UNIT3:

TAXATION SYSTEMS

3.1 GLOBAL, SCHEDULAR AND MIXED SYSTEMS OF TAXATION

Three main systems are used for the charging of tax on income – the global system, the schedular system and the mixed system.

Global System

A global (or unitary) system of taxation is one in which a single tax is imposed on all income, whatever its nature. For example, income earned by a person in form of salary, interest, rentals and royalties will be aggregated and subjected to a single tax rate. In the benchmark global system, there is no matching of particular types of income to the expenses incurred to derive the income. All income and expenses are considered together to arrive at a single net gain that is subject to tax. Thus, under a pure global system, the category of income is irrelevant.

The global system is popular in developed countries. It is considered fairer and achieves equity in taxation as it is possible to take into account the personal circumstances of each taxpayer. As such there is more compliance by taxpayers in such a system.

Schedular System

A schedular system of taxation is one in which separate taxes are imposed on different categories of income. In the benchmark schedular system, gross income and deductible expenses are determined separately for each type of income; in some cases, limited deductions or no deductions may be allowed. The rates of tax applicable to each category of income are then applied to the taxable amount of the income. The rates of tax may vary from category to category, for example, salaries may be categorized under one schedule and taxed at certain rates, dividends may also be categorized under a separate schedule and subjected to their own tax rates, etc.

Different procedures may apply to each category of income for the reporting, assessment, and collection of tax. Some types of income may be taxable only through withholding; others may involve the filing of returns. Schedular systems used to be more widespread; a few countries still have such a system, or one with substantial schedular elements. For example, Burundi, the People's Republic of China, Eritrea, Ethiopia, Lebanon, Romania, Rwanda, Somalia, Sudan, the Republic of Yemen, the Democratic Republic of Congo and Zambia have a substantially schedular system of income tax, in which different rate schedules apply to different major categories of income.

The schedular system does not take into account personal circumstances of the taxpayer and therefore is considered not to be a fair system of taxation.

Mixed System

The “mixed” or “composite” system combines the features of a global system and the schedular system.

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

(a) The separation of a taxpayer’s income into more than one tax regime may make it difficult or impossible to impose progressive taxation and to provide for personal tax relief (in the form of exemptions, deductions, or rebates). Progressive taxation is commonly seen as the most effective way of levying taxes on an ability-to-pay basis, and to the extent that ability to pay is indicated by an increase in total economic capacity, the tax should be levied on a taxpayer's total income. Under a schedular system, a progressive marginal rate structure may be applied to some categories of income only, leading to inequities between taxpayers who earn different types of income. Similarly, under a schedular system, personal tax relief must be either applied wholly against one category of income, such as employment income - in which case the relief may not be fully effective - or divided among various categories of income, which increases complexity.

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

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

An advantage of the schedular system is tax rates can be adjusted to compensate for underreporting and tax evasion. For example, rates can be higher on business profits and professional earnings, than on salaries and wages because it is presumed that the former will be less fully reported than the latter.

While a global income tax may be preferable from a conceptual perspective, the purest form remains a theoretical ideal only. In practice, all global income tax systems contain some schedular elements and most existing income tax systems lie on the spectrum between schedular and global. While some countries with a global income tax system define income without breaking it down into categories, others have a schedular structure to the identification of taxable amounts, whereby such amounts are defined according to categories of income. The global systems of many countries have also become partially schedularized by the use of final withholding taxes on certain types of income, particularly dividends and interest, and lower tax rates on capital income.

3.2 PROGRESSIVE, REGRESSIVE AND PROPORTIONAL TAXES

Tax systems fall into three main categories:

(a) progressive taxes;

(b) regressive taxes; and

(c) proportional taxes.

Progressive tax system

A progressive tax system is a system in which tax is imposed in such a manner that the tax rate increases as amount of taxable income increases. A progressive tax system therefore essentially imposes more tax on more income. Progressive tax systems therefore impose more tax on wealthy, high-income earners, than they do on low or middle-income earners.

For the progressive tax system to operate there must be progressive or increasing tax rate schedules or bands, which may change from year to year depending on government policy. For example, the income of individuals may be taxed at the following rates:

0% on the first amount of up to K3,000
25% on the next K800
30% on the next K2,100
35% on the balance

Example:

Ms X is an employee of UNILUS Limited, a company based in Zambia, and gets salary of K12,000 per month in 2013. For the charge year 2014/15 the applicable tax rates on emoluments were as follows:

0% on the first amount of up to K3,000 per month
25% on the next K800
30% on the next K2,100
35% on the balance

Calculate the total tax payable on Ms X's salary to the ZRA if the progressive tax system is used (assuming there are no allowable deductions).

