those years.

Other items that can be explicitly enumerated in a definition of business income include the following:

- amounts received as consideration for accepting a restriction on the capacity to carry on business;
- amounts received as an inducement payment to enter into a contract or business arrangement (e.g., a lease "inducement" payment received for entering into a lease of business premises);
- gifts received by a person in the context of a business relationship;
- recovery of amounts previously deducted as business expenses, including bad debt claims; and
- amounts received in respect of lost business profits under a policy of insurance or a contract for indemnity or as a result of a legal action.[31]

As stated above, a specific inclusion rule may also be used to give priority to the characterization of a particular item of income as business income where the income may also be characterized as investment income. For example, investment income will usually be defined to include interest income. However, where interest income is derived by a person in carrying on a business of banking or money lending, it is appropriate to treat the income as business income and not investment income. It is also appropriate to treat interest income as business income when its derivation is incidental to business operations. This would be the case, for example, with interest derived on a business's normal bank accounts or short-term investments. The same

[28]Where the debt is a fixed-interest security, this may come about because a general rise in interest rates has resulted in a reduction in the value of the debt, so that the debtor is able to repurchase the debt for less than its face value. It may also come about under a debt- defeasance arrangement whereby a borrower liable to repay a loan at some future date pays a third party an amount approximating the present value of the loan in consideration of the third party's agreeing to pay the amount owed by the borrower when it becomes due. Finally, it may come about because the value of the debt has decreased because the debtor is in financial difficulties.

[29]*E.g.,* LSO ITA § 19(2); UGA ITA § 19(1)(a); USA IRC § 61(a)(12).

[30]*E.g.,* UGA ITA §§ 19(3), 39(3) (insolvency); USA IRC § 108 (insolvency or in formal bankruptcy proceedings). Some countries apply this rule in all cases and not just to debtors in financial difficulties. *See e.g.,* AUS ITAA (1936) sched. 2C; CAN ITA § 80 *et seq*.

[31]It may be preferable to deal with the last two of these specific inclusions with general inclusion rules applying to all types of income (and not just business income). If general rules are used, it will be necessary to provide rules concerning the category of income into which these items fall.

can apply to rental income where the business of the person deriving the income is the holding or letting of property.

The proper characterization in these circumstances may be relevant to the application of rules that quarantine deductions against particular classes of income.[32] Where income is derived from foreign sources, the characterization of the income may also be relevant to the calculation of the foreign tax credit limit.[33] It should be provided that the treatment of such income as business and not investment income for inclusion purposes does not preclude the income from retaining its characterization as interest or rental income for other purposes of the legislation. This ensures that any specific provision applying to such classes of income (such as nonresident withholding tax) is not avoided by an argument that the income is not interest income but business income.

C. Deduction of Business Expenses

In theory, all costs incurred to derive business income should be recognized for the purpose of determining net income, although the timing of recognition may vary for different types of expenses.[34] Early income tax laws often used restrictive language such as "ordinary and necessary" when defining deductible expenses.[35] Phrases such as this invite a subjective ex post facto analysis as to the desirability or effectiveness of business expenses. Other early income tax laws referred to expenses that were "wholly and exclusively" incurred to derive income subject to tax.[36] Terminology of this sort opens the door to a complete denial of a deduction for dual-purpose expenses, such as those incurred to derive both exempt income and income subject to tax, or those incurred for both personal purposes and to derive income subject to tax.

Generally, courts in jurisdictions that employ restrictive language of the sort described have read the provisions creatively and refrained from applying them to deny taxpayers deductions for genuine business expenses. The courts have adopted flexible interpretations of terms such as “ordinary and necessary” to discourage tax officials from second-guessing business decisions and denying a deduction for what subsequently proved to be ineffective or inappropriate outgoings.[37] Similarly, courts have applied language such as “wholly and

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[32]For example, it may be provided that expenses incurred in deriving investment income may be deductible only against investment income. *See infra* sec. VI(A)(3).

[33]In some countries, the limit must be calculated separately for different types of income. *E.g.,* USA IRC § 904.

[34]*See infra* sec. IV(D). The issues raised here are similar to those that arise under the value-added tax (VAT) for input credit, and the reader might usefully compare the discussion in vol. 1, at 219–20.

[35]USA IRC § 162, for example, has retained the phrase "ordinary and necessary expenses."

[36]This was the rule in early Australian and Canadian income tax laws. GBR ICTA § 74(a) has retained this phrase. It is still also found in many income tax laws derivative of U.K. principles. *E.g.,* KEN ITA § 15; SGP ITA § 14; ZMB ITA § 29.

[37]This has been the experience in the United States. *See* Welch v. Helvering, 290 U.S. 111 (1933) and Commissioner v. Tellier, 383 U.S. 687 (1966).

exclusively" in a pragmatic fashion. Under such an approach, an expense that can be apportioned may, in relation to a part of the expense, be seen as incurred wholly and exclusively for the purpose of deriving income subject to tax.[38]

An alternative model for the design of a deduction provision commences with broad, nonrestrictive language and then supplements the general rule to allow deductions (the "positive" limb or limbs of the deduction provisions) with specific restrictions on deductions (the "negative" limb or limbs).[39] To accommodate dual-purpose expenses, the positive limbs should contain apportioning language: for example, "expenses are deductible *to the extent* that they are incurred in the production of income subject to tax." To ensure that the broad objectives of the positive limbs are achieved, it may be useful to refer to alternative bases for deductions—for example, deductions may be allowed for expenses incurred in the production of income subject to tax *or* incurred in the operation of a business carried on for the purpose of producing income subject to tax. Many outgoings incurred by a business are necessary or appropriate to the operation of the business but not consumed directly in the income-earning process of the business. A specific reference to expenses of a business will ensure that all legitimate business expenses are deductible.

Negative limbs, prohibiting deductions for particular types of expenses, fall into three broad categories: restrictions on deductions for personal expenses, restrictions on immediate deductions for capital outgoings (incurred to derive long-term or long-life benefits), and restrictions on deductions motivated by policy considerations. It is important in drafting to state clearly the relationship between provisions denying deductions and any specific rules allowing deductions (such as depreciation provisions).[40] Ordinarily, the prohibition rules override general rules for the allowance of a deduction, but are in turn subject to specific rules allowing deductions. For example, the prohibition on immediate deductions for capital outgoings overrides the positive limb allowing a deduction for business expenses, but, as explained below, the prohibition may in turn be overridden by measures that allow the outlay to be deducted under a depreciation or amortization regime.

[38]In the case of GBR ICTA § 74(a), *see* Ransom v. Higgs [1974] 1 WLR 1594.

[39]*E.g.,* LSO ITA § 33.

[40]*See* Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) discussed in ch. 17 *infra* at note 57.

There are two advantages to a general deduction provision designed with broad positive limbs followed by specific negative provisions that specify the types of nondeductible outgoings. First, this technique avoids the impossible task of enumerating the endless list of expenses that may be incurred by a business.[41] It is impossible for legislative drafters to anticipate every type of expense that will be incurred, and, as a result, a system that allowed deductions only for enumerated expenses would inevitably prejudice some businesses. Second, and more important, the drafting approach that commences with a broad general deduction measure followed by specific deduction-denial measures provides a logical and sound framework for taxpayers, tax administrators, and tax adjudicators and makes the task of characterizing unusual expenses simpler for all parties.

1. Personal Expenses

The first category of deduction-denial measures applies to personal expenses and is relevant only to unincorporated businesses, because companies are inherently incapable of incurring personal expenses.[42] In the context of individuals deriving business income, it may be redundant to restrict the deductibility of personal expenses, since by definition a personal expense will not satisfy the criteria for deduction as a business expense. Nevertheless, as indicated in chapter 14 in the context of employment expenses,[43] statutes often prohibit deductions for personal expenses. Courts in particular find negative provisions of this sort useful for reinforcing decisions to deny deductions for personal outgoings. Further specific restrictions are sometimes used, for example, restrictions on deductions for "luxuries" where the value of the outgoings will not be taxed to the beneficiaries of the expenditures.[44]

Another type of personal expense to which specific restrictions are often applied is a "hobby" expense. A hobby is a personal activity that in other circumstances might constitute a business. For example, a holiday or weekend property could be nominally operated as a farm. Similarly, a taxpayer might pursue a recreational hobby, such as photography, sculpture, racing, or gambling, that constitutes a business for other taxpayers. Restrictions are needed to prevent taxpayers from deducting the expenses associated with such properties or activities.

Restrictions on the deductibility of hobby expenses may be achieved in two ways. First, reliance may be placed on a suitable definition of "business," drafted to exclude investments or activities that are not primarily intended as income-earning ventures. This approach has proved

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[41]The exhaustive-list approach seems to be favored by jurisdictions with a history of central planning. *See, e.g.,* MNG BEIT § 5(1); CHN EIT § 6.

[42]There is, however, a line of U.K. judicial authority that suggests that some business expenses, such as damages or fines, may be incurred by traders (including legal persons) in a personal capacity. *See* Strong & Co. Ltd. v. Woodifield [1906] AC 448 (brewery company held to incur damages in its capacity as householder rather than innkeeper). This authority now has little impact, particularly outside the United Kingdom, as later courts have distinguished the decision and largely confined it to the particular facts of the early cases.

[43]*See infra* ch.14, sec. IV(B).

[44]*See* BEL CIR § 53/10; DEU EStG § 4 V 7; Klaus Tipke & Joachim Lang, Steurrecht 261–63 (13th ed. 1991).

to be of little utility because courts in jurisdictions using this approach have found it almost impossible to map a clear line between genuine businesses and hobbies that are conducted with businesslike features.[45] A second approach is to allow expenses of any activity to be deducted only against income generated by the activity unless the taxpayer can demonstrate, by reference to objective criteria set out in the legislation or in regulations, that the activity constitutes a business.[46] Further, under such an approach, a rule based on profitability can be applied to determine that an activity is a business. For example, it can be provided that where the activity is the taxpayer's principal source of livelihood, it will not be considered a hobby and expenses will be deductible in future years, subject to loss-carryover rules.[47] Alternatively, an activity can be presumed to be a business based on profitability over several years—for example, three years out of five.[48] Care must be taken that such rules do not prevent a genuine business activity from being treated as such during an extended period of recession or of adverse seasonal factors.[49] Given this caveat, this approach prevents abuse of the deduction measures while recognizing the start-up costs and profit fluctuations that legitimate businesses may encounter.

2. Capital Expenses

The second category of deduction-denial measures applies to capital expenditures, which are incurred to acquire assets or benefits[50] with a life extending beyond the tax period. In principle, measures preventing deductions for capital expenditures are not intended to impose absolute prohibitions on their recognition. Rather, they are supposed to prevent immediate deduction for outgoings relating to long-term benefits, and other provisions in the law should allow for their recognition on a more appropriate timing basis. However, in some countries, the effect of rules preventing immediate deductions for capital expenditures is to prevent any deduction for these expenses.

A properly designed system will provide for the recognition of all types of capital expenditures. Under such a system, the method of recognition depends on the nature of the asset

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[45]This approach is used in Australia. The limited efficacy of this approach prompted the government to adopt specific hobby expense restrictions in 1985, but political and technical difficulties led to their withdrawal, and tax authorities continue to rely on the business definition as the sole means of restricting deductions for hobby expenses.

[46]*E.g.,* USA IRC § 183. The regulations under § 183 list nine factors to consider in characterizing a taxpayer’s activities. It is made clear in the regulations that the list is not exhaustive and that no one factor or even a majority of factors is decisive.

[47]*See infra* sec. IV(A)(2).

[48]*See* USA IRC § 183(d).

[49]For example, a farmer may be forced to take a job in town during a period of adverse seasonal conditions or a period of depressed commodity prices. During this period, the farming activity may not be the farmer’s principal source of livelihood nor may the farming activity be profitable, but this should not prevent the farming activity from being treated as a business.

[50]A benefit is a business advantage that does not involve the acquisition of any asset, such as, for example, the reduction of competition. *See* Graeme Cooper et al., Cooper, Krever & Vann’s Income Taxation 10-34 to 10-54 (1993).

or benefit acquired by the expenditure and, in particular, on whether the asset or benefit "wastes" over time. An asset or benefit wastes if it declines in value through usage or over time. Examples are buildings, plant, machinery, patents, and contractual rights of a limited life (such as an agency dealership for a fixed term). For such assets or benefits, the cost should be recognized by way of depreciation or amortization deductions allowed over the life of the assets or benefits.__epreciation and amortization rules are discussed in detail in chapter 17.

An asset does not waste if its value does not decline through usage or over time, although it may vary in response to market conditions. Examples are land and shares. For such assets, the cost of acquisition should be recognized upon disposal of the asset, through provisions that allow the cost base of the asset to be deducted in computing gain or loss on the disposal. Rules for cost inclusion and gain calculation are discussed in section V, below.

The design of a comprehensive regime for the recognition of capital expenditures must adequately provide for expenditures yielding benefits with uncertain lives. For example, a person may incur substantial expenditures in fighting the license application of a potential competitor or defending title to an asset already owned. Given that such expenditures may result in long-term benefits, they may be characterized as a capital expenditure; because the life of the benefit is uncertain, however, they may not fit within the ordinary amortization rules. To deal with such expenditures, it is suggested that a residual amortization rule be included to allow recognition over an arbitrary period of any capital expenditure for wasting or uncertain life benefits not covered by specific depreciation or amortization rules, or that it be included in the cost base of identifiable assets.[51]

An alternative approach that can be used in jurisdictions that have separate capital gains provisions for business taxpayers is to recognize the expenditure as a capital loss when the benefit acquired by the expense has expired.[52] However, this approach suffers from several major flaws. First, recognition of the expenditure is deferred until the asset or benefit expires, so that there is not a proper matching of expenses to revenue. Second, the expenditure is then recognized as a capital loss that, under the capital gains rules, may be applied only against capital gains. Third, even under a comprehensive regime for the taxation of capital gains, some capital expenditures will not be covered—namely, expenses that are not related to the acquisition of an identifiable tangible or intangible asset.[53]

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[51]For example, Canada uses a residual amortization rule that allows a taxpayer to recognize expenditures for wasting benefits not covered by other depreciation provisions on a 7 percent declining-balance basis. Not all the cost is recognized; *see* CAN ITA § 14.

[52]Australia, for example, has adopted this approach.

[53]Such expenditures never recognized for tax purposes are sometimes known colloquially as "nothings"(as in Canada prior to the adoption of the residual amortization rule in that jurisdiction), or "black holes," the term gaining currency in Australia.

The cost of inventory is not considered a capital expense in the ordinary sense because inventory is related to on-going business operations. Nevertheless, inventory does not waste, and, therefore, the cost of acquiring inventory should not be recognized until it is sold.[54]

3. Policy-Motivated Restrictions

The third category of deduction-denial measures applies to expenses that satisfy the positive nexus test for deductibility but that the legislature chooses, for various reasons, to disallow as a deduction. One reason the legislature may choose to do this is to discourage or penalize a particular activity for public policy reasons. Examples include prohibitions on the deductibility of fines and similar penalties[55] and bribes and similar illegal payments.[56]

A deduction-denial rule may also apply to income tax paid to other domestic or foreign jurisdictions, as well as to the domestic tax itself.[57] The treatment of foreign taxes will depend on the international tax regime.[58] The problem of other domestic income taxes arises most commonly in federal jurisdictions. The treatment by the federal or subordinate governments of taxes paid to the other level of government will depend on the fiscal support arrangements in place in the jurisdiction. In some jurisdictions, the two or more income taxes operate in parallel; in others, one level of government provides a deduction or credit for income taxes paid to the other.[59]

Other policy-motivated deduction restrictions may be designed to reinforce tax administration. A common example is the denial of a deduction for payments made by the taxpayer that are subject to withholding tax if the taxpayer has failed to withhold tax as required.[60] Another example is payments that are not properly substantiated by documentary evidence.[61]

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[54]*See infra* sec. IV(D)(4).

[55]*See, e.g.*, AUS ITAA (1997) § 26-5; EST IT § 16(4); LSO ITA § 33(3)(e); UGA ITA § 23(2)(h).

[56]*See, e.g.*, GBR ICTA § 577A (expenditure incurred in making a payment where the making of the payment constitutes the commission of a criminal offense); USA IRC § 162(c); OECD, Implementation of the Recommendation on Bribery in International Business Transactions, 4 OECD Working Papers, No. 34 (1996).

[57]*E.g.,* EST IT § 16(3); LSO ITA § 33(3)(b); SGP ITA § 15(1)(g); UGA ITA § 23(2)(d).

[58]*See infra* ch. 18.

[59]*See* vol. 1, at 68. It may be concluded that no explicit deduction prohibition is needed where deductions are not to be given for income taxes paid to another level of government as the payment may not satisfy the positive nexus tests in the deduction provisions (because the tax is not considered an expense of earning income). This means that if recognition is to be provided for another domestic income tax by way of deduction (*e.g.*, USA § IRC 164), a specific allowable deduction or tax offset provision will be needed.

[60]*E.g.,* AUS ITAA (1936) § 221YRA(1A) (no deduction for royalties paid to a person outside Australia until withholding tax paid to the Commissioner).

[61]*E.g.,* AUS ITAA (1997) § 900-70 (car expenses) and § 900-80 (business travel). These rules apply only to individuals and partnerships in which an individual is a partner.

The legislature may also choose deduction denial to deal with borderline expenses that have elements of both business expenses and personal consumption. Such expenses are discussed in chapter 14 in relation to employment,[62] but the issues are equally relevant where the expenses are incurred by a business for the benefit of a customer, client, or other business associate. The main examples are entertainment, meal, and refreshment expenditures. For these expenditures, a deduction may be disallowed to the extent that the amount is not included in the income of the beneficiary of the expenditure (subject to exceptions where, for example, the benefits are provided to paying customers or given to a broad cross section of the public as samples).[63] Alternatively, some countries limit the deductible portion of expenses to a fixed amount specified in the statute.[64] Similar limitations apply in relation to costs incurred in providing leisure facilities maintained for the benefit of employees and business associates, and the payment of social club membership fees for the benefit of employees.[65] A limitation may also be included on the deductibility of the cost of a gift made directly or indirectly to an individual if the gift is not included in the individual's income.[66]

Other examples of policy-based deduction-denial rules are some interest expenses;[67] contributions to nonapproved pension, superannuation, or private social security schemes (to encourage contributions only to schemes with rules that achieve the government's retirement income policies);[68] and contributions to political lobbying organizations or to political parties.[69]

III. Investment Income

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[62]*See infra* sec. IV(B).

[63]*E.g.,* AUS ITAA (1997) § 32-5 (entertainment expenses deductible only if the value of the benefit is included in the recipient's income, is subject to fringe benefits taxation, or in other limited cases); UGA ITA § 24 (entertainment expenses only deductible if the value of the benefit is included in the recipient’s income or the entertainment is supplied to the public as part of the taxpayer’s business).

[64]*E.g.,* CAN ITA § 67.1 (deductible amount is 80 percent of the expenses incurred); IND ITA § 37(2) (first 10,000 rupees is deductible plus 50 percent of the excess); LSO ITA § 33 (deductible amount limited to 50 percent of the expenses incurred); NZL ITA § 106G (deductible amount is 50 percent of the expenses incurred); USA IRC § 274(n) (only 50 percent of expense is deductible).

[65]*E.g.,* AUS ITAA (1997) §§ 26-45 (recreational club facilities) and 26-50 (leisure facility or boat); CAN ITA § 18(1)(l); NZL ITA § 106G.

[66]*E.g.,* UGA ITA § 23(2)(f).

[67]*See infra* sec VI(A).

[68]*E.g.,* LSO ITA §§ 95, 96.

[69]*E.g.,* CAN ITA § 18(1)(n) (political contributions).

As with employment and business income, the characterization of an amount as investment income[70] (or as a particular type of investment income) is important in both schedular and global income tax systems.[71] Under a schedular system, characterization determines which tax regime applies to the income. Under a global system, there may be a specific inclusion rule for investment income or special timing or administrative rules.

There are two broad approaches to the inclusion of investment income in gross income. First, the inclusion rule could refer to investment income, which is then separately defined by reference to specific categories of income, such as annuities, dividends, interest, rent, and royalties.[72] Where capital gains on the disposal of investment assets are included in the income tax base, investment income may also be defined to include such gains.[73] Alternatively, the inclusion rule may refer to specific categories of investment income rather than to a collective notion of investment income.[74] Even under this design, it may still be necessary to define investment income for particular purposes under the income tax law.[75]

Under either method of inclusion, the specific categories of investment income may be the subject of supplementary definitions. While these supplementary definitions will be relevant to the income inclusion rules, they may in fact be more relevant to other aspects of the income tax, particularly withholding on payments such as interest and royalties paid to nonresidents. Given the flexibility of modern commercial law contracts, a nonresident may derive income that is functionally equivalent to interest, royalties, or rent, but is not within the ordinary meaning of those terms. In the absence of broad definitions of interest, royalties, and rent, this income may not be subject to tax.[76] In these cases, there may be no doubt that what is derived is income, but it may not be covered by the definition of interest or royalties for the purposes of the relevant nonresident withholding tax.

In light of this, the drafting of supplementary definitions of specific categories of investment income, such as royalties, may be influenced by international practice, particularly that reflected in the OECD Model Tax Convention on Income and Capital [77] (OECD Model Treaty).

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[70]In some jurisdictions, the term "property income" or "capital income" may be used.

[71]*See also supra* ch. 14, sec. IV.

[72]*E.g.,* LSO ITA §§ 17(1)(c), 20; UGA ITA §§ 18(1)(c), 21.

[73]*E.g.,* LSO ITA § 20.

[74]*E.g.,* EST IT § 9; IDN LCIT § 4; SGP ITA § 10.

[75]*See supra* text at notes 24 and 25.

