

## **UNIT 2:**

### **TAXATION OF INCOME**

#### **2.1 DEFINITION OF INCOME**

Income tax is, as its name implies, is a tax on a person's income, not on transactions or things. Since income tax is levied on the "income" of an entity, it is significant to know what income is for tax purposes.

The term "income" is not really defined in legislation and has several meanings in daily usage of the term. The term "income" has a very broad scope and it is not possible to define it exhaustively. Therefore, for tax purposes, the Income Tax Act, Chapter 323 of the Laws of Zambia provides a classification of what is included in the term "income".

Section 17 of the Income Tax Act classifies "income" to include the following items:

- (a) gains or profits from any business for whatever period of time carried on;
- (b) emoluments;
- (c) annuities;
- (d) dividends;
- (e) interest, charges and discounts;
- (f) royalties, premiums or any like consideration for the use or occupation of any property;
- (g) income from the letting of property; and
- (h) the income as further classified in the First Schedule of the Income Tax Act.

The First Schedule of the Income Tax Act further classifies income to include the following:

- (a) amounts received by way of maintenance or allowance under any judicial order or decree in connection with matrimonial proceedings, or under a written separation agreement;
- (b) the value of improvements effected on land or to the buildings thereon by any other person pursuant to an agreement with the other person;
- (c) any amount received in connection with the taking up of employment or by reason of the cessation of any agreement for employment including compensation for loss of office or employment;
- (d) lump sum payments;
- (e) capital recoveries;
- (f) the market value of any exotic timber that is on any land which is disposed of for valuable consideration;

- (g) any farm stock owned by a farmer at the beginning and end of each period for which he makes up the accounts of his farming business;
- (h) the gross sale proceeds or proceeds from sale of options in respect of shares allotted, reserved or acquired by an individual in terms of an approved share option scheme net of any amount paid for the acquisition or exercise of such shares or options by the individual concerned; and
- (i) amounts refunded to any person carrying on mining operations pursuant to the Mines and Minerals Development Act.

The concept of income under the Zambian tax system therefore is wide to cover any form of money or money's worth that a person receives. However, what is clear is that money should fall within the meaning of income under section 17 and the First Schedule of the Income Tax Act for it to be taxable.

See: *Mohammad Hussein v Zambia Revenue Authority - 2001/RAT/36* where it was held that money brought into Zambia for purposes of investment was not earned income within the meaning of section 17 of the Income Tax Act and therefore was not taxable.

### **Capital receipts are not income**

The Zambian income tax system is a tax on income and not capital. While a receipt of money or money's worth assessed to be income is assessable for taxation purposes, capital is not assessed for taxation purposes. It is thus very important to be able to differentiate between income and capital; these have very different meanings as far as tax assessment is concerned.

The exclusion of tax from capital receipts stems from the fact that when income tax was first introduced, the conceptual idea behind an income tax was that tax should be paid upon a taxpayer's annual income: that is, from a taxpayer's annual fruits, profit or labour, rather than upon the capital or the means by which that income was produced. It was the accountant's annual period that was chosen for calculating the tax, and it was the accountant's concept of a calculated amount of revenue receipts less revenue outgoings that was chosen as the amount upon which to levy tax. It was not a tax on wealth, or upon individual transactions; the tax was upon the regular, recurrent and periodic returns to individual taxpayers, excluding capital receipts and after allowing losses and outgoings properly referable to the derivation of the income over a twelve-month accounting period. The system of taxation adopted as a tax upon income, therefore, took as its target the accountant's profit and loss statement (adjusted for tax) rather than the balance sheet. The words "income" and "taxable income" were used as the statutory basis for the exaction, but they referred to more fundamental general concepts found in commerce, business and the ordinary world.

### ***Capital receipts***

Capital receipts are the receipts received by the company, which are non-recurring in nature. They are part of the financing and investing activities rather than operating activities. The capital receipts either reduces an asset or increases a liability. The receipts can be generated from the following sources:

- Issue of Shares
- The issue of debt instruments such as debentures
- Loan taken from a bank or financial institution
- Government grants
- Insurance Claim

- Additional capital introduced by the proprietor

### ***Revenue receipts***

Revenue receipts are the receipts that arise through the core business activities. These receipts are a part of normal business operations that is why they are recurring. Their effect is short term, and their benefits are usually only enjoyable in the current accounting year. Revenues receipts are generated from the day-to-day activities of a business's operations, such as:

- Revenue generated from the sale of inventory
- Services Rendered
- Discount Received from the creditors or suppliers
- Interest Received
- Receipt in the form of dividend
- Rent Received