Solution:

		Tax
Monthly salary	12,000	
Taxable @ 0%	3,000	0
	9,000	
Taxable @ 25%	800	200
	8,200	
Taxable @ 30%	2,100	630
Taxable at 35%	6,100	2,135
Total tax		**2,965**

The progressive tax system is considered to be a fair tax system to taxpayers in that those that are rich will pay more than those that are poor. This is because a bigger amount of their income will be taxed at higher tax rates while the small amount of money earned by the poor will be taxed at lower rates.

Note: in actual practice tax is calculated after taking into account other rules of taxation such as deductions and credits.

Progressive tax system is used in Zambia for computation of income tax for individuals e.g. salaries and sole traders.

Regressive tax system

The regressive tax system is a system in which tax is imposed in such a manner that the tax rate decreases as the amount of taxable income increases, i.e. any extra band of income of a taxpayer is taxed at a lower rate than the earlier band. Regressive tax systems therefore impose greater tax burden on the low-income earners relative to the high-income earners.

For example, income of individuals may be taxed as follows:

35% on the first amount of up to K3,000
30% on the next K800
25% on the next K2,100
0% on the balance

Example:

Ms X is an employee of UNILUS Limited and gets salary of K12,000 per month in 2013. For the charge year 2013/14 the applicable tax rates on emoluments were as follows:

35% on the first amount of up to K3,000 per month
30% on the next K800
25% on the next K2,100
0% on the balance

Calculate the total tax payable on Ms X's salary to the ZRA if the regressive tax computation system is used (assuming there are no allowable deductions).

Solution:

		Tax
Monthly salary	12,000	
Taxable @ 35%	3,000	1,050
	9,000	
Taxable @ 30%	800	240
	8,200	
Taxable @ 25%	2,100	630
Taxable at 0%	6,100	0
Total tax		**1,920**

The regressive tax computation system is considered unfair to poor taxpayers because most of their income is taxed at a higher rate, while the rich, though they pay more tax in terms of actual amounts paid, in percentage form they pay less than the poor do. This system may therefore discourage the poor from paying taxes.

Proportional tax system

A proportional tax system (or flat tax system) is a system where the tax rate applied on all taxable income of a taxpayer is the same for all taxpayers, regardless of the income bracket in which they fall, i.e. the rate of tax is fixed irrespective of how high or low the taxable income is. For example, under this system, a tax rate of 30% may be applicable on all income earned by individuals.

This type of tax computation is used in Zambia for example to tax companies whose income is less than K800,000 per annum (turnover tax) and for adjusted profit for some companies whose income is over K800,000 per annum. For companies the tax rates in Zambia differ depending on the type of company and its status. For example, the income of a company listed on the LuSE is taxed at 33% in the first year of listing while all other unlisted companies generally pay tax at a rate of 35%.

3.3 COMPANY TAX SYSTEMS

There are basically two schools of thought with regard to taxation of companies.

The first is that since companies have a legal existence of their own distinct from that of the shareholders, the taxation of companies should be independent of the taxation of the shareholders who own the company. A problem arising from separate entity concept is that company income may be subject to double taxation – first at the corporate level when it is earned, and again at the shareholder level when it is distributed as dividends.

The other school of thought suggests that since a company is a legal fiction, the corporate veil should be lifted and all profits accruing, whether distributed or not, should be regarded as belonging to the shareholders who should be taxed at their individual marginal tax rates.

The approach in most jurisdictions is a mixture in which taxes are levied at both the corporate and shareholder levels in varying degrees. For example, in Zambia, tax at the corporate level is levied at a standard rate of 35 percent while tax at the shareholder level in respect of dividends is at 15 percent.

There are four commonly used company tax systems. These are:

(a) the classical system;
(b) the imputation system;
(c) the split rate system; and
(d) the integrated system.

The type of system used influences the company structure of companies, i.e. whether equity or debt.

The Classical System

This system embodies the principle that the tax liability of a company should be completely independent from that of its shareholders i.e. since the company is treated as a distinct entity it should bear its own tax. The company is subjected to a flat rate of corporate tax on its taxable profits while the shareholders pay income tax on their respective dividends.