[76]If the nonresident withholding tax rules do not apply, then it is often fairly easy to structure the transaction so that the income derived by the nonresident has a foreign source.

[77]*See supra* ch. 18, note 9.

Supplementary definitional rules for annuities, interest, rent, and royalties are discussed below. The definition of dividends is discussed in chapter 19, section VI.

A. Annuities

In common law jurisdictions, annuities were originally developed in the context of trust law, where they were used to impose a support obligation on an estate. The obligation required the estate to pay a fixed stipend to a beneficiary, using both income derived by the estate and capital, if income was insufficient to satisfy the payment obligation. Commercial or purchased annuities are a more recent development. A taxpayer purchasing a commercial annuity provides an "annuity provider" with a capital sum that is returned with compensation conceptually similar to interest in fixed payments over a specified term or, in the case of a life annuity, over the taxpayer's life.

A taxpayer must be allowed to recover the cost of purchasing an annuity, so that only the profit portion of the gain is taxed. The usual procedure is to recognize the cost of the annuity on a pro rata basis over the life of the annuity. The cost recognized as a portion of each annuity payment is determined by dividing the cost by the total number of payments for a fixed annuity and by the total number of estimated payments for a life annuity. This can be done by first prorating the payments and recognizing only a part of each payment as income or by recognizing the entire annuity payment as income and allowing an offsetting deduction for the cost component attributed to the payment.[78]

This method of cost recovery results in a deferred taxation of annuity income. This deferral makes annuities an attractive investment vehicle for both individuals and businesses. In particular, it is possible to structure an ordinary commercial loan so that it takes the legal form of an annuity, and thereby take advantage of deferred taxation. From an economic perspective, fixed-term annuities are in many respects the functional equivalent of a “blended” loan in which the borrower repays the loan principal over the period of the loan. In a blended loan, each payment contains a return of principal and an interest component, but the interest component of the initial payments is high compared with the repayment of principal, while the interest component of the last payments is small, since most of the principal on which interest is calculated has been repaid by the time of those payments. Given the functional similarity between blended loans and annuities, commercial lenders may try to characterize an ordinary commercial blended loan as an annuity in order to defer recognition of interest income by recognizing interest income in equal installments over the life of the transaction rather than predominately in the initial payments.

Under normal circumstances, a borrower would prefer to enter into an ordinary loan arrangement than an annuity arrangement, because the former entitles the borrower to larger deductions in the early period of the loan. However, if the borrower is a tax-exempt person (or is in a net operating loss position), a loan offers no advantages over an annuity because there will be no tax advantage from recognizing the higher interest component at the beginning of the loan.

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[78]*E.g.,* AUS ITAA (1936) § 27H; ZAF ITA § 10A. *See infra* sec. VI(A)(4).

If the borrower is indifferent between a loan and an annuity, the lender may suggest the annuity option and offer a reduced rate of interest in return for the deferral opportunity.

Many common law jurisdictions vulnerable to this practice have enacted antiavoidance provisions to prevent exploitation of the annuity rules in this manner. The simplest solution is to restrict the annuity treatment described in section III(A), above, to limited categories of annuities such as retirement annuities and to define other annuities as ordinary compound interest blended payment loans for tax purposes, whatever the legal designation given to them by the parties. This will allow tax authorities to notionally dissect annuity payments into interest and principal components, as if the payments were made pursuant to an ordinary commercial loan contract.

B. Interest

Interest is the compensation earned by a creditor for the use of his or her money during the period of the loan. Fundamental to the ordinary notion of interest is that there is a debt obligation. To make this clear, interest may be defined by reference to a debt obligation with a separate definition of debt obligation in the law that includes accounts payable and obligations arising under promissory notes, bills of exchange, debentures, and bonds.[79]

As indicated above, modern commercial law contracts make it possible to convert interest on debt or quasi-debt obligations into a variety of other forms, including discounts and premiums in respect of loan principal. Thus, interest is often defined for tax purposes to include commonly used interest substitutes such as discounts and premiums. However, even terms such as these have a recognized legal meaning, and, like the notion of interest itself, characterization as discount or premium may be avoided. Consequently, it is suggested that the definition of interest include a general formula to more effectively cope with the flexibility available to taxpayers in the way they structure their financial transactions. For example, interest could be defined to include “any other amount that is functionally equivalent to interest.”[80]

C. Royalties

The definition of “royalties” for tax purposes is complicated by the fact that the term has diverse meanings across jurisdictions, and, even within a jurisdiction, may be applied to fundamentally different types of payments. One meaning is a payment for the use of a person’s intellectual property. Thus, an author may be paid royalties for the right to print and sell books containing the author’s copyrighted material, a musician may be paid royalties for the right to produce and sell tapes or compact discs containing the musician’s work, or an inventor may be paid royalties for the right to produce and sell the inventor’s patented system. Royalties may also be payable for the right to sell products bearing a trademark or copyrighted identification marks, or for the right to use know-how. In each of these cases, royalty payments are normally based on output (so much for each unit sold or produced).[81]

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[79] *E.g.,* UGA ITA § 3 (definitions of interest and debt obligations).

[80] *E.g.,* UGA ITA § 3 (definition of interest).

[81] *See generally* Murray v. ICI Imperial Chemical Industries Ltd. [1967] 2 All E.R. 980, at 982–83.

A related type of royalty is a payment for the sale of intellectual property. Rather than licensing a publisher to print a book with an author's work, the author may sell the copyright to a publisher, with the proceeds from the sale being paid as royalties based on sales. In essence, the copyright is sold for an unknown price, to be determined and paid as the books are sold. This sort of royalty is fundamentally different from the first one in that it is consideration for a sale, not payment for the use of the recipient's property. However, despite the legal difference, there may not be much of an economic difference in some cases. For example, the sale may cover only a limited geographic area or a limited period of time and may therefore have essentially the same effect as a license covering this area and period of time.

A third type of royalty is paid for the exploitation of natural resources connected with land, most commonly mineral resources (including petroleum), gravel, or timber. Calculation of the amount of royalties payable is normally based on the quantity or value of the resources taken, for which these royalties are effectively a purchase price.

Because royalties encompass so many different types of payments, the characterization of amounts as royalties for tax purposes varies from jurisdiction to jurisdiction. In particular, not all countries classify royalties as a category of income in its own right. Some countries classify some kinds of royalties as rental income[82] or, for royalties received by individuals for intellectual property created by personal exertion, as income from independent labor.[83] Other countries classify royalties as investment income subject to the same basic rules as interest income.[84]

The definition of royalties for tax purposes may also be influenced by international practice. There is a definition of royalties in article 12 of the OECD Model Treaty, which applies to transactions between the Contracting States. This definition has been included in the domestic tax law of many countries either generally or in relation to the taxation of nonresidents.[85] The article 12 definition includes payments for the use of, or right to use, intellectual property rights or know-how. It also includes payments for the provision of technical assistance ancillary to the use of intellectual property rights or know-how.[86] The definition does not include natural resource royalties. This is because such royalties are treated as income from immovable property under the OECD Model Treaty and, therefore, are dealt with under article 6 rather than under article 12. This reflects a distinction between royalties related to property that has its origin

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[82]AUT EStG § 28 (1)3; DEU EStG § 21(1).

[83]NLD WIB § 22/1 (b).

[84]BEL CIR § 17 par.1/4.

[85]*See generally infra* ch. 18, sec. IV(E).

[86]Prior to 1992, the definition of royalty in the OECD Model Treaty also included amounts received for the use of, or right to use, any industrial, commercial, or scientific equipment (i.e., amounts received under a lease of movable property). The OECD Model Treaty was amended in 1992 to exclude such amounts from the definition of royalties with the intention of bringing them within the business profits article. Notwithstanding this, the definition of royalties in the domestic tax law of some countries still includes such amounts. *See, e.g.,* AUS ITAA (1936) § 6; KEN ITA § 2; LSO ITA § 3; UGA ITA § 3; ZMB ITA § 2.

outside the jurisdiction (such as technology rights), for which there may be limited source-country taxing rights, and royalties related to immovable property located in the jurisdiction (such as the taking of natural resources), for which there are full source-country taxing rights. If natural resource royalties are excluded from the domestic law definition of royalties, they may be included in the definition of rent (which is not usually subject to nonresident withholding tax) or treated as a separate category of income.

A definition of royalty based on the use of, or right to use, certain rights can be avoided by structuring the transaction as a disposal of the right. For this reason, some countries also define royalties to include the gain arising on the disposal of rights or property covered by the royalty definition.[87]

D. Rent

Under ordinary principles, rent is an amount received as consideration for the use or occupation of, or right to use or occupy, immovable property or tangible movable property. As indicated above, the scope of the definition of rent for the purposes of the income tax may depend on the definition of royalties. If rent from the lease of movable property is included as a royalty, then the definition of rent may be confined to consideration for the lease of immovable property. Similarly, for the reasons given above, natural resource royalties may be treated as rent rather than as royalties.

As with transactions involving the payment of interest, it may be possible to structure a leasing transaction so as to convert rent into other forms, such as premiums on leased premises. Thus, a definition of rent for income tax purposes should include commonly used rent substitutes, such as premiums.[88]

IV. Issues of Tax Accounting

A. The Tax Period

1. Annual Measurement of Taxable Income

Given that the income tax is imposed on an annual basis, it is necessary to specify the income tax year. The tax year will normally be specified as the calendar year, or as a fiscal year set to complement the government's fiscal year. In the discussion below, this is referred to as the "normal tax year."

In many jurisdictions, taxpayers may be permitted to substitute a different 12-month period as their tax year.[89] However, allowing taxpayers to choose a tax year that differs from that

[87]JPN Corp TL § 138(7); KEN ITA § 2; UGA ITA § 3. *See further infra* ch. 18, sec. IV(E).

[88]*E.g.,* UGA ITA § 2 (definition of rent).

[89]*E.g.,* AUS ITAA (1936) § 18; EST IT § 6; IDN LCIT § 12; LSO ITA § 49; UGA ITA § 40.

of other taxpayers may result in some revenue loss if taxpayers are able to exploit the inconsistency.[90] It is suggested, therefore, that a taxpayer should be allowed to use a substitute tax year only with the permission of the tax administration, and, for this purpose, a procedure for applying for permission should be provided in the law or regulations. Permission should be granted only when the taxpayer demonstrates a legitimate need to use a substitute tax year.[91] To ensure that there is no loss or unacceptable deferral of tax resulting from the move to or from a substitute tax year, the tax administration should be allowed to prescribe conditions for the use of the substitute tax year. The right to apply for permission to use a substitute tax year may be restricted to corporate taxpayers or may extend to other business taxpayers (although cases where a sole trader can demonstrate a need to use a substitute tax year are likely to be rare).

A taxpayer using a substitute tax year may wish to cease to do so or to change to another substitute period (perhaps as a result of takeover). A procedure for making such changes may be provided, and, ordinarily, the rules outlined above should also apply to such applications.

Special rules are needed for "transitional" years when a taxpayer changes its tax year. The transitional period should be specified as the period commencing at the end of the taxpayer's last complete tax year to the beginning of the changed tax year. This ensures that the different years mesh with the rest of the legislation and prevents transitional problems, such as an extended tax year (greater than 12 months) when a taxpayer changes from one tax period to another.

The tax law is typically enacted (and amended) for application to the normal tax year. For example, changes to the income tax law may be stated to apply to the calculation of tax liability for a particular year and all subsequent years. Where taxpayers may use a substitute or transitional tax year, it is necessary to specify the law that is to apply to that tax year. For example, it may be provided that the law applicable to a normal tax year applies also to a substitute or transitional tax year that commences during the normal tax period.

2. Loss Carryovers

The annual measurement of income from economic activity that extends over a number of years is likely to lead to fluctuating measurements over the years, and this, combined with fluctuations in economic performance, may result in tax years in which allowable deductions exceed gross income (i.e., a taxpayer suffers a net loss for the year).

The tax law may provide for a net loss to be carried forward and allowed as a deduction in a subsequent tax year or carried back and allowed as an additional deduction in a previous tax year. The carryback of a net loss requires reopening the taxpayer's assessment for the prior tax year. From a theoretical perspective, taxpayers may be allowed virtually unlimited carryback and

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[90]An example is the use by a partnership of a substitute tax year to defer tax. *See infra* ch. 21, sec. II(B)(4). Another example involves taxpayer *A* paying at the end of its tax year a deductible expense to taxpayer *B*. If *B* is on a different tax year, *B* may not be taxed on the payment until later.

[91]For example, a case for using a substitute tax year may be established by a corporate taxpayer where the taxpayer belongs to a group of taxpayers (including foreign entities) with a group balance date for business accounting purposes that differs from the normal tax year.

carryover of net losses for recognition in years other than the years in which they are suffered,[92] but this theoretical case is tempered by two practical considerations.

First, there are significant divergences between the actual tax system adopted in any jurisdiction and the theoretical ideal. So long as it is impossible to guarantee the integrity of a comprehensive income tax base, safeguards against "bottomless holes" must be adopted; limitations on loss carryback or carryover are important elements in the safeguard armory.[93]

Second, unlimited carryback or carryover of net losses is possible only with sophisticated administrative resources, resources much greater than those available to taxpayers and administrators in most jurisdictions. For this reason, it is suggested that only loss carryovers be allowed. There may be some advantage in setting the loss-carryover period to coincide with the period in which the tax administration can amend an assessment (this period will also usually coincide with the period for which a taxpayer is required to keep records), but a longer period may also be specified. In countries where loss carryover is limited, examples of periods allowed are 5,[94] 7,[95] 8,[96] and 20[97] years.

Under a schedular income tax, carryover of losses will be provided for by reference to classes of income separately dealt with in the schedules. Even under a global income tax, carryover of losses may be to some extent schedularized.[98] Further, the carryover of losses by

[92]*See generally* Dale Chua, *Loss Carryforward and Loss Carryback*, *in* Tax Policy Handbook 141 (P. Shome ed. 1995). Examples of unlimited loss-carryforward rules are AUS ITAA (1997) § 36-15; GBR ICTA § 393 (there is also a three-year loss-carryback rule in ICTA § 393A); NZL ITA § 188; ZAF ITA § 20; SGP ITA § 37; ZMB ITA § 30. Other countries with unlimited carryovers include Belgium, Germany, Ireland, Luxembourg, and Sweden. *See* Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 242 (1992).

[93]For example, a large backlog of loss carryovers, which resulted from a combination of factors, such as inadequate definition of inflation adjustment and abuse of tax holiday provisions, threatened to undermine the corporate income tax in Argentina in the late 1980s and early 1990s. *See* vol. 1, at 464–65.

[94]*See, e.g.*, EST IT § 21; FRA CGI §§ 156(I) and 209(I); HUN CTDT § 17(1); IDN LCIT § 6 (the Minister of Finance may decree that an eight-year period applies to specific types of businesses). Five-year periods are also allowed in Denmark, Greece, Italy, Japan, Portugal, and Spain. *See* Commission of the European Communities, *supra* note 92, at 242.

[95]*See* CAN ITA § 111 (a three-year carryback rule also applies); CHE LIFD § 67(I); Commission of the European Communities, *supra* note 92, at 242.

[96]*See* IND ITA § 72.

[97]*See* USA IRC § 172.

[98]*See infra* sec. IV(B)(5) (foreign currency losses); VI(B) (capital losses); USA IRC § 469 (passive activity losses).

companies (and other entities as appropriate) whose ownership changes may be restricted to prevent trafficking in "loss" entities.[99]

B. General Timing Issues in the Recognition of Income and Deductions

1. Method of Accounting

The use of a tax year to measure, on a year-by-year basis, income from economic activity that extends over more than one tax year requires rules to allocate income and expenses to particular tax years. Under both the balance-sheet method and the receipts-and- outgoings method, the allocation of income and expenses is made by reference to cash- or accrual-basis accounting systems. Both systems measure income when it is derived and recognize expenses when they are incurred, but the time at which a taxpayer is considered to have derived an amount or incurred an expense can differ significantly under the two systems.

Under the cash-basis system, income is derived when it is actually received by, or made available to, or applied to the benefit of, the taxpayer, and expenses are incurred when they are paid. Under the accrual-basis system, income is derived when the right to receive the income arises, and expenses are incurred when the obligation to pay arises.

Practices for determining the appropriate method of tax accounting to be applied by a taxpayer vary. In some countries, the law leaves the matter to be determined according to financial accounting principles[100] or by the courts.[101] In other countries, the tax law may, within limits, give taxpayers a choice in the method of accounting to be applied.[102] Whatever practice is adopted, salary and wage earners would normally account for income and deductions on a cash basis, and legal persons conducting businesses account for income and deductions on an accrual basis. Individuals conducting business typically enjoy some flexibility. In particular, it may be appropriate and simpler for smaller businesses to use cash-basis accounting. However, if small businesses are allowed to use cash-basis accounting, the threshold between cash-basis and accrual-basis taxpayers must be set out.[103]

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[99]*See infra* ch. 20.

[100] *See infra* appendix (France, Germany).

[101]In Australia, the courts have made it clear that a taxpayer's method of accounting is to be determined according to legal principles and not according to generally accepted accounting principles. Nonetheless, the courts have developed legal principles that, in most cases, bear a close relationship to accounting principles.

[102]*E.g.,* EST IT § 37 (an individual may use either the cash or the accrual basis of accounting for business income, but other taxpayers must use the accrual method); LSO ITA § 50 (a taxpayer may account on a cash or an accrual basis except when gross income for a tax year exceeds a monetary threshold, in which case the taxpayer must account for business income on an accrual basis in all subsequent years); UGA ITA § 41 (a taxpayer may account on a cash or an accrual basis, provided that the tax method chosen conforms to generally accepted accounting principles and subject to the tax commissioner's power to prescribe otherwise in particular cases).

[103]*E.g.,* LSO ITA § 50. *See supra* note 102.

When taxpayers are allowed a choice of accounting method, they may change their basis of accounting, particularly if a threshold is set above which accrual-basis accounting must be applied. Changes in accounting methods can also arise from changes in the law, which may require all taxpayers to change the way they treat particular types of transactions.[104] When a taxpayer changes its method of accounting, transitional measures are needed to prevent lacunae or overlaps. A lacuna can arise, for example, when a taxpayer changes from a cash to an accrual basis because amounts billed but not received in the tax year prior to the change may escape taxation. This is because no amount has been received in the tax year in which the cash method applied, and no entitlement to receive has accrued in the tax year to which the accrual method applies.

It is suggested that transitional rules relating to a change in accounting method be drafted in broad terms because it may not be possible to anticipate every area needing such rules. In particular, the rules should not be confined to income and deductions because issues may arise in relation to tax offsets or other aspects of the income tax. A broad rule should permit adjustments to be made to the income, deductions, offsets, or other items as necessary to ensure that no item is omitted or taken into account more than once. It is also necessary to specify the tax year in which the adjustment is to be made. Ordinarily, this would be the first tax year under the changed method.[105] To properly monitor a change in tax accounting method, it may be provided that the change can be made only with the permission of the tax commissioner.

To minimize problems of administration, it may be decided to stipulate that once a taxpayer has been required to use the accrual method, the taxpayer must continue to use that method even if his or her gross income is less than the applicable threshold in a subsequent year. Some jurisdictions allow taxpayers to change back and forth between systems provided their income rises above or falls below the threshold for a number of consecutive years.[106]

The timing of recognition of income and expenses is crucial to the calculation of taxable income under both the receipts-and-outgoings system and the balance-sheet system. Under both systems, the choice between cash-basis accounting and accrual-basis accounting will have a significant effect on the measurement of taxable income. So, too, will the rules that govern exactly when receipts and expenses are recognized under cash- and accrual-basis accounting.

In Anglo-American jurisdictions, the financial accounting rules are typically established by generally accepted accounting principles devised by the accounting profession through self-

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[104]For example, suppose the law is changed to require capitalization of certain costs of producing inventory that could be deducted under prior law as current expenses. An effect of this rule would be to increase the value of opening inventory for the tax year in which the changed method is first applied. This would lead to a gap because the opening inventory would exceed the prior year's closing inventory (valued under the old method).

[105]*But see* USA IRC § 481 (three-year spread).

[106]For example, Hungary requires taxpayers who are above the threshold for two consecutive years to change from cash-basis accounting to accrual-basis accounting and allows, at the taxpayer's option, unincorporated taxpayers to switch from accrual-basis accounting to cash-basis accounting if their taxable incomes fall below the threshold for two years. *See* Act XVIII of 1991, Accounting Act § 13.

governing autonomous professional bodies. In civil law jurisdictions, the rules may be established by an accounting act or by the commercial code, supplemented by generally followed accounting practices or by regulations. In both cases, it may be necessary or appropriate for the income tax law to specifically address particular types of transactions whose accounting treatment may be vulnerable to manipulation intended to distort the measurement of taxable income (usually by accelerating recognition of deductions or deferring recognition of income). It may, therefore, be desirable both to reinforce fundamental tax accounting rules with clarifying statements of principle and to adopt more detailed tax accounting rules for particular types of transactions. The extent to which specific rules need to be articulated for tax purposes, therefore, will differ from case to case and will depend on the clarity and specificity of the financial accounting rules. This qualification applies to much of the discussion below. Thus, while it is suggested that a number of rules be specified for tax purposes, in many jurisdictions it may not be necessary to provide an explicit tax rule because the matter is already taken care of appropriately by the accounting rules.

Specific tax accounting issues that may be addressed in the income tax statute are reviewed below.

2. Currency Translation Rules

A taxpayer's income, deductions, and offsets[107] must be measured in the national currency. With the greater integration of the world's economies, it is increasingly likely that a taxpayer will derive income or incur expenses in a foreign currency. The income tax law should therefore include rules for translating amounts denominated in a foreign currency into the national currency.