### ***Summary of key differences between capital and revenue receipts***

The key distinctions between capital receipts and revenue receipts can, therefore, be summarized as follows:

1. Receipts generated from investing and financing activities are capital receipts, on the other hand, receipts from operating activities are revenue receipts.
2. Capital receipts do not frequently occur, as it is non-recurring and irregular. However, revenue receipts do occur repeatedly, as they are recurring and regular in nature.
3. The benefit of capital receipt can be enjoyed in more than one year, but the benefit of a revenue receipt can usually only be enjoyed only in the current year.
4. Capital receipts appear on the liabilities side of the Balance Sheet whereas revenue receipts appear on the credit side of the Profit and Loss Account as income for the financial year.
5. A capital receipt either decreases the value of an asset or increase the value of liability e.g., a sale of a fixed asset, a loan from bank etc. A revenue receipt neither increases nor decreases the value of an asset or liability.

The main similarities between capital receipts and revenue receipts are as follows:

1. Both receipts are a part of business activities.
2. Both are necessary for the survival and growth of the company.

### ***Distinguishing capital and revenue receipts in unclear cases***

Whether a receipt or an outgoing has the character of income or capital will usually be obvious enough, even though we do well to remember that it is the context of the receipt or outgoing that will usually be decisive to its character. For example, rent, interest, dividends, salaries, wages, business profits and other receipts are easily classified as income. Money coming from the sale of an asset is usually classed as capital. You do not usually pay tax on capital receipts as such, though certain sales such as sales of land and shares may be taxable under property transfer tax laws.

However, the difference between a revenue receipt and a capital receipt can sometimes be quite difficult to determine and may at times be non-existent in economic outcome. Indeed, the economic relationship between capital and income is sometimes so closely interwoven that in

economic terms the two are economically indistinguishable. In *Commissioners of Inland Revenue v British Salmson Aero Engines Ltd*<sup>1</sup> Sir Wilfred Greene MR put it more bluntly by saying that:

‘There have been many cases which fall on the border-line. Indeed, in many cases it is almost true that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons. But that class of questions is a notorious one, and has been so for many years.’<sup>2</sup>

However, difficult as it might be to articulate tests for the difference and to give reasons for the conclusions reached, the difference and the reasons still matter. They matter not just because more or less tax may be paid, but because the difference reflects an underlying system adopted for taxation that needs to be understood and applied consistently with principle and with the underlying concepts. In other words, they matter not only because more or less tax will be paid or gathered, but also because they need to reflect, and to give effect to, the underlying policy objectives weaved into the fabric of the legislation.

In decided cases the courts have had regard to various factors in determining whether the proper nature of an item of receipt is income. There is no single infallible test.

The tests that have been developed over the years have varied as between receipts and outgoings. In the case of receipts, the enquiry focused upon the occasion by which the receipt was derived; in the case of outgoings the enquiry focused upon what the receipt secured. A moment’s reflection will reveal how much these tests owe to the affairs of business:

- receipts should be taxed if referable to the fruits of enterprise;
- outgoings should be deductible if expended in the process of producing income but not if their expenditure is reflected as part of the continuing capital of the enterprise and capable of subsequent disposal or exchange.

Some of the considerations by the courts when determining whether a receipt has the character of income or capital can be observed from a number of decided cases, including the following:

- (a) **Recurring receipts:** Generally, a receipt will be in income receipt if it recurs or is likely to recur annually or repeatedly to form a series.

See: *Cooper (Inspector of Taxes) v Stubbs (1925) 2 KB 753*  
*Moss Empires Ltd v IRC [1937] AC 785*

However, a receipt may still be income even if received as a lump sum.

See: *Shove (Inspector of Taxes) v Dura Manufacturing Co. Ltd [1941] 23 TC 779*

- (b) **Restrictions on activity:** if as part of his trading arrangements, the taxpayer agrees to restrict his activities in return for payments made to him, the payments are revenue receipts.

In *Thompson v Magnesium Elektron Limited (1944) 1 All ER 126* where the taxpayer manufactured magnesium that required chlorine, a by-product of which is caustic soda. ICI agreed to supply the chlorine at below market value and paid the taxpayers a lump sum to prevent them from making their own chlorine and caustic soda, sales of which

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<sup>1</sup> [1938] 2 KB 482.

<sup>2</sup> Ibid at 498.

would compete with those of ICI. The sum was a taxable receipt paid as compensation for profits that the taxpayers would have made on the sale of caustic soda.

- (c) **Sterilisation of an asset:** A payment for the permanent restriction on the use of an asset is capital even if the sum is computed by reference to loss of profits.