The major objection to this system is that dividends are subject to double taxation – first at the corporate level, and then at the shareholder level. For example, if a company that has profits of K100,000 in a particular year and makes a dividend distribution of its entire after-tax profits, the following will be the tax consequences:

Corporate Profits	K 100,000.00
Corporate Income Tax @ 35%	K 35,000.00
Distributed Dividends	K 65,000.00
Dividend Income Tax @ 15%	K 9,750.00
Total After-Tax Income	**K 55,250.00**
Total Tax Rate	**44.75%**

The two layers of tax create a significant tax burden on company income as illustrated above. Out of profits of K100,000 the company needs to pay the corporate income tax of K35,000 (at the standard rate of 35 percent), which leaves the company with K65,000 in after-tax profits. When the company distributes these profits as a dividend, the income is taxed again at the shareholder level. The shareholders then pay K9,750 in income taxes (at the standard rate of 15 percent). In total, the K100,000 of company profits face a combined marginal tax rate of 44.75 percent (i.e. 44,750 / 100,000 x 100 = 44.75%).

The economic effects of the classical system are three-fold:

First, there is discrimination between dividends and retained profits because retained profits are only subject to corporate tax. This may encourage companies to retain profits and channel them out by way of high salaries, loans, non-taxable fringe benefits or generous pension schemes, etc.

Second, the classical system favours debt financing over equity financing due to the fact that interest payments are deductible in ascertaining the business profits of the company for tax purposes; while the cost of servicing capital raised from shareholders (i.e. through payment of dividends) is not.

Third, from the revenue point of view, the classical system results in higher tax receipts because tax is collected at the corporate level and at the shareholder level.

The Imputation System

The imputation system is where the company pays corporate tax on its profits, and any profits which are subsequently distributed to shareholders as dividends bear not tax as it is assumed that tax thereon has already been paid at a specified rate (known as the rate of imputation) by the company. The shareholders therefore pay no tax on the dividends received as the tax paid by the company is imputed to the shareholders.

The imputation system is therefore designed to mitigate the tax liability on dividends paid out by a company to take into account the fact that the profits out of which they have been paid have already bore corporate tax. This is achieved by crediting shareholders with the tax paid by the company. This credit may be used to set-off the shareholders' income tax liability on dividends, i.e. part of the company's tax liability is imputed to shareholders and is regarded as pre-payment of their income tax on their dividends.

The main argument in favour of the imputation system is that it is more beneficial to the shareholder and hence encourages capital formation from equity financing.

A few countries such as Australia, Finland, Italy, Mexico and New Zealand have an imputation system that eliminates the double taxation of dividends paid by a company to its shareholders. Australia, for example, has allowed dividend imputation since 1987. This is achieved through the use of tax credits called "franking credits" or "imputed tax credits" - shareholders are allowed a franking credit or imputation tax credit for the tax paid by the company on the profits it has distributed to the shareholders as dividends but only to the extent that the shareholders have assessable income to offset. The tax credit allowed is equal to the gross-up amount included in the shareholder's assessable income. The Australian tax authorities are notified that a company has already paid the required income tax on the income it distributes as dividends and the shareholder then does not have to pay tax on the dividend income.

The Split-rate System

The split-rate system is where distributed profits i.e. dividends are taxed at a lower rate than retained profits. Where it is desired to eliminate double taxation altogether, the tax on dividends may, for example, be zero-rated.

The Integrated System

The integrated system is essentially a variation of either the imputation system or the split-rate system which results in the integration of corporate and individual income taxes, the distinctive feature being that there is a total alleviation of double taxation.

Integration may either be effected at the corporate level (split-rate system) or at the shareholder level (imputation system).

At the corporate level, the profits of a company may only be subjected to corporate tax and the dividends paid to shareholders may be exempt or zero-rated. At the shareholder level, integration may be effected by allowing companies a deduction for dividends paid to shareholders in arriving at the taxable profits of the company and then subjecting shareholders to tax on the dividends received. Alternatively, shareholders and companies both pay tax on their income, but shareholders can be given a credit to offset taxes the company has already paid. In either way, the dividend is subjected to only one tax.

Countries such as Estonia have integrated their corporate and individual tax codes to reduce or eliminate the two layers of taxation on corporate income.