The basic rule should provide for currency translation on a transaction-by-transaction basis. Under such a rule, each receipt of income denominated in a foreign currency should be translated into the national currency at the time the income is derived. Similarly, each deductible expenditure denominated in a foreign currency should be translated into the national currency at the time the expenditure is incurred. The basic rule should be broadly stated so that it can apply to other amounts taken into account for tax purposes. For example, the translation rule should apply to foreign tax when a foreign tax credit applies.

If multiple exchange rates apply at the time the foreign currency is to be translated into the national currency, it is necessary to specify which rate is to apply. For example, when a buying and selling rate is specified for the relevant day (as is usually the case), it could be provided that the exchange rate midway between the two for that day is to apply.[108] In other cases, there may an official exchange rate and a market rate, in which case a discretion may be provided to the administration to require the taxpayer to use the exchange rate that most accurately reflects the taxpayer's income.

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[107]For an explanation of tax offsets *see* ch. 14, sec. XI.

[108]*E.g.*, UGA ITA § 58.

A requirement to translate amounts denominated in a foreign currency on a transaction basis may be too onerous for a taxpayer who enters into multiple transactions in a foreign currency. For example, a taxpayer may have a foreign branch that engages in many transactions daily in the foreign country in which the branch is located. The branch's financial accounts are most likely to be maintained in the currency of that jurisdiction, and the tax law may allow the taxpayer to keeps its tax accounts in that currency as well. In this case, the taxpayer will be permitted to calculate the taxable income of the branch in the foreign currency (referred to as the "functional currency" of the branch). The taxable income of the branch will be translated into the national currency at a specific exchange rate. Ordinarily, the rate specified would be the average exchange rate for the tax year. It may be desirable to permit tax authorities to substitute alternative translation formulas in special circumstances, such as when dealings are in a particularly volatile currency.[109] Alternative formulas may include the use of weighted averages (taking into account when most transactions take place) or even requiring translation by reference to shorter averaging periods, such as a month, a week, or even a day. Because the functional currency is the currency of the country in which the branch is located, when the foreign branch derives amounts denominated in a currency other than that currency, the ordinary transaction-based rules should apply to translate that other currency into the functional currency.

The currency translation rules apply only for the purpose of reporting in national currency any foreign currency amounts derived, incurred, or otherwise taken into account for tax purposes. Foreign currency transactions themselves may generate gains or losses for a taxpayer. These are discussed in section IV(B)(5), below.

3. Claim of Right

Taxpayers often receive or pay amounts that are disputed or potentially subject to dispute because, for example, the amount is received by mistake, is erroneously computed, or is the subject of a controversy about, say, performance or quality. The question is when these amounts should be recognized as income or deductions.

In the broadest sense, all amounts received and payments made are contingent in that they may later be subject to dispute. The income tax would not be workable if there were no recognition of receipts and expenses until the payments were settled (in some cases, this could involve waiting until the expiration of lengthy statutory limitation periods). To solve the problem, it is usual to require taxpayers to recognize amounts for which they make an initial claim of right and expenses that they are initially obligated to satisfy. This rule eliminates arguments by taxpayers that the recognition of an amount for tax purposes is unclear because its legal status is uncertain.

A claim-of-right rule may arise under general principles[110] or through specific legislative provision.[111] Under a claim-of-right rule, the normal tax accounting rules as to when income is

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[109]*See* vol. 1 at 460–62.

[110]This is the case in the United States. *See* North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932).

[111]*E.g.,* UGA ITA § 45(1).

derived or expenditures are incurred[112] apply to an amount even if there is a dispute or potential dispute as to entitlement or obligation.

When a claim-of-right rule applies, an issue arises as to the treatment of repayments made or received should it ultimately be found that the taxpayer is not entitled to receive, or obliged to pay, the amount. Two broad approaches may be identified for dealing with such cases. First, the assessment for the tax year in which the income or expenditure is recognized can be reopened and adjusted, so that the original inclusion or deduction and the repayment are treated as a single transaction; or, second, the adjustment can be made in the tax year in which the claim of right or obligation to pay is withdrawn.

While the first approach may be theoretically correct and is used in some industrial countries, it may not be administratively feasible for developing and transition countries to adopt such a rule . Consequently, the second approach is considered preferable.[113] Again, the basis of the timing of the adjustment will depend on the tax accounting rules applicable to the taxpayer. In the case of a cash-basis taxpayer, an adjustment is made to eliminate income and expenses when payments are refunded to the appropriate party. In the case of an accrual-basis taxpayer, the adjustment is made when the claim of right is given up. It will be necessary to coordinate the claim-of-right rules applicable to deducted expenditure with the general rules on recoupment of deductions.[114]

4. Price Uncertainty

It is not uncommon in commercial transactions for the determination of the price to be subject to some contingency. In this case, the uncertainty relates not to the existence of a right to receive or obligation to pay, but to the amount that is ultimately receivable or payable.[115] Contingent prices may be based on either "positive" contingency conditions or "negative" ones.

Positive contingency conditions usually establish a fixed base price and a further payment obligation in line with criteria such as productivity and profitability. For example, mining rights may be sold for a lump sum or installment payments plus an amount for each ton in excess of a floor amount mined. Similarly, a business may be sold for a lump sum or installment payments plus a percentage of profits for a given period following the sale.

A negative contingent price establishes a fixed base price that is subject to downward variation if a condition is not met. For example, mining rights may be sold for a lump sum or a

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[112]*See supra* sec. IV(B)(1).

[113]This approach was adopted by the courts in the United States (U.S. v. Lewis, 340 U.S. 590 (1951). In certain circumstances, under IRC § 1341, an adjustment is made to the current year based on the tax reduction that would have resulted by excluding an amount from income in the prior year.

[114]*See* ch. 14, sec. III(D)(2).

[115]*See supra* sec. IV(B)(3), and *infra* sec. IV(C)(1) and (D)(1) for the treatment of amounts due or payable that are subject to uncertainty as to legal rights or obligations.

series of installment payments that presume a certain tonnage will be available. In the event that the property produces less than the amount expected, the price will be adjusted downward by a particular amount for each ton.

A simple way of dealing with positive contingent prices is to dissect the sale price into two components—a right to receive or an obligation to pay a fixed amount (either as a lump sum or in installments) and a right to receive or an obligation to pay additional amounts contingent upon the occurrence of a specific event—and to recognize the two elements separately. The fixed amounts are recognized according to normal tax accounting rules (including those relating to installments, if relevant). The later contingent amounts are treated as though they attach to contingent rights or obligations that crystallize when the condition precedent to further payments is satisfied.

Negative contingency obligations are treated similarly in respect of the initial fixed payment or payments, but offsetting deductions or adjustments are made available when it becomes clear that the original payment was not correct.

While the approach suggested above for ignoring contingencies until the time they are resolved may result in some use of contingent terms to defer accrual of income, it is suggested that, from an administrative point of view, this is the most appropriate way for most developing and transition countries to deal with contingent amounts.

5. Foreign Currency Exchange Gains and Losses

While the translation of foreign-currency-denominated amounts is dealt with above, this section deals with gains and losses on foreign currency exchange transactions (and similar transactions described below). The primary issue in relation to such gains and losses is timing; although, for those income tax systems derivative of U.K. principles there may also be characterization issues (i.e., whether the gain or loss is recognized under general principles or whether specific statutory recognition rules are needed).

The simplest type of foreign currency gain or loss is that realized in respect of foreign currency holdings. A taxpayer may have foreign currency holdings as a consequence of engaging in international transactions. For example, a taxpayer may receive foreign currency as payment for services rendered or goods supplied or may acquire foreign currency to meet a business expenditure.[116] Alternatively, a taxpayer may keep foreign currency holdings as a hedge against inflation or as an investment. In each case, the foreign currency is an asset of the taxpayer so that a gain or a loss will accrue as the value of the foreign currency fluctuates relative to the local currency during the period in which the foreign currency is held.

From the perspective of a comprehensive income tax base, the ideal tax treatment of foreign currency holdings is an annual valuation and recognition of gains and losses on an

[116]While the foreign currency translation rules discussed in section IV(B)(2), above, apply in determining the amount in national currency of the income derived or the expenditure incurred in these cases, the taxpayer may actually hold the foreign currency for longer than the exchange day.

accrual basis. Many industrial countries are moving toward recognizing gains and losses related to financial instruments through an annual valuation commonly known as "mark to market."[117] If accrual-basis taxation is adopted for financial instruments, it may be important to recognize foreign exchange gains and losses on both the asset and the debt side on an accrual-basis as well, so as to avoid serious distortions in the treatment of financial instruments generally. This is particularly important in highly inflationary economies.[118] However, unless the remainder of the income tax system measures gains consistently on an annual accrual basis, accrual-basis taxation of foreign currency holding gains and losses may be out of step with the remainder of the income tax system and may impose a considerable administrative burden on revenue authorities with limited experience in relatively sophisticated accrual measurement systems.

For these reasons, foreign currency holding gains and losses are often taken into account on a realization basis. Provided that foreign currency is treated as an asset, all dealings in foreign currencies (acquisitions, disposals, and conversions into other foreign currencies) can be dealt with by the provisions for recognizing income and losses that apply to ordinary property transactions.

A second source of foreign currency gains and losses arises from foreign currency loans and debt claims. Under a realization-based system, no special rules are needed for interest payments or interest receipts. If these are made in foreign currency, they are translated into local currency under the general translation rules. With respect to repayment of principal, provision should be made for lenders and borrowers to recognize as a gain or a loss (as appropriate) the difference between the value in local currency of a loan principal at the time the loan is made and its value in local currency at the time it is repaid. Once again, however, if accrual-basis taxation is used for financial instruments, it may be more appropriate to recognize foreign exchange gains and losses on an accrual basis as well, by incorporating these changes into the annual valuation rules for obligations and debt claims denominated in foreign currency.

Special rules may be needed for rollovers or refinancing of foreign debt, which arises when a foreign debt owed by a taxpayer is rolled over or refinanced by a new loan in the same foreign currency from the same lender. In theory, there is no reason to treat this arrangement any differently from one in which a borrower repays a foreign currency loan by borrowing from a completely different borrower. However, in some jurisdictions, this type of arrangement may be treated for tax purposes as an extension of the original loan and may thus not be recognized for the purpose of measuring foreign currency gains or losses.

A third type of foreign currency gain or loss arises as a by-product of the separation of income and expense recognition and actual receipt or payment in accrual-basis accounting. Accrual-basis taxpayers will initially record the amount of income derived in a foreign currency or expenses incurred in a foreign currency by translating those values into their national currency

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[117]For example, Canada, New Zealand, and the United States have adopted accrual-basis taxation for some financial instruments, and Australia proposes to do so.

[118]*See* vol. 1, ch. 13.

at the time the income is derived or the expense incurred.[119] If there has been movement in the national currency against the foreign currency between those times and the times at which income is actually received or expenses paid, the amounts recorded in the taxpayer's accounts and the amounts actually received or paid will differ, and an adjustment must be made to "correct" the original amount recorded.

There are, in theory, three ways this can be done. First, the taxpayer's accounts can be reopened and recalculated, with the actual income received or expenses paid (as translated to the national currency) substituted for the amount originally recorded by the accrual-basis taxpayer. However, in many cases this correction requires reopening a previous year's accounts. As has been explained earlier, it is very rare for tax systems to adopt procedures involving reopening accounts of previous years because of the administrative burden this imposes on both taxpayers and tax officials.

A second solution is to correct the taxpayer's accounts by attributing the difference between the income or expense originally recorded and the amount actually received or paid to the specific account to which the amount relates. Thus, if an income amount turns out to be more or less than originally recorded, it is corrected by adding an amount to income or subtracting (as an allowable deduction) an amount, depending on which way the currency moved. Similarly, if an ordinary deduction turns out to be more or less than originally recorded, the correction takes the form of an addition to income or an additional deduction, as the case may be. If the amount refers to the acquisition of property—either inventory, depreciable property, or nondepreciable property—the correction is made to the relevant property account. That is, if the expenditure is on inventory, an adjustment is made to the closing value of inventory in the year in which the expense is paid and the currency difference crystallized. Similarly, if the expenditure is on depreciable property, the tax value of the asset is adjusted in that year, and if the expenditure is on non-depreciable property, the cost base is adjusted in that year.

The second solution is the preferable option from a theoretical perspective, because it achieves the correct timing recognition of currency rate differences attributable to the purchase of property. Because the difference is attributed to the actual property acquired, it will be recognized in line with the recognition of the expense generally—for example, if the expense is for depreciable property, the cost of the property is adjusted and correctly recognized over the life of the property. Similarly, if the expense is for nondepreciable property, the corrected cost is recognized when there is a disposal of the property.

Whatever its theoretical merits, the second solution is not commonly used, probably because of the administrative costs it involves. The third solution, adopted in most jurisdictions, is by far the simplest from an administrative perspective. Under the third approach, when a foreign currency difference crystallizes because previously recorded foreign currency income is received or a previously recorded foreign currency expense is paid, the difference is simply recognized as a foreign currency gain or loss without any attempt to change underlying accounts by attributing the amount to the underlying transaction.

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[119] *See supra* sec. IV(B)(2).

A realization system of recognizing foreign currency gains and losses should be accompanied by a quarantining system. This can be accomplished by treating foreign currency gains and losses as capital gains and losses, so that foreign currency losses are subject to the same limitation as capital losses.[120] Such a quarantining system is necessary to prevent taxpayers from entering into "wash" transactions intended to generate paper foreign exchange losses without any real change in the taxpayer's economic position. Without a quarantining system, if the local currency falls in value against a foreign currency in which a taxpayer has borrowed, the taxpayer with the foreign debt can trigger a recognition of a paper loss simply by refinancing the loan. By borrowing an additional amount in the foreign currency sufficient to repay the loan principal, the taxpayer is able to extinguish the original debt and claim a deduction for the difference between the value of the principal in local currency when the loan is made and the value at the time the loan is "repaid."

Quarantining rules will not be needed if foreign exchange gains and losses are taken into account on an accrual basis. In this event, depending on the rules for interest income and expense and any inflation-adjustment rules, it may be appropriate to provide that foreign exchange gains and losses are treated as interest income and expenses, respectively. The rationale for this is that the exchange difference plus the actual interest paid on a foreign currency debt will be roughly equivalent (on an ex ante basis) to interest paid in domestic currency on a domestic currency debt. If foreign currency losses are not treated as interest expenses, then transactions can easily be structured to circumvent limitations on the deductibility of interest expense.

6. Bad Debts

For tax purposes, debts fall into two broad categories. The first comprises amounts recognized by an accrual-basis taxpayer as income on an account yet to be satisfied.[121] The second consists of amounts due on a loan provided by the taxpayer. Both types of debts represent a liability to the debtor and an asset to the creditor. In the ordinary course of events, if the debt proves unrecoverable, the creditor should be able to recognize a deduction or loss when the debt or loan is written off as unrecoverable. However, it is usual for special rules to be adopted to deal with both types of debt.

In some jurisdictions, losses on assets such as debts owing to the taxpayer will not be addressed by the general rules for measuring business income. In other jurisdictions, the loss may otherwise be recognized, but a specific rule is adopted to control the timing of loss recognition or to impose conditions on the recognition. The primary purpose of the special rule applying to loans that subsequently become uncollectible is to control the timing of the loss recognition. In some jurisdictions, only taxpayers in the business of money lending are allowed to recognize bad debts related to loans.[122]

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[120]*See infra* sec. VI(B).

[121]A cash-basis taxpayer who has provided a customer with goods or services may find it impossible to collect payment. Usually, tax systems provide no special rules for debts in this situation, although the taxpayer may be able to recognize the loss under general provisions or, in some cases, under capital gain and loss rules.

[122]*E.g.,* AUS ITAA (1997) § 25-35; CAN ITA § 20(1)(p) (moneylenders and insurers); IND ITA § 36(1)(a), (2) .

There are two approaches to the calculation of bad debt deductions: the charge-off method and the reserve method.[123] Under the charge-off method, taxpayers are able to recognize bad debts only on previously recognized income amounts or on nonrecoverable loans when the debt owing to the taxpayer is determined to be worthless. The reserve method, by way of contrast, allows a taxpayer to partially recognize debts when they become doubtful and before they are fully written off for financial purposes. In other words, under the reserve method, taxpayers will be allowed a bad debt deduction for an outstanding loan before the debt is formally treated as nonrecoverable.

It is suggested that the charge-off method should be used by all taxpayers other than financial institutions to recognize losses on loans. The difficulty in applying the reserve method is that it requires an accurate estimation of debts that are most likely to prove worthless. Because of the nature of their business and the standards imposed by external regulatory bodies requiring continuous monitoring and maintenance of accurate information on outstanding loans owed to them, financial institutions should be able to determine with a reasonable degree of accuracy the percentage of loan debts owed to them in the tax year that will ultimately prove bad. Further, the determination of the bad debt reserve can be based on the classification of the institution's loans made according to the rules of the central bank or other regulatory agency. It should be possible to ensure, therefore, that the bad debt reserve claimed by the financial institution accurately reflects potential bad debts. For other taxpayers, under the reserve method, the bad debt reserve is likely to be an arbitrary percentage of outstanding debts at the end of the tax year.[124] For many taxpayers, such a rule simply results in an unwarranted deferral of recognition of a portion of the taxpayer's income to the following tax year.

The key issue in applying the charge-off method for recognizing a deduction for a bad debt is when a debt has become worthless (as discussed below, this is also relevant for the reserve method). Determining whether a debt is bad usually involves considering all the circumstances, including continual nonperformance, adequacy of security, and the financial state of the debtor. To prevent abuse, the law could provide that a taxpayer must have reasonably pursued without success certain avenues for recovery before the debt is written off for income tax purposes.

Where a bad debt deduction has been allowed under the charge-off method and the taxpayer subsequently recovers or part of the debt, the amount recovered should be reincluded in gross income. Reinclusion in gross income may be pursuant to a specific rule to that effect or a rule applicable to the recoupment of deductions generally.

The reserve method contrasts with the charge-off method in that it allows recognition of some losses on debts before they are written off as nonrecoverable. Under this method, a reserve

[123]*See generally* Julio Escolano, *Loan Loss Provisioning, in* Tax Policy Handbook 145 (P. Shome ed. 1995).

[124]In countries that use the reserve method, the law may stipulate that the bad debt reserve is such amount as the administration considers reasonable given the taxpayer's circumstances. With such a rule, though, the practice often develops that the administration allows all taxpayers to claim an arbitrary amount as the bad debt reserve. Taxpayers who want to claim a reserve in excess of that amount then have to make a case to the tax commissioner.

is established as an allowance against the eventuality that some outstanding (nonperforming) loans may prove to be uncollectible. The bad debt deduction in the reserve method thus includes recognition of doubtful debts that have not turned Abad in the sense of being written off. The method uses a formula that takes into account debts that are sufficiently doubtful at the end of a year to be recognized for commercial financial accounting purposes under relevant financial institution rules, doubtful debts that are finally recognized as nonrecoverable and written off during the year, and recoveries of debts previously written off.

Under a normal reserve method, regardless of how the actual reserve is calculated, the tax deduction for bad debts is computed as follows

(i) Closing reserve (amount of doubtful debts at end of year), less

(ii) opening reserve (amount of doubtful debts at end of prior year), plus

(iii) debts written off during the tax year, less

(iv) recoveries of previously written off debts, equals

(v) bad debt deduction for the tax year.

The closing reserve for one year becomes the opening reserve for the following year. Determining the tax deduction for loan losses based on a reserve method may appear, at first, to provide a double deduction for loan losses. Each loss, however, is deducted for tax purposes only once. There is no double deduction because, once loans are written off, there is no end-of-year reserve with respect to those loans. The end-of-year reserve relates only to loans outstanding on the books at the end of the year. When a previously written-off amount is subsequently recovered, the deduction otherwise allowed must be reduced by the recovered amount. Thus, the previous deduction is reversed.

For example, suppose a taxpayer has at the end of its first year of doing business $1,000 of doubtful debts. No debts have been written off during this year. The taxpayer's bad debt deduction for the year would be calculated as follows:

Closing reserve = $1,000
Opening reserve = 0
Bad debt deduction = $1,000

Further debts that become doubtful during year 2 will be taken into account in determining the amount of the reserve, as will debts that were recognized as doubtful in year 1 and actually written off as nonrecoverable in year 2 and formerly doubtful debts that subsequently proved recoverable. If the taxpayer had another $1,000 of debts that became doubtful in the second year and wrote off half of the previous year's doubtful debts ($500) while collecting one-fourth of the previous year's debts that had been classified as doubtful, the second-year reserve deduction would be calculated as follows:

(i) closing reserve ($1,250), less

(ii) reserve at the beginning of the tax year ($1,000), plus

(iii) debts written off during the tax year ($500), equals

(iv) bad debt deduction for the tax year ($750).

The closing reserve for year 2 is the amount of doubtful debts remaining at the end of the tax year. This would comprise $250 from the previous tax year ($500 of the previous year's doubtful debts are no longer doubtful, because they have been written off, and $250 are no longer doubtful because they were subsequently collected) plus $1,000 arising in year 2).

Some of the previous year's reserve amount representing doubtful debts ($500 worth) has actually been written off. The reserve is reduced by that amount, and the same amount is included directly in the bad debt deduction by adding it to the formula for deduction of bad debts.

Where a previously written-off amount is subsequently recovered, the deduction otherwise allowed must be reduced by the recovered amount. Thus, if we assume in year 3 that the taxpayer encounters another $1,000 of doubtful debts as of the end of the year, writes off no further debts, and recovers $200 of a previously written-off debt, the taxpayer's doubtful debt deduction for year 3 would be

(i) closing reserve (amount of doubtful debts remaining, $2,250), less

(ii) reserve at the beginning of the tax year ($1,500), plus

(iii) debts written off during the tax year (0), less

(iv) recoveries of previously written-off debts ($200), equals

(v) bad debt deduction for the tax year ($550).