See: *Gleinboig Union Fireclay Co Ltd v IRC (1922) 12 TC 427*

If the compensation is for the temporary loss of an asset, however, the receipt is a revenue receipt:

See: *Burmah Steamship Co Ltd v IRC (1931) 16 TC 67*

- (d) **Cancellation of a business contract:** when a taxpayer receives compensation for the cancellation of a contract, the nature of the receipt depends upon the significance of the cancelled contract to the business. If the cancelled contract is so fundamental to the taxpayer that its loss would cripple or destroy the taxpayer's business, the compensation will be treated as a capital receipt.

In *Van de Berghs Ltd v Clark (1935) 19 TC 390* the appellant received a lump sum payment of £450,000 from a Dutch competitor for the cancellation of three agreements that it had with a Dutch competitor, so-called pooling agreements. The payments and receipts under the agreements that the company had made or received over the years had been treated as trading deductions or receipts, as the case may be. After the First World War long and costly arbitration as to the amounts arising during the period of hostilities were brought to an end by the Dutch company paying the said £450,000 in consideration of the appellant's consent to terminate the pooling agreements. The appellant was assessed to Income Tax for the year 1928-29, in an amount which included the sum of £450,000. On appeal, the General Commissioners decided that the £450,000 was paid "in respect of the pooling agreements" and must be considered for the purpose of arriving at the profits and gains of the appellant for the relevant period. It was held that the £450,000 was a payment for the cancellation of the appellant's future rights under the agreements, which constituted a capital asset of the Company, and that it was, accordingly, a capital receipt. Lord Macmillan at page 431 that:

"The three agreements which the appellant consented to cancel were not ordinary commercial contracts made in the course of carrying on their trade; they were not contracts for the disposal of their products or for the engagement of agents or other employees necessary for the conduct of their business; nor were they merely agreements as to how their trading profits when earned should be distributed as between the contracting parties. On the contrary, the cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants' activities, defined what they might and what they might not do, and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure, or money received for the cancellation of, so fundamental an organisation of a trader's activities can be regarded as an income disbursement or an income receipt."

See also: *Barr Crombie & Co Ltd v CIR, [1945] 26 TC 406*

However, if the contract is merely one of the many and of short duration, the compensation received is an income receipt.

In *Kelsall Parsons & Co v IRC (1938) 21 TC 608*, the appellant traded as manufacturers' agents. The business began in 1914 with two agencies, one of which

was for George Ellison Ltd. Over the years the Ellison's agreement was renewed from time to time and on occasion the terms and conditions were modified. Other agencies were also acquired. Between 1930 and 1934 the company held between 9 and 11 agencies. The Ellison's agency was the single most lucrative and at times yielded as much as half the company's gross commission. The company received £1,500 compensation for the termination at the end of the second of a three-year agreement. The compensation was held to be a trading receipt. At page 619 the Lord President, Normand, drew an important contrast between the contracts in *Kelsall Parsons* from the agreements in *Van den Berghs*:

‘That was a contract incidental to the normal course of the Appellant's business. Their business, indeed, was to obtain as many contracts of this kind as they could, and their profits were gained by rendering services in fulfilment of such contracts.’

(e) **Unclaimed monies received from a customer:** The tax treatment of unclaimed monies, being monies received from, or held on behalf of, a customer, and not returned to or paid to the customer, will be treated according to the circumstances, as follows:

(i) Where a sum of money is received from a customer as a deposit towards the purchase price of goods to be supplied to the customer and the sum of money is later forfeited because of the customer's failure to take delivery of the goods, then such a sum will be a revenue receipt to the supplier.

See: *Elson v Prices Tailors Ltd (1962) 40 TC 671*  
*Gower Chemicals Ltd v R & C Commissioners (2008) Sp C 713*

(ii) Where the money becomes that of the business by operation of law it may be held to be a business receipt.

In *Jay's The Jewellers Ltd v IRC (1947) 29 TC 274*, unclaimed balances held by pawnbrokers became theirs by operation of statute. In this case, it was held that these were trading receipts because their character had altered by operation of law.

(iii) Where the payments are received in consequence of a business carried on by the recipient, they will be taxable as income of that business.

In *Pertemps Recruitment Partnership Ltd [2011] BTC 1,675* the appellant, a recruitment agency, had released to its profit and loss account monies paid to it in error by its customers. The Upper Tribunal found that the payments made in error had the same characteristics in the hands of the appellant as payments made for its services; the payments having derived from the business relationship between the appellant and its customers and having been made by those customers in the belief that money was owed to the appellant for services supplied in the course of the appellant's trade.