Note the closing reserve for year 3 (and thus the opening reserve for year 4) takes into account doubtful debts, but is not affected by recoveries, while it was affected by debts written off. Debts written off will no longer be included in the reserve, while recoveries have no effect on the amount of doubtful debts held by a taxpayer. All that has happened is that part of a previous deduction has been reversed.

C. Timing Issues in the Recognition of Income

1. Income Subject to Potential Claims or Charges

Financial accounting attempts to measure the income of a continuing business over an extended period. Tax accounting, by contrast, measures *annual* net gains to determine a net amount that should bear a tax liability. The different objectives of the two accounting systems explain why they often diverge significantly with respect to their treatment of income when there is some doubt about the taxpayer's right to retain the income or when the receipt of income is tied to possible future outgoings.

Cases for which there may be some doubt about the taxpayer's right to retain the income fall into two categories. The first is attributable to the attendant risk in business that once a service or product has been delivered, the customer may demand a refund because of dissatisfaction with the service or product. This category is addressed through the claim-of-right rule discussed in section IV(B)(3).

The second type of doubt arises in respect of income that relates to the future provision of services or goods. An example of doubt about a taxpayer's right to retain income is the receipt of an up-front payment for a service or product that will be delivered over a period of years—for example, under a contract to provide continuing lessons or a contract for a multiyear magazine subscription. Similarly, a taxpayer may accept a refundable deposit for delivery of a product or service in a future year. An example of a case where the receipt of income is tied to possible future outgoings is the sale of a product, such as a car, subject to a multiyear warranty. Financial accounting rules often treat both types of situation similarly, while it is not unusual for tax accounting rules to prescribe greatly different treatment of the two situations.

Financial accounting rules tend to spread recognition of income over the periods during which the retention right is uncertain or the possibility of related expenses remains. This is normally done through reserves. Where a business derives income in either of these situations, it will establish a notional reserve in its financial accounts to indicate that part of the income received is not available for use or distribution, but rather is being held to satisfy a possible repayment obligation or to cover anticipated future costs associated with the income. The net income reported for financial accounting purposes will not include amounts in reserves.

Tax accounting rules often distinguish between the two situations and sometimes allow taxpayers to defer recognition of income that is subject to possible repayment while denying deferral of income merely because its receipt may give rise to future expenses.

The rule allowing taxpayers to defer recognition of income that is subject to possible repayment may reside as a general tax accounting principle established by the courts or may be incorporated into the tax legislation if it is not normal for the courts in a jurisdiction to adopt tax accounting rules outside the statute. Where the rule is based on judicial doctrines, it is usually established by interpreting the term "derived" with respect to income as meaning a right to retain income without the risk of return. Thus, in the case of a prepayment for the provision of future services, a taxpayer will be treated as deriving the income not when it is received but rather on a year-by-year basis, as services are provided and customers lose their rights to refunds.[125] If the rule is established through legislation, it is important that the onus be placed on the taxpayer to demonstrate, on the basis of previous experience or statistical evidence, that there is a genuine

[125]For example, the rule is established by judicial doctrine in Australia.

risk that the taxpayer's customers will cancel the contract for future services or products and upon cancellation will be entitled to a refund of amounts previously paid.[126]

This approach is not universal. In some countries, tax authorities have interpreted tax accounting principles to require immediate recognition of prepaid amounts. This approach may be modified in particular instances.[127] However, taxpayers are usually not required to recognize refundable deposits or security deposits (such as those paid to utility companies to guarantee payment of accounts or to landlords to cover possible damage to the premises). Rather, these are treated as akin to loans or receipts over which the taxpayer has no claim of right.[128]

The focus on annual measurement explains why tax accounting rules make no similar provision for potential future expenses, such as warranty expenses connected with current derivation of income. Once again, the lack of recognition for possible future obligations can be the result of judicial doctrines or specific statutory prohibitions.[129] This approach is consistent with the concept of economic performance discussed in section IV(D)(1), below.

2. Installment Sales

Where a taxpayer sells property on an "installment" basis, payment may be made over a number of tax periods. Some jurisdictions have allowed both cash-basis and accrual-basis taxpayers to recognize income from the sale over the period of payments, under the so-called installment method.[130] Where this system is used, taxpayers recognize gain on a pro rata basis over the payment period, assuming that each payment contains an equal return of cost and each payment therefore also contains an equal percentage of the total profit realized.[131]

The installment method involves a number of serious tax policy problems. Some problems are relevant to all disposals of property, while others are relevant only to disposals that

[126]*E.g.*, CAN ITA § 20(1)(m), which requires that payment be for goods or services that it is "reasonably anticipated" will have to be delivered or rendered after the end of the year. *See also* USA IRC § 455 (deferral of prepaid subscription income).

[127]*E.g.*, in the United States, tax authorities have interpreted tax accounting rules to deny deferral of income related to goods and services to be provided in future years, but have adopted some exceptions, such as a ruling that allows taxpayers to recognize income for services over two years in some cases (Rev. Proc. 71-21, 1971-2 CB 349) and to defer recognition of payment for the sale of some types of inventory and other specified assets (Treas. Reg. § 1.451-5).

[128]*See supra* sec. IV(B)(3).

[129]*See, e.g.*, CAN ITA § 20(7).

[130]*E.g.,* USA IRC § 453.

[131]It has been observed that the U.S. rule results in a reduction of tax liability compared with a vendor who receives the whole price at the time of disposal. This is because no account is taken of the effect of time on the value of money in determining the amount of each taxable installment. *See* Marvin A. Chirelstein, Federal Income Taxation 284–85 (1994).

give rise to capital gains, particularly if capital gains are treated preferentially relative to other gains.

If capital gains are treated more preferentially than to interest income, vendors may seek to disguise all or part of the interest component of installment payments as a capital gain by raising the total price and reducing the interest charged. To combat this, special measures may be needed to "carve out" the implicit interest component of each payment so it can be taxed as interest.[132]

Even if capital gains receive no tax preference compared with interest income and appropriate interest is charged on installment payments, or if gains on the disposal of property are treated as business income, the installment basis of income recognition can lead to serious inequity and inefficiency. This is because it effectively subsidizes vendors providing vendor finance relative to vendors who sell for cash, leaving the purchasers to finance the acquisition from third-party lenders. The taxpayer selling on an installment basis (and thus providing vendor finance) can defer recognition of gain and payment of tax until payments are made, while the vendor selling for up-front consideration enjoys no tax deferral. If the tax savings from deferral are passed on in part to the purchaser (through a lower sale price or interest rate), installment sale vendors will also enjoy a market advantage compared with those unable to finance the sale of their own property.

The solution to this problem that some jurisdictions have adopted is to recognize the entire sale price at the time an installment sale contract commences.[133] This has the effect of treating the installment sale as a sale for full value to the purchaser, supplemented by a loan from the vendor to the purchaser.

3. Long-Term Contracts

It is not uncommon for businesses to enter into contracts that extend beyond the tax period and that require both performance and payment to be made over the life of the contract. These contracts are referred to as long-term contracts.

In a long-term contract, the total payment to be received by the taxpayer is often set out in the contract.[134] In a sense, the taxpayer is therefore "entitled" to receive the money upon entering into the contract, although the taxpayer is not entitled to actual payment at that time. However, unlike with an installment sale, the taxpayer has not performed all that is required under the contract. The various rationales set out earlier for up-front recognition of gain on an installment sale do not apply to long-term contract arrangements, because the arrangement is not a substitute for the up-front payment that would otherwise take place, as with an installment sale.

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[132]*E.g.* AUS ITAA (1936) § 256; CAN ITA § 16(1); USA IRC § 63(b).

[133]*E.g.,* AUS ITAA (1936) § 160ZD(1)(a); USA IRC § 453(b)(2), (e), (g), (k) (providing circumstances under which installment method does not apply).

[134]This will not always be the case. For example, a contract may be of the cost-plus type or may involve an incentive fee.

In economic terms, it may be appropriate to recognize a certain amount of income upon signing the contract based on the present value of the profit that the taxpayer is expected to make. However, this amount will often be impossible to measure.

The adoption of specific rules for long-term contracts can avoid confusion, particularly for accrual-basis taxpayers, about the recognition time for income and deductions arising under a long-term contract. Two accounting methods commonly used for long-term contracts are the percentage-of-completion method and the completed-contract method. Under the percentage-of-completion method, profit is recognized in proportion to the progress made on the contract during the relevant accounting period. In other words, the profit is recognized as it "emerges" over the life of the contract. Under the completed-contract method, profit is not recognized until the contract is substantially performed. Accounting standards now clearly favor the percentage-of-completion method as a better measure of "periodic accomplishment" over the life of the contract. From a tax perspective, the completed-contract method gives rise to an unwarranted deferral of tax.

The principal issue under the percentage-of-completion method is, not surprisingly, how to measure the percentage of the contract completed during the taxable year. A relatively administrable, although somewhat arbitrary, rule is to assume that the percentage of completion equals the percentage of total contract costs incurred during the year.[135]

Example

Contractor enters into a construction contract to be completed over three years. Under the contract, Contractor expects to incur expenses of $50,000 and to derive gross income of $1,500,000, for a taxable net profit of $1,000,000. In the first year of the contract, the contractor incurs expenses of $200,000. Contractor's expected taxable net profit is allocated to each tax year in a pro rata fashion, using the ratio of actual expenditure to expected total expenditure as the key. Thus, in this example, the recognized taxable profit in the first year would be $1,000,000 x $200,000/$500,000 = $400,000. If expenses of $200,000 were also incurred in the second year, recognized taxable profit in that year would also be $200,000.

Long-term contracts that envisage performance and payment made over a number of tax years fall into the broad categories of fixed-price and cost-plus contracts. Under the former, the total consideration for the contract is agreed on before work begins; under the latter, the customer agrees to pay the taxpayer a consideration based on costs incurred plus a profit margin.[136] The formula used to determine annual recognition of profits under the percentage-of-completion method will initially use estimates of total profit in fixed-price contracts or total profit and total costs in cost-plus contracts. As the contract proceeds, the calculation must be

[135]*E.g.,* UGA ITA § 46.

[136]A variant is the cost-plus-incentive-fee contract, where the contractor's profit margin may vary depending on the extent of cost overruns, timeliness of completion, or other factors. The various kinds of contracts are described here for information; they should not be defined as separate categories for tax purposes.

revised to reflect the changed base figures and an adjustment made for what turned out to be the incorrect amounts previously recognized. An adjustment may also need to be made where profits change because, for example, the contractor is paid an "incentive fee" for early completion.

The correction for changed expenses or profit can be done two ways. Some jurisdictions use a sophisticated "look back" method to reallocate contract profits over the years of the contract at the time it is completed.[137] While this method is useful for minimizing tax avoidance, it is probably too complicated to be advisable for most developing and transition countries. A simpler alternative is to revise the calculation and make adjustments when the change becomes known. The revision approach can lead to a loss in one year even though the total project yields a profit. The phenomenon can be illustrated using the example provided above and assuming costs in the final year run to $300,000 instead of the expected $100,000.

Example

If there were no cost overrun in the final year, the contractor's taxable income for the third year would be $1,000,000 x $100,000/$500,000 = $200,000. However, if the costs were $300,000, the total profit on the project would be only $750,000 ($1,500,000 gross payment less $750,000 total expenses). The taxpayer has already recognized $800,000 in profits in previous years. Thus, in the third year of the contract, the taxpayer would recognize a loss of $50,000.

The loss recognized in the final year can be dealt with under the normal rules for loss carryovers. One problem that may emerge for developing and transition countries is that the contract may be the taxpayer’s only income-producing activity in the country, so that there is no benefit in a loss-carryover rule. To overcome this problem, a special loss- carryback rule for long-term contracts can be formulated.[138]

The definition of a long-term contract subject to the long-term contract income-recognition rule should include any contract for the manufacture, installation, or construction of property (including a contract for the performance of services related to such manufacture, construction, or installation), provided the expected term of the contract extends over more than six months and the contract is not completed in the tax year. This would ensure the rule applies to, for example, the construction of buildings, bridges, dams, pipelines, tunnels, and other civil engineering projects; construction management contracts in relation to such projects; the construction of major items of plant; and contracts for the refurbishing of hotels and other business premises. The long-term contract rules would not apply to most service contracts, however.

D. Timing Issues in the Recognition of Expenses

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[137] *E.g.,* U.S.A. IRC § 460.

[138] *E.g.,* UGA ITA § 46 (loss carryback allowed only with the permission of the tax commissioner).

1. Economic Performance and Recognition of Expenses

A fundamental principle that merits reinforcement is the nexus between legal and economic liability for accrual-basis taxpayers and between payment and economic liability for cash-basis taxpayers. It was noted earlier that an accrual-basis taxpayer is normally understood to have incurred an expense when the obligation to pay arises, and a cash-basis taxpayer is treated as having incurred an expense when it is paid. It is important that the "obligation to pay" for accrual-basis taxpayers and "amount paid" for cash-basis taxpayers be interpreted in an economic sense, not a strict legal contractual sense.

This means that the act of legally entering into a contract that will obligate a taxpayer to make future payments should not in itself cause an accrual-basis taxpayer to be treated as if it had incurred the payments. In an economic sense, an obligation to make payment in the future is not actually "incurred" until there has been an economic performance that gives rise to the obligation to pay. While a taxpayer may commit to make a payment in the future for services to be provided in the future, the obligation is not actually incurred until the services are provided, as the obligation is only contingent prior to the provision of services. For example, a taxpayer can enter into a long-term contract to rent premises for a number of years. The rental obligation with respect to each of the future years is not actually incurred until those years. Similar principles apply to cash-basis taxpayers who actually make payments for services or goods that will be received over several years. Insofar as the payment relates to future years, it does not represent an expense incurred at the time of payment. Rather, it is akin to a security deposit to the recipient to guarantee the price for the goods or services to be delivered in the future. If, for some reason, the contract is terminated before delivery, the taxpayer should be entitled to a refund, either under the contract itself or under contract law principles in most jurisdictions.

The basic deduction provisions in many income tax systems may not be interpreted to operate in this strict way. In particular, immediate deductibility under the general deduction provision is normally not restricted to expenditures that are consumed in a tax period.[139] Consequently, in the absence of a specific rule to the contrary, an accrual-basis taxpayer that enters into a long-term commitment for the purchase of goods or services may be allowed to deduct the entire amount payable under the contract. Similarly, a cash-basis taxpayer who makes a prepayment for the future delivery of goods or services may be able to deduct the entire amount paid. To prevent this result, some countries have added to their income tax laws a supplementary rule, sometimes known as an economic performance rule, to reinforce the principles that accrual-basis taxpayers should recognize expenses as incurred when the obligation to pay has crystallized and not when the agreement creating the obligation is entered into, and that cash-basis taxpayers should recognize expenses as paid when the contracted good or service is provided and not when initial consideration is given to the supplier. The economic performance rule provides that an expense will not be treated as incurred before economic performance with respect to the expense occurs.

[139]An exception is Indonesia, where it is provided that costs of earning income that have a useful life of more than one year may not be deducted at once, but rather are to be deducted under the amortization rules. The position under the Indonesian income tax conforms closely to the theoretical model outlined in the text. *See* IDN IT §§ 6(1)b, 9(2), and 11(10).

If it is thought that a general economic performance rule applicable to all taxpayers is not needed because under general principles accrual-basis taxpayers are considered to have incurred expenses only in the years in which goods or services are provided, then a prepayment rule applicable to cash-basis taxpayers should be provided.[140]

2. Accruing Liabilities

A taxpayer's ongoing business will normally give rise to accruing liabilities that will not have to be satisfied until a future tax year. Common examples include the liability of borrowers to pay compounding interest when a debt matures, the liability of insurance companies to pay insurance claims related to the current year when the claim is settled in a future year, the growing liability of extractive industries to restore property when mining is completed, and the obligation of employers to pay future benefits to employees on the basis of current work.

No consistent approach is universally adopted to address these issues. It is generally the case that accruing liabilities that give rise to actual debts can be recognized as they accrue. This is true, for example, with a compounding interest obligation, where compounded interest is treated as a new deposit by the lender. While there are exceptions to the rule, discussed below, taxpayers generally are not permitted to recognize accruing liabilities where no actual debt is created by the accruing liability. In some cases, however, tax legislation may allow recognition for specific types of accruing liabilities, such as to fund environmental restoration or to provide pension or retirement benefits to employees where the funds are notionally allocated to a reserve by the taxpayer.

The simplest statutory approach to the problem is to enact a general rule that, subject to specific exceptions,[141] denies taxpayers deductions for an accruing liability until the liability has crystallized into an actual obligation to pay or created an actual debt of the taxpayer. Possible exceptions can then be considered on a case-by-case basis where the interests of the taxpayers can be balanced against the revenue costs of the exceptions. Appropriate conditions can be attached to each exception allowed. For example, to qualify for recognition of an accruing liability, a taxpayer may be required to establish an actual reserve in its accounts and insulate those funds from encroachment to satisfy other liabilities of the taxpayer.

3. Repairs and Improvements

An area that gives rise to disputes in a number of jurisdictions is that of expenditures for repairs and improvements. It is common for income tax systems to distinguish between expenses for these two purposes and to allow deductions for the former, while the latter are capitalized into the cost base of the assets to which they relate and recognized over time through the

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[140]*E.g.,* AUS ITAA (1936) §§ 82KZL–82KZO.This applies to all types of prepayments, but does not apply where the benefit is provided within 13 months of the date the expenditure was incurred, where the prepayment is required by legislation or court order, or where the prepayment is less than A$1,000.

[141]Such as for bad debts of financial institutions. *See* secs. IV(B)(6) and VI(D).

depreciation system or as part of the cost base when calculating a gain or loss on final disposal is calculated.

From an income tax perspective, the distinction between repairs and improvements is quite artificial. The complicated and contradictory case law in many jurisdictions illustrates well how impossible it is in practice to establish mutually exclusive camps and to classify categorically work on assets as either repairs, improvements, or acquisitions of new subassets that are incorporated into larger assets.[142] Even if a satisfactory method of distinguishing repairs, improvements, or acquisition of replacement parts can be devised, the distinction is unlikely to yield appropriate tax treatment; as often as not, the classification has no relevance to the life of the benefit acquired, which is the principal criterion determining recognition and timing for business expenses.

The application of the expense recognition principle—recognition over the life of the benefit—is almost impossible to apply to many repairs, alterations, or improvements, because there is often no way in which the effective life of these benefits can be estimated. Accordingly, a surrogate formula is needed to determine the tax treatment of such outgoings.

The simplest rule is one that eliminates the need to distinguish between repairs, improvements, or the installation of replacement parts through the use of a simple mathematical formula (sometimes known as a repair allowance).[143] The formula system presumes that, on average, the amount of repairs needed will bear a relatively fixed relation to the total value of depreciable property. Any excess over this amount can be presumed to be an improvement. Thus, it is logical to presume that high expenditures relative to the value of the relevant property are likely to give rise to benefits that enjoy a life approximating that of the underlying property, while low expenditures relative to the value of that property are likely to enjoy briefer lives. For example, expenditures on repairs or improvements that exceed, say, 5 percent of the value of an asset can be considered to be the purchase price of a long-term benefit and added to the cost base of the asset, while expenses less than that threshold can be considered to be costs incurred to derive short-term benefits and deducted immediately.[144]

If the traditional approach of immediate write-offs for repairs and capitalization of improvements is adopted in preference to a repair allowance, a special rule for initial repair expenses should be considered. Where a taxpayer acquires a used asset and incurs initial repair expenses to prepare the property for use in the taxpayer's business, it is arguable that the initial expenses should be wholly capitalized and treated as part of the acquisition price for the asset. If the vendor incurs the repair expenses and sells the property in a ready-to-use form, the costs would be directly incorporated into the cost of the asset. A purchaser should not be able to accelerate deductions by purchasing property not ready for use and then repairing the property to bring it to usable form.

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[142]*See infra* ch. 17, sec. II(B).

[143]*See infra* ch. 17, note 50.

[144]Where a pooling depreciation system is used (*see infra* ch. 17, sec. III(G)), the 5 percent threshold can be applied by considering expenditures on all assets in a pool relative to the value of the pool.

There are three ways in which a rule of this kind can be formulated. First, one could establish a bright-line rule under which all repairs within, say, six months of an asset's placement in service are treated as capital costs, regardless of the facts of the individual case. Alternatively, one could establish a presumption that repairs undertaken within a certain period are capital in nature, which the taxpayer can rebut by showing that the repair is genuinely a repair rather than a set-up cost. A third approach is to adopt a cost formula similar to the repair allowance described above. For example, the rule can apply only to repair costs incurred within one year of the acquisition of an asset and allow a deduction for repair costs of up to 5 percent of the original acquisition cost while requiring taxpayers to capitalize repair costs in excess of that amount incurred within that year.

4. Inventory

Income tax systems commonly measure gains and losses from the acquisition and disposal of inventory separately from gains and losses arising from the disposal of other property.[145] The essential purpose of tax accounting rules relating to inventory is to ensure that a deduction is not allowed for the cost of acquiring inventory until the inventory is sold.[146] This policy objective is consistent with the general rules regarding gains and losses from the disposal of nonwasting assets, but separate rules are adopted for inventory in recognition of the continual turnover of this type of property.

As with other tax accounting rules, the rules relating to inventory may be based on commercial accounting standards or may be specified in the tax law or in regulations. An initial issue that should be addressed in the inventory rules is what is encompassed in inventory and thus subject to those rules.[147] In some jurisdictions, inventory is not defined and, therefore, takes its normal commercial meaning.[148] In other jurisdictions, it is defined, but in terms largely declaratory of its normal commercial meaning.[149] Essentially, inventory is anything that is turned over in the ordinary course of business (i.e., it is the things in which a business trades). Inventory may be bred or grown (such as livestock and agricultural produce), manufactured, purchased, or otherwise acquired (such as through a barter transaction). Inventory is not confined to finished goods. It includes goods in the process of production (i.e., work in process), and raw materials and supplies that are to be consumed directly or indirectly in the production of goods.

Inventory is not limited to tangible movable property. In particular circumstances, immovable or intangible property can be inventory. Generally, there is nothing in the intrinsic nature of any particular item that gives it the character of inventory. The same item may be

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[145]*See generally* Dale Chua, *Inventory Valuation, in* Tax Policy Handbook 139 (P. Shome ed. 1995).

[146]*See supra* sec. II(C)(2).

[147] In jurisdictions that rely on British legal concepts, inventory is commonly referred to as "trading stock."

[148]Singapore is an example of such a jurisdiction.

[149]*E.g.,* AUS ITAA (1997) § 70-10.

inventory in the hands of one person but not in the hands of another. For example, a motor vehicle may be inventory in the hands of a motor vehicle dealer but not in the hands of a person who purchases it from the dealer. In fact, a person may hold the same type of item in different capacities. For example, the private motor vehicle of a motor vehicle dealer will not be part of the inventory of the dealer, nor will a vehicle acquired to deliver parts or pick up customers.[150]

The system used to defer recognition of the cost of inventory will depend on whether the income tax system generally uses the receipts-and-outgoings method or the balance-sheet method to determine business income. There are two equivalent systems for measuring the cost of inventory in jurisdictions in which the receipts-and-outgoings method is used to calculate taxable business income. The simpler of the two systems is based on financial accounting principles.[151] In this case, a deduction is allowed for the cost of goods sold during the tax year calculated according to the following formula:

(Opening inventory + cost of purchases) - closing inventory.

An equivalent system used in some jurisdictions is to allow a deduction for the cost of inventory acquired during the tax year, followed by a re-inclusion in gross income of the value of closing inventory.[152] The re-included amount is the excess for the tax year of closing over opening inventory. Where opening inventory exceeds closing inventory, a deduction should be allowed for the excess to ensure that expenses incurred in prior years are recognized when stock is eventually sold.[153]

It should be provided that the value of closing inventory for a tax year becomes the value of opening inventory for the next tax year. Items included in inventory should follow the accounting rules for purchases and sales. Thus, if the taxpayer has recognized the cost of inventory that is not yet physically received, it should nevertheless be included in inventory, and, if the taxpayer has recognized income from the sale of inventory, it should not be included in inventory, even if physically on hand at the close of the year.

In many jurisdictions, taxpayers are able to value closing inventory at the lower of cost or market value. Thus, if the market value of inventory falls below its cost,[154] a taxpayer can recognize the loss in the tax year in which it occurs without actually disposing of the inventory. In some jurisdictions, taxpayers can also use the higher of market value and cost to value closing

[150]It is possible that an asset may change status. For example, a motor vehicle dealer may take his or her private motor vehicle into inventory, or vice versa. The tax consequences of a change in status of an asset are discussed in sec. V(E)(1), below.

[151]*E.g.,* UGA ITA § 47.

[152]*E.g.,* AUS ITAA (1997) § 70-35.

[153]A variation on this approach applies in New Zealand where taxpayers are allowed a deduction for the cost of inventory and a deduction for the value of opening inventory, while the value of closing inventory is included in gross income. *See* NZL ITA §§ 85, 104.

[154]This may arise, for example, because of damage, deterioration, or obsolescence.

inventory, to bring forward recognition of gain prior to disposal.[155] There is no persuasive policy reason in favor of the latter concession, and it may be used for tax minimization or avoidance purposes by generating gains to offset losses that might not otherwise be recognized for tax purposes. Accordingly, while the choice between the lower of cost or market value may be incorporated into the inventory rules, a choice of higher cost or market value is not recommended.

In the ordinary case, closing inventory will be valued at cost. Two particular issues arise when valuation is based on cost: first, the identification of amounts included in the cost of inventory that is manufactured or constructed by the taxpayer; and second, the valuation of closing inventory where the cost of inventory has varied and it is not possible to trace individual items of stock.

The first issue with cost concerns the extent to which ancillary costs such as labor costs or factory overhead costs should be included in the cost of manufactured or constructed inventory. If such costs are included in the cost of manufactured or constructed inventory, they will not be recognized until the inventory is sold. Two basic models are used to determine the cost of manufactured or constructed inventory. Terminology differs from jurisdiction to jurisdiction, but the fundamental features of the two models are similar across tax systems. Under the simplest method—commonly known as the prime-cost method—the cost of inventory is the sum of direct material costs, direct labor costs, and variable factory overhead costs. Direct material costs are the cost of materials that become an integral part of the inventory produced. Direct labor costs are the costs of labor directly involved in the production of inventory. Variable factory overhead costs are those factory overhead costs that vary directly with the volume of production. Under the more complex method–the absorption-cost method–a percentage of fixed factory overhead costs (such as rent) is included in the cost of inventory. Where absorption costing is used, rules must be adopted to distinguish costs that are attributable to the inventory and costs that should be considered general overhead expenses (and are thus deductible without reference to the inventory provisions).[156]

Different rules may be adopted for cash-basis and accrual-basis taxpayers with respect to the amounts included in the cost of inventory. A cash-basis taxpayer may be allowed to determine the cost base of inventory using either the prime-cost or the absorption-cost method, while accrual-basis taxpayers are usually required to use the absorption-cost method.[157]

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[155]*E.g.,* AUS ITAA (1997) § 70-45; NZL ITA § 85(4).

[156]Ordinarily, general, administrative, and selling expenses are not included in the cost of inventory. *See, e.g.,* USA IRC 263A and the regulations thereunder (in 1986, the types of expenses required to be included in the cost of producing inventory were substantially broadened). As an economic matter, however, all costs incurred by a firm should ultimately be recovered as part of the cost of production, so that arguably all expenses of a firm should be allocated to costs of production. Such a rule would also be simpler to administer, because it would minimize the requirement to draw distinctions among different types of costs. *See* Victor Thuronyi, *Tax Reform for 1989 and Beyond,* 42 Tax Notes 981–96 (Feb. 20, 1989).

[157]*E.g.,* UGA ITA § 47(5).

The second issue that arises when valuation is based on cost relates to the identification of items of inventory that are on hand at the end of the tax year. This is necessary where the cost of acquiring, constructing, or manufacturing different units of inventory has varied. For unique products, businesses can trace the actual movement of stock and thus ascertain the exact cost of closing inventory. More commonly, businesses buy and sell generic stock, and there is no record of the movements of individual items. Thus, for inventory other than unique traceable stock, a presumptive tracing rule must be applied. While a number of variations are used in different jurisdictions, most fall into one of three inventory tracing methods, the first-in-first-out (FIFO), average-cost, or last-in-first-out (LIFO) system. Under the FIFO method, the cost of inventory on hand at the end of the tax year is determined on the assumption that items purchased or produced first are sold first, so that the items on hand at the end of the year are those last purchased or produced. Under the average-cost method, the cost of inventory on hand at the end of the tax year is determined by reference to the weighted-average cost of all items on hand at the beginning of the tax year and purchases during the year. Under the LIFO method, the cost of inventory on hand at the end of the tax year is determined on the assumption that items purchased last are sold first, so that items on hand at the end of the year are the earliest items purchased or produced. In a period of moderate inflation, the use of the LIFO method for valuing trading stock will provide taxpayers with a simple compensation for the effects of inflation on measuring profits.[158] However, the LIFO method is complex and results in undervaluation of inventory.[159]

5. Research and Development

The longevity of benefits derived as a result of expenditure on research and development is incapable of measurement at the time the expense is incurred. It may be presumed, however, that some long-term benefit is realized as a consequence of any research and development expense. For example, even if a research and development outlay yields no direct, relevant results, the expenditure may provide long-term benefits by narrowing down options and suggesting possible paths for other research initiatives.

Because it is not possible to estimate accurately the useful life of benefits resulting from research and development expenses, a hypothetical life must be adopted. In many jurisdictions, doubts about the longevity of benefits from research and development expenses are resolved in the taxpayer's favor through the use of relatively short amortization periods, or immediate deductions, for these outgoings.[160] Such treatment is also seen as a tax expenditure (i.e., tax concession) that encourages research and development.[161] An additional argument in favor of

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[158]Special rules for valuing closing inventory apply under comprehensive inflation adjustment systems. *See* vol. 1, ch. 13.

[159]*See* McLure et al., The Taxation of Income from Business and Capital in Colombia 239–40 (1990).

[160]*E.g.,* AUS ITAA (1936) § 73B (immediate deductions range from 100 percent to 125 percent of the relevant expenditure incurred); LSO ITA § 40 (immediate deduction); UGA ITA § 33 (immediate deduction); USA IRC § 174 (at the taxpayer's election, research and experimental expenditures may be immediately deductible or amortized over five years).

[161]*See generally* Stanley S. Surrey & Paul R. McDaniel, Tax Expenditures 211–12 (1985).

allowing an immediate deduction for research and development costs is that it may be difficult to distinguish them from other general business expenses. There are, however, disadvantages to the use of an amortization period for research and development outgoings that is significantly shorter than the period applicable to other capital expenses. Most important, generous treatment of research and development expenses will lead to taxpayers recharacterizing expenses as research and development outlays to accelerate the deduction of these expenses. This may happen, for example, with equipment that is used both in manufacturing products and in developing new products. To limit the scope for recharacterization, it may be provided that research and development expenditure does not include the cost of acquiring a depreciable or intangible asset, the cost of acquiring land or buildings, or the expenditure incurred for the purpose of ascertaining the existence, location, extent, or quality of a natural deposit.

A possible hybrid approach is to prescribe a limited amortization period for research and development expenses and to allow an immediate deduction of that part of the expense that is attributable to any project or line of inquiry pursued by research if the project is abandoned without generating results.

V. Issues Relating to the Taxation of Assets

A number of issues arise in the design of the income tax as it applies to assets.[162] Some issues may be specific to particular classes of assets,[163] while others may be relevant to all assets. It is suggested that the asset rules be structured so that the rules common to all assets are included in a single regime of general application. These rules include those for determining the cost base of assets, realization and recognition rules, and rules for determining gain or loss on disposal. In systems based on the balance sheet, they will include rules for determining the balance-sheet value of assets. Specific rules for particular classes of assets can then build on these basic rules. This approach not only ensures that rules are provided for all assets, but also means that there is a fundamental consistency in the basic treatment of different classes of assets. An alternative approach in some countries is to provide detailed rules for a particular class of asset (such as investment assets), with much briefer rules provided for other assets. It is recommended that this approach be avoided.

A separate asset regime of general application is supplementary to the operation of the inclusion and deduction provisions in the law. It is not the purpose of the regime to bring amounts to tax or allow amounts as a deduction. Rather, its purpose is to elaborate the meaning of concepts used in the inclusion and deduction provisions. The main areas that can be dealt with in a separate asset regime are timing and calculation matters. The timing rules identify the tax year in which the inclusion and deduction provisions apply to an asset, and the calculation rules provide for the determination of the taxable or deductible amount. Depending on the asset, the taxable amount may be a gain calculated by subtracting the cost base of the asset from the consideration received for the asset, and the deductible amount may be a loss calculated by subtracting the consideration received for the asset from the cost base of the asset. In other cases, such as inventory, the taxable amount may be the consideration received, and the deductible amount may be the cost of the asset. In either case, the asset regime should provide for the determination of the cost base of, and consideration received for, assets.

The main matters that may be dealt with in a separate asset regime are discussed below.

A. Timing Rules for Realization of Gain or Loss

Ordinarily, gains or losses arising in relation to assets are taxed not as they accrue, but rather in the tax year in which the taxpayer realizes the gain or loss. In most cases, a gain or loss is realized at the time the taxpayer ceases to own the asset. While a taxpayer will normally cease to own an asset as a result of the sale of the asset, there are other ways in which this can occur

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[162] The concept of an asset is used in this discussion in preference to the concept of property that is used in some tax laws (*e.g.,* IDN IT § 4(1)d ("gains arising from the sale or transfer of property")). In its ordinary meaning, an asset is any thing that may be turned to account. Depending on general law meanings, the notion of property may not be interpreted this broadly. For example, legally enforceable rights that are purely personal in nature may not be regarded as property.

[163] For example, specific rules may apply to inventory, depreciated or amortized assets, and assets subject to capital gains taxation.

(e.g., as a result of an in-kind exchange, a gift, or a distribution of the asset). Thus, it is suggested that the concept of disposal, rather than a narrower concept like sale, be used to state the basic realization rule. In its ordinary meaning, disposal covers all situations in which the ownership of the asset changes. Even so, an extended definition of disposal will be necessary to cover all intended realization events in relation to assets, particularly those relating to intangible assets. The definition of disposal should include the redemption, expiry, cancellation, surrender, loss, or destruction of an asset. It should also be provided that the disposal of an asset includes a partial disposal. An example of a partial disposal is the sale of a lot that has been part of a single block of land that has been subdivided.

The disposal rules may also provide for gain or loss recognition where an asset that is outside the tax system is brought within the tax system, or vice versa. This can occur because a change in the taxpayer's circumstances changes the tax status of assets held by the taxpayer. For example, a nonresident taxpayer may become a resident taxpayer. If the new country of tax residence taxes worldwide income, then the change in residence may bring assets held by the taxpayer at the time of the change within the tax system of the new country residence (these assets previously being foreign assets of a nonresident). Alternatively, a resident taxpayer may become a nonresident taxpayer. The effect of the change may be to take some assets held by the taxpayer at the time of the change outside the tax system of the taxpayer's former country of tax residence (these assets now being foreign assets of a nonresident). A similar situation can arise where an exempt person becomes a taxpayer, or vice versa. This can happen as a result of a change either in the taxpayer's circumstances or in the law.

In these situations, there is no change in the ownership of the asset, and so there is no disposal in the ordinary meaning of the word. If an entry or exit from the tax system is to be treated as a realization event, then it will be necessary to include deemed-disposal rules to cover this situation.[164] Comprehensive deemed-disposal rules can be difficult to enforce and may not be necessary for developing or transition countries.[165] However, it will be necessary to include some such rules, particularly to prevent taxpayers from obtaining a tax deduction for what is essentially consumption expenditure (e.g., if a personal-use asset becomes a business asset, there should be a deemed disposal and reacquisition to ensure the decline in value due to personal use is not recognized for tax purposes). The effect of a deemed-disposal rule is to treat a particular event as giving rise to the disposal of an asset for a consideration equal to either the market value or the cost base of the asset at that time depending on the circumstances.[166] If relevant, the taxpayer will also be treated as having immediately reacquired the asset for the same consideration. This then becomes the new cost base of the asset for tax purposes.

[164]Rather than artificially "deem" that a disposal has occurred when one has not, an alternative approach is to define the situations in which gains and losses are brought to account as taxation "events"—*see*, *e.g.*, AUS ITAA (1997), proposed Div. 104.

[165]It is suggested that this is the case for residence change situations. *See* ch. 18, sec. VI(E).

[166]Market value consideration will be recognized when an asset moves in or out of the tax system (*see supra* sec. V(A)), while consideration equal to cost will be recognized in most cases when an asset changes tax status (*see infra* sec. V(E)(1)).

B. Cost Base

The basic rule is that the cost base of an asset is the consideration given for the acquisition of the asset.[167] This should include any borrowed funds used to acquire the asset. Where the taxpayer has given consideration in kind for the asset, the market value of the in-kind consideration at the time of the acquisition should be included in the cost base of the asset. The cost base of an asset should include any ancillary costs incurred in the acquisition of the asset, such as legal and registration fees relating to transfer of the ownership of the asset, transfer taxes, agent's fees, installation costs, and start-up expenses to make the asset operational. The cost base of an asset should also include any capital expenditures incurred to improve the asset and expenses incurred in respect of initial repairs.[168]

When there is a partial disposal of an asset, it is necessary to provide rules to apportion part of the cost of the original asset to the part of the asset sold. For this purpose, the cost of the original asset should be apportioned by reference to the market values of the respective parts of the asset at the time the asset was originally acquired.[169] It may be difficult to apply this rule when an asset was acquired without contemplation of part disposal. The information may thus not be available at the time of disposal to apportion cost on the basis of market values of the respective parts of the asset at the time of acquisition. In this case, the original cost can be assumed to be allocated on a pro rata basis by reference to relative market values of the part sold and the part retained at the time of disposal.[170]

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[167]While much tax terminology is similar in different countries, this is not the case for "cost base" and its equivalents. It is in fact more than a difference in terminology, and has to do with differences in the structure of income tax laws. The United States has an underlying concept of "basis" (and adjusted basis) which is used throughout the income tax law for such purposes as computing capital gains or depreciation deductions (for example, the term adjusted basis is used more than 300 times in the Internal Revenue Code). The concept is defined in USA IRC §§ 1011–1016. Similarly, Australia has the concept of cost base of assets, which is defined in AUS ITAA (1936) § 160ZH, but this concept is not as pervasive in the tax law as is the American concept; it does not govern depreciation deductions, for example, which are determined according to the cost of plant. *See* ITAA (1997) §§ 42-60 to 42-90. The Canadian approach is similar. *See* CAN ITA § 54 (adjusted cost base). Most countries do not have a formal underlying concept of basis. They might refer to the cost or acquisition cost of assets in rules for determining capital gains. For example, the Spanish law refers to the acquisition value in its capital gains rules. *See* ESP IRPF § 46. France similarly refers to the acquisition price. *See* FRA CGI § 150 H. The United Kingdom uses the concept of cost both for capital gains purposes and for purposes of determining qualifying expenditure for depreciation purposes. On the other hand, Germany, like the United States, has an underlying concept for the valuation of assets, namely *Buchwert* (book value). The concept of *Buchwert* is used both for purposes of computing capital gains and for purposes of the balance-sheet method of determining taxable income (for which see Appendix *infra*). *See* DEU EStG §§ 6, 6b(2). In most cases, the *Buchwert* of an asset for purposes of German tax law will correspond to the concept of adjusted basis as used in U.S. tax law.

[168]*See infra* sec. IV(D)(3).

[169]*E.g.*, UGA ITA § 53(5).

[170]*E.g.*, AUS ITAA (1936) § 160ZI. Another approach, not recommended, is to allocate cost on a pro rata basis using features of the property sold, such as the size of a part of immovable property sold compared with the size of the part retained. Given that it is only by chance that there would have been a consistent movement in the market value of the respective parts of the asset since the original asset was acquired, this approach is likely to lead to inappropriate allocations of original cost.

A taxpayer may hold a number of assets of the same type. When the assets have been acquired for different costs, and the taxpayer disposes of only a part of his or her holdings of the asset, it will be necessary to know which asset or assets have been disposed of for the purposes of determining the cost of those assets. Ordinarily, outside of inventory, it should be possible to identify the particular asset or assets disposed of so that the actual cost of those assets is used. However, there may be some types of asset for which actual identification is not possible. Examples include shares of a company that is not obliged to use registration numbers and holdings of precious metals. For these assets, a presumptive tracing rule needs to be provided. While several possible tracing rules may apply when the asset is inventory,[171] an identification rule based on first-in-first-out is suggested for noninventory assets.

Cost-base rules should cover two special cases. The first case is where a taxpayer acquires an asset in circumstances in which the acquisition constitutes the derivation of an amount included in the taxpayer's gross income. For example, a taxpayer may be remunerated with an asset rather than with cash. In this case, the cost base of the asset should be the amount included in gross income plus any consideration given by the taxpayer for the asset. The purpose of this rule is to prevent double taxation.

The second case is where a taxpayer acquires an asset in circumstances where the acquisition of the asset is the derivation of exempt income. In this case, the cost of the asset should be the exempt amount plus any consideration given by the taxpayer for the asset. The purpose of this rule is to ensure that the exemption is not clawed back on a subsequent disposal of the asset.

C. Consideration Received

The basic rule is that the consideration received for the disposal of an asset is the price received for the asset, including the market value of any in-kind consideration. Where borrowed funds are included in the cost base of the asset, any relief from the debt by the transferee must be treated as part of the consideration received on disposal of the asset.

Where a taxpayer disposes of two or more assets for a single undissected consideration, it is necessary to provide for the apportionment of the consideration among the assets. For this purpose, the consideration received should be apportioned by reference to the market values of the assets disposed of as of the time of the disposal.

In some situations, the consideration for a disposal of an asset may be nominal or zero. For example, a taxpayer may give an asset (such as inventory) to a customer or a client as a sample or as part of a promotion. Where the parties are genuinely unrelated and the purpose of the dealing is not to shift value to some related, but tax-preferred transaction between the parties, the actual consideration received (if any) should be treated as the consideration for the disposal of the asset. The treatment of non-arm's-length transactions is discussed in section V(D), below.

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[171] *See supra* sec. IV(C)(5).

The consideration rules must correspond to the notion of disposal that applies for the purposes of the law. For example, it was stated above that the notion of a disposal should extend to situations where an asset has been lost or destroyed. For these disposals, there may be no consideration received for the disposed asset, or the taxpayer may have received insurance proceeds or damages (see below).There are a number of different rules in different jurisdictions that apply in these circumstances. Often, however, these are explicable by reference to particular historical factors and are of little precedential value. In the absence of special circumstances, the simplest and fairest rule is to measure losses arising from such involuntary disposals by reference to the actual consideration received, if any. If no consideration is received, then the taxpayer will have incurred a loss on the disposal equal to the cost of the asset.

Where a taxpayer is subject to a deemed disposal in respect of assets moving in or out of the tax system, a market value rule should apply to the disposal. This means that the taxpayer is treated as having disposed of the assets for their market value at the time of the deemed disposal and to have immediately reacquired them for the same amount. This ensures that only the gain or loss arising while the asset is within the tax system is recognized.

Special rules may be needed for compensation (such as insurance proceeds or damage awards) received in relation to assets. Where compensation is received in respect of the loss or destruction of an asset, the amount should be treated as the consideration received for the disposal constituted by the loss or destruction of the asset. For this purpose, it is necessary to ensure that the definition of consideration received is drafted broadly so as to cover such amounts.

Compensation may also be received for damage to an asset where the asset has not been lost or destroyed. If the amount of the compensation equals the cost of repairs (e.g., fixing the car after an accident), then no gain should be recognized in relation to the compensation amount. Where the compensation offsets damage that cannot be repaired, it should be recognized through a reduction in the cost base of the asset.

D. Non-Arm's-Length Transfers

In the absence of prophylactic measures to control the amount of cost and consideration for tax purposes, related parties may choose transfer prices in the hope of achieving a variety of tax objectives—minimizing recognition of gain to defer taxes, inflating gains to absorb losses that were carried forward, value shifting to transfer gains to a lower bracket or exempt taxpayer, and so forth. Objectives unrelated to taxation, too, may also influence transfer values. For example, taxpayers may wish to shift value to improve their balance sheet for the purpose of obtaining debt finance.

To prevent manipulation of transfer prices, rules for determining the deemed market value consideration are needed for non-arm's-length transactions. In broad terms, an arm’s-length transaction is a transaction in which the parties act completely independently of each other and seek to put their own interest first. A transaction between related parties would be presumed to be a non-arm’s-length transaction because one or both parties may be willing to subordinate their own interest to that of the other party or a related third person for the purpose of achieving an overall tax saving. However, this is only a presumption because related parties can enter into a transaction on arm’s-length terms. The nature of the transaction is usually tested by reference to the price that would be expected if unrelated parties entered into the transaction.

Non-arm’s-length transactions require complementary deeming rules. The person disposing of an asset in a non-arm’s-length transaction should be treated as having received consideration for the disposal equal to the market value of the asset at the time of the disposal. The same amount should then be treated as the cost base of the asset for the person acquiring the asset.

While gifts are usually non-arm's-length transfers, they raise special conceptual issues. Genuine gifts occur most commonly within families; most "gifts" outside the family involve some sort of quid pro quo. The case for treating gifts in the same manner as other non-arm's-length transactions (i.e., as a disposal for a deemed market value consideration) is strong. Any other treatment introduces inefficiencies and inequities by distinguishing between persons who dispose of property or services for arm's-length consideration and make a gift of the proceeds and those who provide the property or services directly.

The argument commonly raised against deemed market value consideration in respect of gifts is the alleged liquidity problem faced by the donor. Often, the lack of liquidity is at the choice of the donor, given that the donor could have disposed of the property at market value. A secondary argument focuses on the alleged valuation difficulties encountered in a transfer for no consideration. The problem is no greater than that encountered in any non-arm's-length transfer, however, and tax administrators can apply to gift transactions the expertise developed to value all other non-arm's-length transactions.

Similar issues apply to testamentary gifts. While it seems intuitively inappropriate to treat the taxpayer who makes a gift of property differently from the taxpayer whose property transfers on death, a distinction between inter vivos and testamentary gifts is not unusual. Often, jurisdictions that provide a deferral in respect of testamentary transfers impose death duties or similar taxes, and it may be thought that liquidity problems could be exacerbated as a result of the two tax liabilities. Similar treatment of inter vivos and testamentary gifts is desirable, however, in light of the inequities that would follow from a complete exemption from recognition of accrued gains on death (by means of a cost-base step-up for recipients of property) and the economic lock-in inefficiencies that would follow from a deferral of recognition (by means of a cost-base rollover for the recipient). Liquidity problems, if any, can be addressed through, for example, installment payments of tax subject to ordinary finance charges.

E. Nonrecognition Rules

There may be situations in which a taxpayer has realized a gain or a loss on disposal of an asset, but recognition of the gain is deferred until a later event occurs. Similar deferral may apply when property changes its tax status. In some jurisdictions, these nonrecognition rules are referred to as providing rollover treatment. The tax position of a taxpayer or asset is rolled over into another taxpayer or asset, as the case may be. This is done by deeming the taxpayer to have disposed of relevant property for consideration equal to its cost and to have reacquired the property (if there has been no actual disposal of assets) or to have acquired replacement property for consideration equal to the original cost.

Tax laws commonly provide for rollover treatment in four types of situations, described below.

1. Changes in the Tax Status of Assets

An asset can change its tax status in a number of ways. For example, a trader may take some stock from inventory for personal use or consumption (or vice versa, although this is much less common). An item of inventory can also become a business asset of another type, such as depreciable or amortizable property, or vice versa. Similarly, property acquired as business assets or inventory may subsequently be held as an investment asset, or vice versa,[172] and in some cases may thus be subject to different tax rules.

Rollover treatment, which can be applied to most changes of tax status, is the equivalent of saying that the asset was originally acquired for its ultimate use, and so the interim period in which the asset was held for some other use is thus ignored. A deemed disposal for cost will normally lead to no gain or loss recognition. For example, if an item of inventory is removed for personal consumption by the taxpayer, the taxpayer will be treated as having disposed of the stock at the time it was taken out of inventory for cost,[173] which will offset the deduction obtained for the cost of inventory. Some systems (e.g., Germany), however, treat a withdrawal of assets from business use as a disposal for market value.[174]

A special rule is needed when a personal-use asset that would be depreciable property if it were a business asset is converted to a business asset. If rollover treatment were applied in this case, the taxpayer would be able to recognize some personal consumption costs for tax purposes. For example, if a taxpayer converted a machine from personal-use property to inventory, the decline in value due to personal use could be recognized as a loss if the property were rolled over at cost. Such conversions should be treated as disposals for market value.

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[172]This possibility can be confined to individuals carrying on a business, because all assets of a company or partnership should be deemed to be business assets. *See supra* sec. II(B)(2).

[173]*E.g.,* AUS ITAA (1997) § 70-110.

[174]This approach corresponds to the deemed disposal on conversion of assets to business assets–*see supra* sec. IV (A).

2. Disposals Intended to Trigger a Loss

While the income tax system tends to recognize gains and losses only when there is a disposal of an asset or a prescribed tax event giving rise to a deemed disposal, the value of assets changes continuously. The realization event aspect of the income tax system can provide taxpayers with opportunities to reduce tax liability by accelerating recognition of losses on assets that have declined in value while deferring recognition of gains on assets that have appreciated over the same period. If the disposals are genuine market transactions to unrelated parties, the losses will normally be recognized for tax purposes. In some cases, loss recognition will be denied, however, and rollover treatment will be imposed.

The first loss situation in which rollover treatment is prescribed is for below-cost transfers to related persons, even if the price reflects market value. Losses are generated even though the asset continues to be owned by the same group of companies or the same family. To prevent such artificial generation of a loss, the transferor should be treated as having disposed of the property at cost, and the transferee should be treated as having acquired the asset for the same amount. This preserves the accrued loss, which will be realized when the transferee eventually sells the asset outside the group or family.

The second loss situation in which rollover treatment is prescribed is for "wash sale" situations. A wash sale is when a taxpayer disposes of an asset that has declined in value and immediately thereafter acquires the same or a similar asset. The transaction costs may be minimal compared with the tax savings resulting from the realized loss. The effectiveness of such transactions can be avoided by prescribing rollover treatment to wash sales that involve the taxpayer’s reacquisition of the asset within a designated period.

3. Involuntary Disposals

A nonrecognition rule may apply to an involuntary disposal of an asset when a replacement asset has been acquired. Examples of involuntary disposals to which this rule may apply are the loss or destruction of an asset (e.g., through fire or theft) and the compulsory acquisition of an asset by a government authority. There are usually two conditions to the application of the nonrecognition rule. The first condition is that the proceeds of the disposal (such as insurance proceeds) must be used to acquire a replacement asset of a kind similar to the disposed asset. The second condition is that the replacement asset is acquired within a specified time of the involuntary disposal, say, one year. The nonrecognition rule should apply only to the extent that the proceeds of the involuntary disposal are used to acquire the replacement asset. If the proceeds of the involuntary disposal exceed the cost of the replacement asset, then the excess of the proceeds over the cost of the replacement asset should be recognized as a taxable gain arising from the involuntary disposal. Where the nonrecognition rule applies, the cost of the replacement asset is the cost of the involuntarily disposed of asset plus the amount (if any) by which the consideration given for the replacement asset exceeds the consideration received on the involuntary disposal. The nonrecognition rule that applies to involuntary disposals is illustrated by the following example:

Example

A taxpayer owns an office building that cost $1,000,000. The building is destroyed by fire. The taxpayer receives $1,500,000 under an insurance policy, which is wholly used to acquire a replacement office building. Under the nonrecognition rule, no gain or loss is taken into account on disposal of the building to the extent that the insurance proceeds of the disposal are used to acquire the replacement building. The tax cost of the replacement building is $1,000,000—that is, the cost of the destroyed building at the date of its destruction. This means that recognition of a $500,000 gain made by the taxpayer on disposal of the destroyed building is deferred until the taxpayer disposes of the replacement building.

If the actual cost of the replacement building was $1,600,000, then the tax cost of the replacement building would be $1,100,000 (the cost of the destroyed building plus $100,000 paid by the taxpayer for the replacement building in addition to the insurance proceeds). Recognition of a $500,000 gain made by the taxpayer on disposal of the destroyed building is still deferred until the taxpayer disposes of the replacement building.

If the replacement building had actually cost $1,400,000, then the cost of the replacement building would still be $1,000,000, but the difference between the insurance proceeds and the cost of the replacement building ($100,000) would be included in the taxpayers's business income. This is because this part of the insurance proceeds has not been used to acquire the replacement building. Recognition of the other $400,000 of gain in relation to the involuntary disposal is deferred until the taxpayer disposes of the replacement building.

4. Spousal Transfers

A nonrecognition rollover may be provided to facilitate the transfer of assets between spouses (or former spouses) on the breakdown of a marriage. The transferee spouse takes over the original cost of the asset so that recognition of any gain or loss that has accrued prior to the transfer is deferred until a subsequent disposal of the asset by the transferee spouse.

F. Transitional Basis for Assets Previously Outside the Tax Base

The reform of income tax legislation often brings into the tax base gains on assets that were not previously subject to income taxation. To avoid the retrospective application of the tax law, transitional measures should prevent or at least minimize the taxation of gains that have accrued prior to the introduction of the new tax. From a theoretical perspective, the ideal rule is one that sets the cost of assets previously outside the tax base as their market value at the time the new tax reform comes into effect. To prevent market confusion and potential disruption between the unveiling of the new tax rules and their effective date, some jurisdictions that have expanded the tax base in this manner have used the market value as of the time the new measures were unveiled or shortly before.

A rule based on market value when the tax base is broadened is feasible only if market value information is readily available at that time and accessible, when there is an eventual disposal of the property. Experience in industrial countries that have adopted this approach shows that few difficulties emerge when this rule is applied to "publicly listed assets," such as publicly traded shares or precious metals, or to assets included in data bases that can be used to estimate closely the value of an asset at the time of tax reform. An example of the latter is real estate where property records will show the sale price of neighboring properties sold around the time of the tax reform. However, valuation is a prime source of dispute and litigation in the case of assets involving intangible elements such as goodwill (e.g., businesses or shares in private companies). In industrial countries, these values are normally determined by financial indicators, such as comparable rates of return in similar businesses. In developing and transition countries, it is more appropriate to use a surrogate measure of value when the tax base is broadened. The simplest rule for assets acquired prior to tax reform is to deem cost to be the original cost adjusted by a factor such as inflation adjustment. Even this surrogate measurement may be difficult to apply in some cases, for example, when assets have been acquired long before tax reform or through inheritance.

One country attempted to broaden its tax base by introducing measures on a prospective basis so that they applied only to assets acquired after a certain date.[175] This approach is not recommended because it creates arbitrary differences in the treatment of assets depending on when they are acquired. These differences encourage taxpayers to enter into transactions to shift value from taxed to untaxed assets. Further, this approach creates a lock-in effect in that persons holding assets acquired before the relevant date are encouraged to hold onto them.

VI. Special Regimes

A. Interest Income and Expenses

It is common for tax legislation to contain special rules for interest income and expenses. As discussed in section III(B), it is usual to define interest broadly to ensure that amounts functionally equivalent to interest (such as discounts and premiums) are treated as interest for tax purposes.

It is necessary to include special timing rules in relation to interest. These rules serve two purposes. First, they ensure that the different amounts within the broad definition of interest (such as discounts and premiums) are subject to the same recognition rules. In the absence of special accounting rules, it might be possible for a taxpayer to recognize a gain relating to a discount or premium when the gain is realized—that is, upon redemption or repayment of the loan. Thus, even if the discount or premium is taxed as interest, the recipient may still enjoy a significant deferral advantage over ordinary interest. Special accounting rules are needed to

[175]AUS ITAA (1936) § 160L.

deem the recipient to derive the gain represented by a discount or premium as if it were compound interest derived over the life of the loan.[176]

Second, special rules are necessary to prevent taxpayers from taking advantage of timing mismatches that can arise in accounting for the various forms of interest. For example, a mismatch can arise when a financial institution issues a security to an individual under which the payment of interest is deferred for, say, five years. In the absence of special rules, the financial institution may be permitted to deduct the interest expense as it accrues, while the individual accounts for the interest income when it is paid (under cash-basis accounting). To avoid such mismatches, it may be provided that both the lender and the borrower must account for interest income on an accrual basis, regardless of the taxpayer's general method of accounting. An exception may be provided if the interest is subject to withholding tax. Both the lender and borrower may be required in this case to account for the interest on a cash basis.[177]

Limitations on the deduction of interest expenses may be desirable for a number of reasons. In principle, like other expenses incurred to derive business income, interest expenses should be deductible in full. However, restrictions on interest expenses may be used

- to prevent taxpayers from exploiting the full deductibility of interest in periods of high inflation;
- to prevent taxpayers, particularly foreign taxpayers, from exploiting different tax rates on interest and dividends; and
- to prevent taxpayers from exploiting differences in the treatment of interest and capital gains.

Finally, in common law jurisdictions in particular, special rules may be needed to prevent taxpayers from exploiting the different treatment of "blended" payment loans and annuities.[178]

1. Inflation Benefits

In the absence of special rules on interest deductibility, taxpayers who borrow in a high-inflation environment may derive a significant tax advantage from debt financing. Most of what is nominally interest expense may in fact be repayment of a portion of the loan.[179] A system of

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[176]AUS ITAA (1936) §§ 159GP–159GZ; CAN ITA § 12(3), (4), and (9); ESP § 37 Uno 2(A) (rendimientos implicitos); but see, to the contrary, FRA CGI § 125-0 A (capitalized interest taxed only at the time of the expiration (*dénouement*) of the contract, so that the taxpayer has a timing advantage in capitalizing the interest).

[177]Some countries do attempt to apply accrual tax rules although the payment of interest is subject to withholding tax. When payment of interest is deferred by capitalizing it into discounts, premiums, or other forms of capital gains, the rules on withholding tax should provide that the tax becomes due by the payor on any portion of the gain, premium, or discount that has accrued during the taxable period. In such cases, withholding tax is to be paid on an annual basis before effective payment of the income. *See further* BEL CIR § § 19 (3), 267.

[178]*See supra* sec. III(A).

[179]*See* vol. 1, ch. 13, sec. IV(A).

global inflation adjustment can be used to address this problem.[180] However, because most countries will not adopt such a system, partial adjustment for interest could be considered, although the case for inflation adjustment of interest expense is not appreciably stronger than the case for inflation adjustment of the cost of inventory, depreciable assets, and other property. Nor is there a reason why inflation adjustment rules (or surrogate rules) imposed on borrowers paying interest expenses should not apply equally to lenders deriving interest income. Selective recognition of the effects of inflation on only one element of the business income equation will introduce new and potentially more significant distortions into the income tax system. This fact should be kept in mind when proposals for adjusting allowable deductions for interest expenses are evaluated.

2. Thin Capitalization

If the domestic company and shareholder income tax regime is based on a classical tax system, comprising separate taxation of company income and distributions to shareholders, there will be an incentive for taxpayers to invest by way of debt instead of equity. Distributions are thus deductible to the company and are taxed only once in the hands of investors. Extensive reliance on debt financing is known as thin capitalization.

Adoption of a partial imputation system reduces the incentive to recharacterize equity as debt and dividends as interest payments. Adoption of full imputation almost eliminates the distortion in respect of domestic shareholders, provided both dividends and interest are subject to similar tax treatment. If interest is subject to a different regime, such as low domestic withholding tax, shareholders in companies deriving income that will not carry imputation credits are likely to structure their investment as debt in order to convert their returns to interest.

Unless imputation is extended fully to all foreign shareholders, an incentive to engage in thin capitalization will remain for these taxpayers. Even then, a bias toward debt investment will exist if the final tax imposed on interest income is different from that imposed on dividends, as is often the case.[181] Alternative solutions to the problem of thin capitalization as applied to foreign shareholders are discussed in chapter 18.[182]

If rules designed to counter thin capitalization arrangements are to apply to all shareholders, they are best located in the statutory provisions applicable to companies. If the rules are to apply only to foreign shareholders, they can be included with other international tax measures. Thin capitalization rules can also be used in lieu of explicit inflation adjustment of interest expense, which may be considered too complicated to apply. In this case, the rules should apply to the deduction of all interest expenses.

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[180]*See* vol. 1, ch. 13, sec. IV(D).

[181]For example, lower rates of tax on interest, including zero rates, may be prescribed by treaty.

[182]*See infra* ch. 18, sec. (V)(G)(2).

3. Interest Quarantining

A problem confronted in many tax systems is the difficulty of matching interest expenses to corresponding income attributable to those interest expenses. Interest is generally deductible as incurred, while income is recognized as derived. Taxpayers may enjoy considerable tax benefits if they may deduct interest outgoings in the period before the years in which the resultant gains are taxed. The benefits are increased if the income qualifies for a preference—such as partial exemption, special rates, or inflation adjustment—while nominal interest is deductible in full against nonpreference income subject to ordinary rates of tax.

In some cases, it is relatively easy to identify the period of deferral of income. For example, an investment asset may yield no current income, its entire return taking the form of capital gains that will be taxed when they are realized. Another case is when interest expense is incurred to finance the construction of property, such as heavy equipment, a public utility plant, or a building. In this case, because of the passage of time, the taxpayer expects the finished project to be worth at least as much as the incurred costs plus interest on those costs up to the time the property is placed in service or sold.

Other cases of deferral may be more difficult to identify. For example, a taxpayer may acquire immovable property for the dual purposes of using it as business premises and deriving business income during the period of occupancy and of realizing a further gain upon disposal. Alternatively, a taxpayer may acquire property for the dual purposes of deriving rental income during the lease period and deriving a further gain when the property is sold at the expiration of the lease term. In these cases, the property is generating income that is currently taxed, but there is also an element of appreciation in value that will not be taxed until the gain is realized.

Two measures can be used to minimize the mismatch of interest deductions and consequent income. First, interest incurred in respect of the acquisition or construction of property before the property generates income can be capitalized into the cost base of the property. Second, quarantine rules can be applied to interest incurred to derive dual- element income, such as rent or business income and capital gain. Because investment income is most likely to involve dual elements, it is common to restrict quarantining rules to this type of income. Normally, quarantining will limit interest deductions that are incurred to derive investment income to the amount of investment income derived during the taxable year, with an indefinite carryover of undeducted interest. When taxpayers carry on business in a personal (not incorporated) capacity, it will be necessary to separate business credit from personal credit[183] Some countries, in principle, still permit unlimited deductions of interest even on personal loans,[184] which result in a considerable loss of revenue.

B. Finance Leases

[183]BEL CIR art. 14; CAN ITA § 20(1)(c); FRA CGI art. 31/1 (d); USA IRC § 25. The United States provision is considered by some commentators to be excessively complicated.

[184]*See* NLD WIB § 45/1 f, with some limitations in arts. 45/3 and 5; CHE: LIFD § 33(1)(a).

A lease is an agreement under which the owner of an asset (the lessor) grants another person (the lessee) the right to use the asset for a stated period. As consideration for the right, the lessee agrees to make rental payments to the lessor. At all times, the legal ownership of the asset remains with the lessor. The commercial accounting treatment of a lease and its tax treatment will depend on whether the lease is a "finance lease" or an "operating lease."

A finance lease[185] is an arrangement that is legally structured as a lease, but has the same economic effect as a sale on credit and purchase of the leased asset. Thus, under a finance lease, the lessor effectively transfers the benefits and risks of ownership of the leased asset to the lessee while retaining legal title in the asset. An operating lease is one in which the legal and economic ownership of the leased asset remains with the lessor so that the lease payments are genuinely for the use of the leased asset.

Under tax law, three broad approaches to the use of finance leases are adopted. One approach is to give effect to legal form, so that all leases are effectively treated as operating leases for tax purposes. This means that the lessor would be treated as the owner of the leased asset and thus the person entitled to claim depreciation and other deductions relating to ownership. The rental payments are treated as income of the lessor and a deductible expense of the lessee.[186]

The other two methods broadly accord with commercial accounting treatment of finance leases. In contrast to the strict legal approach, commercial accounting rules recognize the economic reality of a finance lease by treating it as a sale and purchase of the leased asset. Thus, the lessee (not the lessor) is treated as the owner of the asset, which is entered into the lessee's books as an asset of that taxpayer. The lessor is shown for accounting purposes as having made a loan to the lessee, the rental payments being treated as payments of principal and interest on the loan.

Treating a finance lease for tax purposes in the same way as other leases gave rise to arrangements under which such a lease could be used to transfer tax benefits from a person who could not use them to a taxpayer who could. Consider, for example, a person who wishes to acquire an item of substantial plant. The person does not have sufficient funds to self-finance the acquisition and will thus need to borrow. In the ordinary case, the person will be able to deduct the interest expense and claim depreciation deductions in relation to the cost of the asset. Suppose, however, that the person is not in a position to use these deductions, or at least not immediately. The person may not expect to earn enough income for several years to take advantage of the deductions, so that the benefit of the deductions is deferred. Alternatively, the person may be a tax-exempt entity, such as a government instrumentality, which cannot utilize the deductions at all. Another possibility, particularly in developing and transition countries, is that the person may be entitled to a tax holiday, and so, again, cannot use the deductions. In these cases, arrangements can be entered into whereby a financier acquires the asset and leases it to the

[185]The term finance lease is commonly used in tax literature. Commercial accounting rules use the term capital lease.

[186]*See* Gustav Lindencrona & Stephan Tolstoy, International Fiscal Association General Report, *Taxation of Cross Border Leasing* 21, 30 (75a Cahiers de droit fiscal *international*) (1990).

person under a finance lease. Because the financier is the legal owner of the asset, it is entitled to claim deductions related to ownership. The effect of the finance lease is to transfer the tax benefits associated with ownership to the financier, although, through the terms of the lease, the economic benefits and obligations are with the lessee. The availability of the tax benefits means that the financier is able to provide the lessee with a lower cost of funds. The arrangement, however, is detrimental to the revenue because it results in the full utilization of what would otherwise be unused tax benefits.

Tax law treatment of finance leases in a manner similar to accounting treatment can be accomplished in two ways. In some jurisdictions, courts will use general interpretation principles to read the tax law as giving effect to the underlying economic form of a lease, not its apparent legal form. In others, the tax law has been drafted to achieve this result explicitly.[187] It is recommended that this approach be adopted in developing and transition countries.

Tax laws drafted to achieve a result similar to commercial accounting practice should make it clear that for tax purposes, the arrangement is treated as a sale on credit from the lessor to the lessee, and so the lessee is treated as the owner of the property and the lessor as a financier. The deemed purchase price is the present value of the rental payments to be made under the lease, and the price is treated as financed through a loan from the lessor to the lessee. Each payment the lessee makes under the lease is treated as a repayment of principal and interest under the loan. The interest component is calculated according to actuarial methods on the principal outstanding at the commencement of each payment period, with the balance of the payment treated as repayment of the principal.[188] The interest component of each payment is treated as an interest expense of the lessee and interest income of the lessor.

The central issue is the determination of whether a lease is a finance lease. It is suggested that several alternative tests based on commercial accounting rules be prescribed. The essence of these tests is to identify cases where economic ownership of an asset effectively passes to the lessee. Under these tests, a lease will be treated as a finance lease if any of the following circumstances is present:

- The term of the lease (including any period under an option to renew) is equal to or greater than 75 percent of the estimated economic life of the leased asset.
- The lease contains an option to purchase the leased asset at end of the lease for a fixed or determinable price.
- The estimated residual value of the property to the lessor at the end of the lease term is less than 20 percent of its fair market value at the commencement of the lease.

[187]*E.g.*, CAN Income Tax Regulation 1100(1.1); LSO ITA § 68; UGA ITA § 60.

[188]*See supra* sec. III(A).

- The present value of minimum[189] lease payments equals or exceeds 90 percent of the fair market value of the asset at the commencement of the lease term.
- The leased property is custom-made for the lessee and, at the end of the lease term, will have little or no value to anyone other than the lessee.

C. Capital Gains

While the concepts of capital gains, their historical basis, and the terminology used vary from jurisdiction to jurisdiction, distinctions between capital gains and other gains are common. In many countries, capital gains (or certain categories of gains) are treated preferentially for tax purposes. Preferences may include lower rates, partial or even complete exemptions, averaging, and inflation adjustment that are not available for other gains.[190]

Even when capital gains are fully taxable in the same manner as other income, the distinction is often retained for the purpose of quarantining capital losses against capital gains. Quarantining is necessary because capital gains are taxed on a realization basis. In the absence of quarantining, taxpayers can defer the recognition of gains and accelerate the recognition of losses to reduce taxes payable on other income.

In some jurisdictions, the concept of a capital gain is legislatively defined, while in others (for the most part the United Kingdom and former U.K. colonies), it is largely a judicial concept defined by tests set out in case law. In former U.K. colonies, in particular, great care must be taken when drafting the definition of capital gains. One problem almost unique to these jurisdictions arises from the fact that the flexibility of property and contract law enables taxpayers to engineer many transactions to give rise to gains that would be characterized by the courts in some of the jurisdictions as capital gains under the governing judicial concepts and thereby excluded from the ordinary income tax base. Because these gains are not generated by disposals of property as those are normally understood, they can be brought into capital gains provisions only with terribly complex deeming provisions. A far simpler approach is to modify the definition of income to ensure that these gains are included in the tax base.[191]

In many jurisdictions, all gains derived from the disposal of assets by legal persons and from the disposal of business assets are treated as ordinary business income.[192] Under this

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[189]The term “minimum lease payments” is intended to include regular “rental” payments plus any supplemental mandatory payments (e.g., the amount of a lessee guarantee of residual value).

[190]*See* generally John King, *Taxation of Capital Gains*, *in* Tax Policy Handbook 155 (P. Shome ed. 1995).

[191]Australia provides an excellent example of the problems that can be encountered if capital gains provisions are used to catch gains that fall outside the judicial income tax base, such as payments for entering into negative covenant (noncompetition) agreements and payments for agreeing not to pursue contractual rights. In Australia, this was first attempted by resort to complex and highly artificial deeming provisions. The courts rejected them as virtually meaningless. A second, and more complex, redraft was needed. Rather than simply adding these gains to the ordinary income tax base, the government now proposes to replace the artificial deeming provisions with legislation defining capital gains "events."

[192]Examples include many European jurisdictions.

approach, capital gains derived in the context of a business are not subject to any preferences that may be available to individuals deriving capital gains on investment portfolios. Exceptions may be made for disposals involving the liquidation of the business, which may be taxed preferentially.

There is a large body of literature debating whether capital gains should be given preferred treatment or taxed at all, and it does not seem useful to repeat the arguments here. Any distinction between capital gains and other gains will of course involve definition problems. Long experience in OECD countries suggests that a completely satisfactory definition cannot be found. Inevitably, taxpayers alter their behaviour to exploit tax concessions in ways not originally intended by the legislation. Transactions are altered to recharacterize income not subject to the concession as gains that do qualify for special treatment. This, in turn, leads to calls for complex antiavoidance provisions, to considerable litigation, and to significant dead-weight losses from energies diverted to tax planning.

At the same time, in the context of limited administrative capacity in developing countries, there are persuasive arguments for excluding from the tax base many types of capital gains and losses derived by individuals. Because capital gains and losses may accrue over many years and are generally recognized on a realization basis, taxpayers may not have maintained adequate records for calculating the amount of the gain or loss. For this reason, and coupled with notorious difficulties of enforcement, it may be appropriate to exclude from the tax base most capital gains realized and losses suffered by individuals, apart from gains and losses attributable to assets, such as shares and other financial investments and immovable property. Other exclusions are desirable for tax policy reasons. Thus, for example, losses on personal-use assets such as cars and appliances whose value declines as a result of use should be excluded to ensure that taxpayers are not able to recognize capital losses on what is essentially personal consumption.[193]

The drafting approach adopted to achieve exclusion of these gains or losses will depend on the general drafting structure; whether a jurisdiction is based on a schedular or a global model; whether the background or judicial concept of income would otherwise include these gains or losses; and, if the jurisdiction uses a global income tax system, whether global taxation is achieved by means of separate inclusions for employment, business, and investment income. If the exclusions are to be legislated through a specific exclusion measure, that provision can refer to all nonbusiness assets owned by physical persons apart from listed assets (which would then include intangible property and immovable property). An alternative approach is to exclude personal-use property other than immovable property, with personal-use property defined as property acquired primarily for the personal use and enjoyment of a physical person or his or her family.

[193]Examples of jurisdictions with exemptions for these assets include Australia and Canada.

D. Farming Income

It is not unusual for jurisdictions to provide special rules for determining farming income, because of, in addition to political considerations

- the possibility that farmers will not retain business records in the same format as other businesses;
- the practical difficulties in auditing farmers;
- the difficulties of valuing farm produce and livestock inventory; and
- the fact that farmers are more likely than other business persons to take items out of inventory for family consumption.

An important consideration in the design of the farming tax regime will be the administrative capabilities of tax authorities. In developing countries in particular, surrogate measures of income using presumptive criteria may be the most efficient method of determining tax liability,[194] at the potential cost of some equity.

Special rules will also be needed to deal with consumption of a farmer's own produce. Several competing policies must be considered in this situation. It is arguable on equity and efficiency grounds that consumption of self-produced inventory should be treated as a disposal at market value. This policy would achieve equity between taxpayers who sell their produce to purchase other types of food in the market and those who consume their own produce. It would also eliminate a distortion in favor of consuming one's own goods as opposed to participating in the market. At the same time, however, it is true that persons other than farmers are able to produce foodstuffs for themselves without tax consequences. If the same treatment were accorded to farmers, it would be necessary to distinguish inventory from production intended for personal use. Also, it could be argued that farmers, by virtue of their knowledge of the industry, could purchase produce for a value much lower than the market price faced by other taxpayers.

These problems are most easily resolved by treating consumption of inventory as a disposal at cost instead of at market value or, equivalently, by disallowing a deduction for the cost of self-consumed produce.

E Non–Life Insurance Companies

Under a short-term[195] insurance contract, the insured person will pay a premium to the insurer as consideration for the insurer, upon the happening of a specified event within a given time, paying to the insured or a nominated person either an agreed sum or the amount of the loss caused by the event. The period of cover under the insurance contract is usually one year, after which the insurance contract is simply renewed. Depending on the sophistication of the local

[194] *See* vol. 1, ch. 12.

[195] Short-term insurance as used here includes property and casualty insurance and term life insurance, provided the term of insurance is not beyond one year or so. Life insurance with longer terms raises other issues that are beyond the scope of this book.

non–life insurance market, insurable risks may be limited to loss of property or may extend to virtually any risk other than loss of life.

The taxable income arising from short-term insurance activities is generally calculated in the same way as the taxable income arising from other business activities, with premiums derived included in gross income and claims incurred allowed as a deduction. However, three features of short-term insurance activities may justify special tax treatment. These are discussed below.

1. Income-Recognition Rules

Income-recognition rules must take into account that some part of the premiums received during a tax period will cover risks for a period after the end of that year (referred to as "unexpired risks"). This is because, in many cases, the period of the insurance policy will not coincide with the insurance company's tax year. The accounting practice is for insurance companies to treat a portion of their short-term insurance premium income received during a year as relating to unexpired risks as of the end of the year. This amount is not regarded as having been earned until the following year and, therefore, is excluded from their income for that year and included in income in the following year. A similar approach may apply for tax purposes. This may be an aspect of the accrual tax accounting rules,[196] or a specific deductible allowance may be provided for premiums in respect of unexpired risks (with a re-inclusion rule for the following year).[197]

2. Deduction-Recognition Rules

On the expense side, deduction-recognition rules must take into account the three types of claims that may arise during a tax year for a company carrying on a short-term insurance business. The first type of claim is one that arises and is paid out during the tax year. This is allowed as a deductible expenditure of the company. The second type of claim is one that arises during the year, but that has not been paid out as of the end of the tax year. This type of claim is also allowed as a deduction under accrual tax accounting on the basis that the obligation to pay has arisen during the tax year. The amount of deduction is based on established insurance practice for assessing the likely amount payable on a claim. The third type of claim is one that is unreported as of the end of the tax year; it relates to an event that has occurred during the tax year but that has not been reported to the insurance company, either because a third party has not made a claim against the insured or because the insured has not reported the claim or the happening of the event. This type of claim may also be allowed as a deduction under accrual tax accounting on the basis that the happening of the event crystallizes the liability of the insurance company to pay, even though the claim has not yet been reported to the company.

3. Contingency Reserves

[196]Premiums paid in respect of unexpired risks may be treated as unearned income.

[197]E.g., UGA ITA § 17 and fourth sched.; ZAF ITA § 28(2); ZMB ITA §25 and third schedule.

For financial accounting purposes, companies carrying on short-term insurance retain a contingency reserve to meet the exceptional level of claims that may arise from a catastrophe. It is not recommended that a deduction for tax purposes be allowed on the basis of the creation of a contingency reserve for financial accounts purposes. As noted in section II(B)(1), reserves are used in financial accounting to provide an accurate picture of the long-term profitability of a business. Tax accounting, on the other hand, is concerned with the accurate measurement of net gains on an annual basis. The establishment of a contingency reserve does not represent a sufficiently certain liability to be recognized for income tax purposes.

VII. Administrative Aspects of Taxing Business and Investment Income

Taxes imposed on income from business are normally self-assessed,[198] which imposes on the taxpayer, in the first instance, responsibility for calculating taxable income and the tax due on that income and for making installment payments at designated times. The taxpayer's calculations are reviewed by revenue officials when returns are filed and may be subject to further audit. The self-assessment system may be supplemented by a withholding system applicable to certain business payments. The withholding system is discussed further below.

A. Advance Payments of Tax

The most crucial element of the system for collecting business tax is the formula for determining installment payments. The object of the system is to require businesses to pay tax on a regular basis throughout the year as income is derived, not when final liability is determined after the end of the tax year. This formula ensures revenue flow to tax authorities, prevents deferral of tax payment, and minimizes the risk of disbursement of income before the appropriate proportion is remitted as payment of a tax liability. Related issues are mechanisms for adjusting payments if the taxpayer's business income changes during the year and reconciliation of installment payments with the final tax liability.

The frequency with which installments of business income tax must be made varies significantly among countries. In many jurisdictions, different frequencies are used for different types of businesses (unincorporated or incorporated) or different sizes of businesses (based on taxable income or turnover). The use of variable installment payment frequencies has two objectives: (1) to minimize administrative costs for smaller businesses; and (2) to reduce financing charges for smaller businesses that face a number of biases in the capital market and, accordingly, tend to place greater reliance on cash flow to fund ongoing operations. In light of these objectives, a frequency distinction based on the size of a business is more logical than one based on legal form. However, rules based on size may be manipulated by taxpayers establishing multiple companies. This practice may be combatted through consolidation rules, but this tends to add complexity to the system. An alternative approach is to base payment schedules on a combination of business size *and* form. The simplest approach is to use the same

[198]In other words, the taxpayer determines (assesses) the amount of tax due and files (lodges) the tax return.

rule as that used to determine when businesses are required to use accrual accounting, or to use the same form of rule with a different threshold.

There are four basic models for the formula used to determine business tax installments. Two systems rely on the previous year's taxable income as the basis for estimating the taxable income of the current year, and two use data from the current year to estimate total taxable income for the year.

The simplest system is based on the previous year's taxable income, divided by the number of installments. (Alternatively, the formula can be based on the previous year's tax liability, adjusted, if necessary, by any change in tax rates.) A slightly more sophisticated system is one based on the previous year's taxable income (or tax liability), adjusted by an "uplift" factor that is based on the actual or projected inflation rate or on a measurement of expected growth in nominal incomes generally.[199]

The simplest system relying on current-year data is based on records of turnover for the installment period. The turnover for the period is multiplied by the ratio of the previous year's taxable income to turnover for that year to estimate the probable taxable income that will ensue from the known turnover for the current year. A more sophisticated system draws on an estimate of actual taxable income for the year based on income derived and expenses incurred in the year until the end of the installment period.

Systems for determining installments on the basis of the current year's income provide a more accurate calculation of a taxpayer's probable total liability for the year and the appropriate installment payments to be made. However, the potential administrative burden they impose on taxpayers is considerably greater than for systems based on the previous year's income. Also, these systems, particularly ones based on a running determination of taxable income for the year, are possible only if taxpayers have access to relatively sophisticated accounting and tax expertise. Accordingly, a system based on actual income for the year is more easily applied in industrial countries than in developing or transition economies. Nevertheless, a number of transition countries require payment of tax according to results for the current period.[200]

Systems based on income of the current year are self-adjusting in terms of changes in business fortunes. If the taxpayer uses prior-year information to calculate liability for current-year installments, some adjustment mechanism is needed if the taxpayer's taxable income for the year is likely to differ significantly from the estimated income on which installments are based. To protect taxpayers from undue hardship in the event of falling business income, the taxpayer should have the option of nominating an expected taxable income that is lower than that yielded by the presumptive formula or of altering the estimate downward if circumstances make this appropriate during the year. Rigorous interest and penalty measures will discourage taxpayers from deliberately nominating lower-than-expected incomes to reduce installment payments and thereby deferring payment of some tax until a final reconciliation payment at the end of the year.

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[199]The uplift system is used, for example, in Australia for individuals deriving business and investment income.

[200]*See* KAZ TC § 51.

These measures should impose a charge significantly higher than the prevailing interest rate to ensure that taxpayers do not use underestimation as a means of securing finance (in effect "borrowing" tax due until the close of the year). Countries with serious tax collection problems may not want to provide any option for taxpayers to reduce required installments, if there is a concern that any reasonable penalty would be ineffective in deterring abuse of such an option.

While most installment systems that are based on taxable income of the previous year provide taxpayers with the option of substituting a lower estimate of expected income, it is not usual to require taxpayers to uplift their estimates if financial information during the year indicates that income will be greater than that yielded by the presumptive formula.[201] Not requiring taxpayers to uplift provides taxpayers with a deferral advantage in times of increasing income. To avoid the problem, taxpayers can be required to use an installment calculation system based on current-year information, such as turnover.

One particular problem with both systems is that of taxpayers commencing business. In the absence of any special provisions, these systems allow such taxpayers to defer tax on the income derived in the first year until the end of that year. Because it is common to allow taxpayers to substitute lower estimates when they believe income is falling, taxpayers leaving business suffer no corresponding overpayment of taxes when closing business operations. Although the deferral by taxpayers commencing business undermines the installment system, most jurisdictions that rely on a formula of installment payments that is based on statistics from previous years do not make any effort to address the problem. Because taxpayers commencing businesses are not likely to earn substantial profits in the first year, the approach of not providing a special rule for these taxpayers is justifiable. However, the absence of a special rule may provide significant windfall benefits to some categories of taxpayers, such as lawyers or accountants, who are invited to join the firm as full partners (and hence become business proprietors). It also opens a potential door to abuse if business owners move the business operations to a new company on a regular basis (or even annually) to defer payment of tax. However, this is not likely to emerge as a serious problem until an economy is fairly advanced.

B. Withholding

A domestic withholding system can be applied to payments made to some self-employed persons, although it is not administratively possible to apply such withholding taxes to all payments made to those persons. For example, given that the tax is withheld by the payer of the income, it is not feasible to apply the tax to all payments to a self-employed person with a large number of small-value customers, particularly nonbusiness (i.e., final-consumer) customers. Even if such customers complied with their obligations to withhold the tax and remit it to revenue authorities, matching the large number of small withholdings to particular taxpayers would be an extremely onerous task for the administration. Withholding tax on self-employed persons, therefore, is usually confined to those industries with a small number of business customers. Even then, there is generally a value threshold before withholding applies and,

[201]Provisions for uplift estimates need not be explicit. The United States imposes an implicit requirement by levying additional tax on large corporate taxpayers whose estimated tax payments are less than actual tax. *See* USA IRC § 6655(d)(2).

possibly, an exclusion for contracts with nonbusiness consumers. The most common industries to which withholding tax applies are construction and transportation.[202] An exception may be provided for taxpayers with a satisfactory compliance record. Consolidation measures may be needed to prevent taxpayers from splitting contracts into multiple contracts, each generating payments below the withholding threshold.[203]

Withholding on payments to self-employed persons is generally at a flat rate applied against the gross amount of the payment. Because the rate is applied against gross income, some amount of deductions is notionally taken into account in determining the rate. This is important because taxpayers in the industries to which such withholding applies are likely to claim substantial deductions for the cost of inputs. If the rate of withholding on gross receipts is set too high, then the withholding tax may ultimately exceed the taxpayer's chargeable income for the year of assessment, causing serious cash- flow problems for the taxpayer.

Withholding on income derived by self-employed persons who are resident taxpayers will generally not be a final tax. A taxpayer will be required to file a return showing taxable income for the tax year and tax payable thereon, and a tax offset will be given for the withholding tax.

C. Withholding on Income from Capital

Final withholding taxes on gross income are the usual method for assessing nonresidents on income from capital. A final withholding tax means the recipient is not required to file a return or face additional assessment in the source jurisdiction with respect to income subject to the tax. The recipient may be subject to additional tax in the recipient's country of residence. In most countries, final withholding taxes are imposed on interest and dividends paid to nonresidents. They are often extended to royalties and less commonly to rental income paid to nonresidents[204] and to distributions from trusts.[205]

The use of final withholding taxes on income from capital paid to resident taxpayers is a growing phenomenon, but the practice is far less common than for nonresidents. Reluctance to use final withholding taxes for resident taxpayers primarily stems from equity concerns. The use of any flat rate will prejudice taxpayers whose incomes would be subject to lower rates if the ordinary rate structure were applied and will provide a windfall to taxpayers whose incomes would otherwise be subject to higher rates.

The widespread use of final withholding taxes on different categories of income effectively creates a schedular system with what are, in effect, separate taxes on different

[202] *E.g.*, AUS ITAA (1936) §§ 221YHA–221YHZ.

[203] *See, e.g.,* Regulations for the Implementation of the Individual Income Tax Law § 21 (State Council, People’s Republic of China, Jan. 28, 1994) (consolidation of payments).

[204] *See*, *e.g.*, CAN ITA §§ 212(1)(d), 215(1).

[205] *See*, *e.g.*, CAN ITA § 212(1)(c).

categories of income. The system may, in fact, become a hybrid system with flat-rate taxes on some categories of income and progressive rates on others. In theory, the system may be designed so as to minimize the loss of progressivity by applying withholding taxes as a final tax only if the taxpayer's income is primarily of the category subject to progressive rates (and therefore not subject to final withholding taxes)[206] In practice, however, such a system would be difficult to implement.

There is no doubt that final withholding taxes on income from capital are preferable from the perspective of administrative simplicity. As was noted in chapter 14,[207] flat-rate withholding taxes on income from capital may not undermine progressivity as much as feared. The important point is that, if income from capital is segregated in this manner, taxpayers are unable to minimize tax by mismatching gains and losses and exploiting inconsistencies in timing or treatment of different types of expenses and gains. In fact, some studies from Scandinavia hold that the movement toward "dual income taxes" (i.e., flat-rate taxes on some types of income from capital and progressive rates on other income) may actually increase progressivity by precluding taxpayers from exploiting arrangements to minimize their tax in these ways.

The choice between separate withholding taxes or ordinary assessment for income from capital will depend on a range of political and administrative considerations. Essential to the effective functioning of either system is a high-integrity taxpayer identification number (TIN) system. This is important for an ordinary assessment system for auditing purposes. The TIN system serves several different functions if withholding taxes are used. One purpose is to facilitate auditing. While tax authorities may no longer be concerned with attributing income from capital to the correct taxpayer if final withholding taxes are used, they will be interested in comparing income from capital with other income sources to ascertain whether the taxpayer declared enough income to explain the investments now generating investment income.

A second purpose of TINs in a system that uses withholding taxes is to give taxpayers the option of filing in appropriate cases. While optional filing complicates the administration of the withholding tax, it can be used to protect the interests of lower-income taxpayers who are subject to ordinary assessment tax rates that are less than the withholding tax rates. It can also be used to protect taxpayers who incur significant expenses to derive their income from capital. This may be the case with, for example, taxpayers deriving rental income.

An alternative to optional filing sometimes mooted to protect lower-income taxpayers from the impact of withholding taxes that are higher than their marginal tax rate is a limited exemption from withholding. The exemption is usually suggested for interest on accounts in financial institutions up to a designated amount. However, because it is impossible for financial institutions to know of other accounts that depositors may hold, higher-income taxpayers are likely to exploit the exemptions by opening multiple accounts. A high-integrity system of

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[206]*See*, *e.g.*, Charles McLure & Santiago Pardo, *Improving the Administration of the Colombian Income Tax, 1986-88, in* Improving Tax Administration in Developing Countries 124, 126–27 (Richard Bird & Milka Casanegra eds. 1992).

[207]*See* footnote 28 and accompanying text in that chapter.

taxpayer identification numbers will enable tax authorities to identify these cases, but a very sophisticated system for cross-referencing data is required. Also, additional tax can be collected only by means of an assessment levied on appropriate taxpayers. The use of mandatory withholding tax coupled with optional filing by lower-income persons is administratively simpler, because it transfers the onus for further action to the taxpayer. Such a system would not be desirable, however, if a large number of additional returns had to be filed. Either system can be used to identify taxpayers who may be involved in shifting arrangements. Appropriate targets for antishifting audits can be identified by comparing claims for lower or zero tax rates with returns of spouses and other family members.

Optional filing for income from capital raises a number of issues. First, it must be decided whether optional filers can elect to have a lower or zero withholding tax imposed or whether they are subject to the withholding tax, with the two being reconciled after the tax year when a return is filed. In that case, a refund of excess withholding tax may be made. Allowing taxpayers to seek a lower or zero withholding tax rate by submitting an appropriate form to income payers ensures that there is no overpayment of tax during the year. However, such taxpayers would have to be required to file returns at the end of the year to ensure that they are entitled to the lower rates or exemptions they claim. This further filing imposes some burden on taxpayers and an additional administrative burden on income payers, who must provide revenue authorities with details of all cases in which taxpayers seek lower withholding rates or exemptions. It also imposes further administrative burdens on tax authorities, who must cross-check with individual returns those cases of lower or zero withholding rates in order to ensure that taxpayers are entitled to the benefits they claim. Measures are needed to discourage taxpayers from deliberately or inadvertently claiming entitlement to lower or zero withholding tax rates. These include interest payable on the deferred payment of tax and penalties depending on the culpability of the taxpayer. Finally, if the choice is between an exemption from withholding and full withholding, taxpayers subject to tax rates even only slightly below the withholding rate would enjoy a significant deferral on their tax liability.

If taxpayers are not given the option of seeking lower or zero withholding rates subject to reconciliation when a return is filed, it must be decided whether refunds of withholding tax should be accompanied by compensation for the use of the taxpayer's funds prior to the refund. Compensation in the form of interest imposes additional administrative burdens on tax authorities, but promotes equity. Only a limited number of persons are likely to file returns to obtain refunds.

If the system of mandatory withholding tax subject to reconciliation when a return is filed is adopted, an exception should be made for exempt taxpayers, who should be able to claim an exemption in any case. Also, the final withholding tax should not be used for interest paid to financial institutions, because these taxpayers will incur significant expenses to derive interest income and their net margin on interest payments will be much smaller than the gross payment.

It is not necessary to choose between a final withholding tax and a withholding tax subject to reconciliation for all classes of income from capital. For example, a final withholding tax can be imposed on interest income and dividends, while taxpayers subject to a withholding tax on rent can be allowed to file a return and seek reconciliation if withholding tax rates are higher than the taxpayers' personal rates.

The taxation of income from royalties is complicated because royalties encompasses several conceptually different types of payments, which are classified differently by different countries.[208] The categorization is important, not so much for the definition of income as for the deduction of losses and expenses. The extent to which taxpayers incur expenses to derive royalty income will vary significantly depending on the type of royalty. Depending on the structure of the tax system and the characterization of royalty income, taxpayers may be entitled to deductions for itemized expenses, a standard deduction, or no deduction at all. This treatment will in turn determine whether a withholding tax can be applied to some or all types of royalties.

If royalties are assessed under a schedular tax system or are subject to a final withholding tax, there is a good case for an effective tax burden in line with the maximum tax rate in the personal income tax and the normal rate of corporate income tax. Any substantial discrepancy between the tax rate for royalties and the rates for other income will cause taxpayers to recharacterize payments as royalties, or as something other than royalties, depending on which alternative leads to the lowest tax burden. Also, any preferential treatment or rates for royalties will encourage multinational businesses to withdraw profits in the form of royalties rather than as dividends or interest.

[208] *See supra* sec. III(C).

Appendix.Relation Between Tax and Financial Accounting Rules

A. Introduction

Commercial companies keep accounts for the information of their owners and creditors. These reflect the assets and liabilities of the company on a balance sheet as well as the profits for the preceding year. The relevance of a company's profits for commercial accounting purposes and for tax purposes is broadly similar. For purposes of the income tax, profits are considered to constitute taxable capacity. Profit is, of course, an imprecise concept. It is a temporal concept, requiring measurement against a defined period of time. Although the basic purpose of measuring profit is shared by commercial accounting practices and by the tax rules, the purposes of tax and financial accounting are not exactly the same. Because of these differences in purpose, and in the light of different legal and commercial traditions, different countries have developed different systems for relating the tax rules and the commercial accounting rules.[209] How they do this is a critical issue for the drafting of the rules for determining business income. At one extreme, business income can be measured according to an entirely self-contained set of rules that are included in the income tax law and regulations. At the other extreme, the income tax law can state simply that income for tax purposes is the same as income as determined under the rules for commercial accounting. As we shall see, in practice most countries adopt a combination of rules.

B. Evolution of Commercial Accounting Rules

In the two centuries since joint-stock companies came to be widely used, pressures have been applied to define how business profits are identified. Membership of businesses has been drawn more widely, and members now require formal checks on the accounts of their businesses. External controls have been imposed, usually by legislation, and include independent audits. Further, many members of a business are portfolio investors, requiring—as do the markets—greater transparency of performance of a business. These accounting regulations have not been applied universally: smaller corporate businesses and noncorporate businesses are often exempted wholly or partly from these obligations.

The original lack of a required form of accounting has been replaced in all OECD countries by a combination of law and accounting practice designed to produce some consistency and objectivity in the presentation of company accounts. There are, however, distinct national differences both in the rules and principles adopted and in the legal or professional forms that those rules and principles have taken. The tendency in civil law countries has been to adopt rules within the commercial code or a law on accounting. By contrast, in common law countries, much of the content of accounting rules has been left for professional bodies or expert committees to produce.

[209]*See generally* Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 50–51, 195 (1992); Guido de Bont et al., Fiscal Versus Commercial Profit Accounting in the Netherlands, France, and Germany (1996).

Accounting laws and practices are being coordinated at regional and international levels, as well as being imposed more strictly at the national level. A comparative discussion of the effectiveness of accounting standards for tax purposes may start with an examination of the International Accounting Standards (IAS), produced since 1973 by the International Accounting Standards Committee, an autonomous body, but associated with the International Federation of Accountants (IFAC), a nongovernment body of professional accountants. Some thirty standards have been issued—a mixture of general principles (e.g., prudence, substance over form, and materiality)[210] and specific rules (such as the information to be disclosed in financial statements).[211]

Within Europe, the countries of the European Union apply a series of company directives that require set principles and formats for company accounts.[212] Some officials of the European Commission attempted to adapt some of these rules into a format to provide a common definition of the tax base for income tax, but the attempt failed even to secure support within the Commission and was never officially published.

Progress has been made in recent years, but accounting norms are inconsistent, incomplete, and evolving. It is too early to expect a common definition of profit at the international level, although one is starting to emerge. But for public companies in states with developed capital markets, there are standard formats, principles, and rules for presenting accounts. The growing internationalization of business reinforces this trend.

C. Current Practice

1. Overview

Some states base their determination of the taxable capacity of companies on the commercial accounts of those companies. In these states, the precise form of company accounts is typically laid down in the commercial code. Subject to some specific exceptions in both tax legislation and jurisprudence, compliance with the commercial law also amounts to compliance with the tax laws, and tax is levied accordingly. The profit that the company declares to the market is closely related to the profit on which it is taxed (although, in practice, the extent of the profit declared to the market may be driven by tax considerations).

Other countries have a tax definition of profits that may be markedly different from the company's own view of its profitability for the purposes of payments of dividends and publication to the market. Historically, these countries have taken a more relaxed view to the detailed form of company accounts for general legal purposes, but have imposed rules requiring specific accounting treatment of both additions and diminutions to wealth for tax purposes only. With limited exceptions, what a company does for accounting purposes is totally irrelevant to its income tax position. As a consequence, the income tax law and regulations must govern in detail

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[210]IAS 1.

[211]IAS 5.

[212]*See* particularly the Fourth Company Directive—78/660/EEC, and the Seventh —83/319/EEC.

the methods of accounting for all the elements that enter into the determination of taxable income.

To clarify the matter, we will review the rules applicable in Canada, France, Germany, the United States, and several transition countries. The topic is a complex one, and the reader should be warned that the discussion below does not capture all the subtleties of each system, which would require a much more in-depth examination.

2. Germany

In Germany, the Commercial Code provides that companies of a specific size are required to keep double-entry books.[213] Fairly detailed rules are provided for how these accounts are to be kept. If an issue is not specifically governed by a written rule, it is to be resolved according to principles of orderly bookkeeping.[214] For tax purposes, determination of taxable income starts with the accounting balance sheet. Specifically, taxable income is determined under the net worth comparison method.[215] The net worth method uses the net worth (assets minus liabilities) in the opening and closing balance sheets for the taxable year.

The basic idea of the net worth method is that taxable income is the difference between closing net worth and opening net worth. It is also, however, necessary to subtract those items that increase closing net worth but that should not be included in taxable income (e.g., tax-exempt receipts and contributions to capital) and to add items that decrease closing net worth but that should not be deductible in determining taxable income (e.g., dividends).

[213]The discussion in this section is based on Brigitte Knobbe-Keuk, Bilanz- und Unternehmenssteuerrecht (9th ed. 1993).

[214]Handelsrechtliche Grundsätze ordnungsmäßiger Buchführung (GoB).

[215]*See* vol. 1, ch. 13, for further discussion of the net worth method. The net worth method is set forth clearly in the income tax laws of France and Germany. *See* FRA CGI § 38; DEU EStG § 4. Under certain circumstances, certain types of income are determined as the difference between income and expenses, instead of being determined by the net worth method. Those familiar with the Haig-Simons concept of income, which also uses a net worth concept, may misunderstand what the net worth method involves. Unlike the Haig-Simons concept, the net worth method generally does not involve mark-to-market taxation, because it uses the book value, rather than the fair market value, of assets on the balance sheet in determining net worth (except in cases where book value is determined according to fair market value).

Accordingly, taxable profit for the year is

(i) the amount of net worth reflected in the closing balance sheet, less

(ii) the amount of net worth reflected in the opening balance sheet, less

(iii) contributions to capital and other receipts that are not taxable, plus

(iv) withdrawals made in favor of the owners and expenses that are not deductible.

There are two questions for each item of the balance sheet: (1) should the item be included as an asset (or liability) and (2) if so, how should it be valued? As to both issues, the general rule is that for tax purposes the treatment in the accounting balance sheet applies unless there is a specific rule to the contrary in the tax law. In some cases, the taxpayer has a choice under the accounting rules as to how to treat an item. In these cases, having made an election for accounting purposes, the taxpayer is bound to follow the same treatment for tax purposes. Once the return has been filed, changes to the accounting treatment are permitted only under limited circumstances. If the treatment of an item on the balance sheet is contrary to the accounting rules, then the taxpayer may make the correction. If the treatment results from an option under the accounting rules, the taxpayer may change the treatment for tax and accounting purposes only with the consent of the tax authorities. Even if the tax law specifically authorizes a favourable treatment of an item, it has been provided that the treatment is not available unless the same treatment is applied for commercial accounting purposes.

In a number of specific cases, however, the tax law specifies that the treatment of an item for tax purposes differs from that applicable for accounting purposes. These concern particularly the allowance of deductions. The tax law also contains relatively extensive rules for valuation of property, which apply instead of the accounting norms.

The consequence of this legal structure is that, in the absence of a specific rule in the tax law, the treatment of an item for income tax purposes is governed by the rules in the commercial code. If this does not contain a specific rule, then the "principles of orderly bookkeeping" apply. It is the principles of accounting practice, rather than specific tax principles, that are consulted in disputes about determining taxable income.

3. France

France also uses the net worth comparison method of determining taxable business income for companies keeping double-entry books.[216] Although tax accounting follows commercial accounting, the application of this principle has been somewhat different from that in Germany. This results from the fact that in France the commercial accounting rules were not codified in the commercial code until relatively recently (1983). Thus, while there was a doctrine that tax and commercial accounting should be the same, absent express provision to the contrary

[216]The discussion in this section is based on Mémento Pratique Francis Lefebvre Comptable 1991, at 28–30 (1990).

in the tax laws, in practice it was left to the tax laws and to courts interpreting the tax laws to develop accounting principles. Thus, for example, the principle of *créances acquises et dettes certaines* (accrued receivables and fixed liabilities)[217] was developed as an interpretation of the tax law to govern the timing of accrual.

Now that fairly detailed accounting rules have been codified in the commercial code, France is in approximately the same position as Germany. Future questions about tax accounting will presumably be handled with reference to the rules of commercial accounting. Of course, if the legislature does not like court decisions applying those rules for tax purposes, it is always free to provide specific contrary rules that will apply for tax purposes.

4. United States

The United States represents an example of the opposite extreme from France and Germany. The tax laws of the United States contain no general principle relating commercial accounting and tax accounting. This means that all of the principles of tax accounting must be contained in the Internal Revenue Code and regulations (or must be derived by courts from interpretation of this legislation). There is a separate concept of tax accounting, which is similar to commercial accounting in that it follows the principle of continuity: the taxpayer cannot generally change the method of accounting without the permission of the Internal Revenue Service. In a few special instances, tax provisions have been made applicable on condition that the taxpayer follow the same method of accounting for commercial accounting purposes (e.g., LIFO).[218] And the minimum tax has been based on income as determined for financial accounting.[219] But apart from these special provisions, tax rules are independent.

5. Canada

In Canada, the definition of taxable income by reference to generally accepted accounting principles was proposed but rejected in 1947.[220] Despite the failure to enact this language, the concept of generally accepted accounting principles has been important in the interpretation of

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[217]This is approximately equivalent to the "all events" test for accrual accounting in the United States. *See* Treas. Reg. § 1.446-1(c)(1)(ii) ("Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability").

[218]*See* USA IRC § 472(c).

[219]*See* Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085, 2326, sec. 701 (1986). The relevant provisions, codified at IRC § 56(f), were subsequently repealed.

[220]*See* Brian Arnold et al., Canadian Income Tax 290 (19th ed. 1993).

the income tax law.[221] This means that while there is not strict conformity between commercial and tax accounting, there should in practice be a fairly close correlation between the two.

6. Transition Countries

Countries in transition have had to address the relation between tax and commercial accounting rules at a time when both are at an early stage of development. A number of countries have followed the French/German approach. For example, in the Czech Republic, Latvia, the Slovak Republic, and Slovenia, the law explicitly refers to commercial accounting as the basis for tax accounting absent specific provisions to the contrary in the tax law.[222] In Estonia, the statute says nothing about conformity between financial and tax accounting and delegates to the Minister of Finance the specification of the accounting rules.[223] However, the regulations issued under this authority call for income measurement according to the accounting norms, unless otherwise specified by the tax law.[224]

The techniques for linking the definition of taxable income to accounting differ depending on the form of the definition. If taxable income is defined on the basis of net worth comparison, there is a reference to the balance sheet in the definition of taxable income, which can be interpreted without further specification as referring to the accounting balance. In countries where taxable income is defined as the difference between receipts subject to tax and deductible expenses, the usual practice is to state that taxable income is the same as commercial accounting income, with the modifications stated in the tax law.

In Russia, Kazakhstan, and other countries whose tax legislation is influenced by the Russian legislation, the traditional approach has been for the same set of accounting rules to apply for all purposes, including taxation. Thus, under the system that applied in the former Soviet Union, the question of the relation between tax accounting and financial accounting could not even be raised, because there was simply one accounting system. The system was spelled out in detail, leaving little or no room for independent judgment by accountants. When new tax laws were adopted at the time of the splitup of the Soviet Union—and because these were modified thereafter—the tax laws often did contain accounting rules (referring to income being determined as the difference between taxable receipts and deductible expenses), which on their face appeared to make the tax laws independent of the financial accounting norms. However, the new tax rules were by and large interpreted in the light of prior practice, that is, as requiring the accounting norms to be applied for tax purposes. At the same time, financial accounting was undergoing often radical reform to bring it into line with international practice. This reform has proceeded at quite different paces in different countries that were formerly part of the Soviet Union. At the time of writing, there is accordingly some uncertainty as to the current or

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[221]*See* Brian Arnold, *Canada*, 10 Tax Notes Int'l 1533 (May 1, 1995); Brian Arnold, *Supreme Court of Canada Discusses Financial, Tax Accounting*, 16 Tax Notes Int'l 730 (March 9, 1998).

[222]*See* CZE ITA § 23(2); SVK ITA § 23(2); LVA EIT § 14; SVN PT § 9.

[223]*See* EST IT § 37(1).

[224]Instructions on the Payment to the Budget of Income Tax on Enterprises, § 5.1.

prospective relationship between tax and financial accounting in these countries. The situation is quite difficult during the transition; in some cases, tax laws have been reformed in advance of accounting reform, so that it is difficult for tax law to refer to accounting practice, which is not fully developed or appropriate for the new tax legislation.[225] Some advisors would in any event prefer to separate tax from accounting. Once accounting reform has been undertaken and accountants have been trained in the new methods, it will be easier to specify a more permanent relationship between tax and financial accounting.

D. Choice Among Different Approaches

As the above review suggests, the relationship between tax and accounting norms differs substantially from one country to the next. It cannot be said that there is one right or best practice for a particular country. The general approach to be pursued in a particular country will be heavily influenced by tradition, and it is usually best to respect the practice with which tax officials and accountants are familiar rather than trying to impose something different because it follows the personal preference of a foreign advisor. Moreover, the state of development of accounting practice is relevant in deciding the extent to which it makes sense to rely on commercial accounting rather than on autonomous tax rules. Within each country's paradigm, however, it is possible to make a number of adjustments so as to assure a solid revenue base. For example, in countries that will be starting with accounting profit, it is important to limit the reserves that are deductible for tax purposes. A number of transition countries have adopted the effective approach of not allowing deductions for reserves unless they are specifically enumerated in the tax law.[226] The reserves allowed can then be limited to those for bad debts (perhaps only for banks) and those for insurance companies. Even these reserves should be carefully circumscribed, but the issues required to do so are beyond the scope of this book.

In addition, in a system that relies generally on the accounting norms, it is possible to provide for any number of deviations from those norms when considered appropriate for tax purposes, although administrative convenience should be taken into account. For example, different rules can be provided for depreciation. To the extent possible, tax and accounting calculations should be on the same basis so as to reduce unnecessary paperwork. In the case of depreciation, accounting norms may provide a number of options to the taxpayer. However, from the point of view of tax policy, it is generally considered preferable to have a single set of rules that apply to all taxpayers. Therefore, it may in any event be impossible to achieve total conformity between tax and accounting norms in this regard.

[225]This is why the tax codes of Georgia and Kazakhstan, and the enterprise profit tax law of Ukraine, do not refer to accounting norms (unlike the Latvian law, accounting reform in that country having proceeded at a much more rapid pace).

[226]*See* ROM PT § 4(3); LVA EIT § 6(3); GEO TC § 52(2); KAZ TC § 18(2).