(iv) However, where a business receives money on behalf of a customer and the customer forgets to claim it from the business, the unclaimed money is not a business receipt.

In *Morley v Tattersall (1938) 22 TC 51*, a firm of auctioneers received money from sales which they held for vendors. Unclaimed sums were transferred to partners' accounts. It was held that these sums were clients' moneys and could not subsequently become trading receipts.

A perusal of the legislation and of decided cases will reveal both how important the distinction between income and capital continues to be and how difficult, and perhaps how controversial, its application can still be to the facts. The legislation continues to maintain taxing differences for receipts and outgoings depending upon their respective character as capital or revenue. The decided cases continue to feature prominently disputes concerning the application of the distinction between Capital and income.

### **Valuations**

It may be necessary in some cases to consider for tax purposes, incomes that are received by a taxpayer in kind. For example, an employee may receive a benefit in kind, or an asset may be acquired or disposed of for consideration given in kind. In each case, the in-kind item must be valued for the purposes of determining the amount to be taken into account for tax purposes.

Tax laws normally provide for rules relating to the valuation of such income received in-kind. It is generally preferable that such valuation rules be of general operation so that it can apply in all circumstances where it is necessary to value an in-kind item.

## **2.2 SOURCE AND RESIDENCE PRINCIPLES OF TAXATION**

Typically, the income or profits of a person may be taxed where the income is earned (the source country), or where the person who receives it is normally based (the country of residence). There are therefore two widely used principles of taxation on income: the source principle and the residence principle. The charging section of a country's income tax legislation will stipulate whether the legislation charges tax on the basis of source, residence, or both.

### **Source principle**

According to the **source principle** of income taxation, if a country considers certain income as taxable income when such income arises within its jurisdiction, such income is taxed in that country regardless of the residence of the taxpayer, i.e., residents and non-residents are taxed on income derived from the country. Source taxation is justified by the view that the country which provides the opportunity to generate income or profits should have the right to tax it.

#### ***Source principle under the Income Tax Act***

In Zambia, section 14(1) (a) of the Income Tax Act imposes a charge of tax on income received from a source within, or deemed to be within, Zambia. The provision reads:

“(1) Subject to the provisions of this Act, tax shall be charged at the rates set out in the Charging Schedule for each charge year on the income received in that charge year-

(a) by every person from a source within or deemed to be within the Republic; and...”

This provision charges tax on income received in a charge year by a person (regardless of the domicile or residency of that person) from a source within or deemed to be within Zambia. The charge of tax on income in Zambia is therefore primarily based on the source principal – that is, where the income is derived from.

Section 18 of the Income Tax Act provides for instances when certain classes of income will be deemed to be from a source within Zambia. According to section 18(1), income will be deemed to be from a source within Zambia if that income:

- (a) arises under any agreement made in Zambia for the sale of goods, irrespective of whether those goods have been or are to be delivered in Zambia;
- (b) is remuneration from employment exercised or office held in Zambia or if it is received by virtue of any service rendered or work or labour done by a person or partnership in the carrying on in Zambia of any business, irrespective of whether payment is made outside Zambia, or by a person resident outside Zambia;
- (c) is remuneration for services rendered outside Zambia to the Government or any statutory corporation if the person rendering the services is resident outside Zambia solely for that purpose;
- (d) is a pension granted by a person wherever resident, irrespective of where the funds from which it is paid are situated, or where payment is made, except where the employment or office for which the pension is granted was wholly outside Zambia, and the emoluments were never charged to tax in Zambia;
- (e) arises from interest incurred in the production of income or in the carrying on of a business in Zambia or paid directly or indirectly out of funds derived from within Zambia;
- (f) arises from a royalty incurred in the production of income or in the carrying on of a business in Zambia or paid directly or indirectly out of funds derived from within Zambia;
- (g) arises from the carriage, by a person who is not resident in Zambia, of passengers, mails, livestock or goods embarked, shipped or loaded in Zambia other than passengers embarking in transit through Zambia or mails, livestock or goods shipped or loaded on transshipment through Zambia; or
- (h) arises from a management or consultant fee incurred in the production of income or in the carrying on of a business in Zambia and is received by a person or persons in partnership for a service other than such part thereof as is rendered by the person or persons in partnership in the carrying on of a business in Zambia.

According to section 18(2), where a person, being an individual ordinarily resident in Zambia or, not being an individual, is a person who is resident in Zambia, receives a share of the profits of a business or partnership carried on partly within and partly outside Zambia, the whole of the person's share of the profits of the business or partnership is deemed to have been received from a source within Zambia.

### **Residence principle**

According to the residence principle of income taxation, residents of a country are subject to tax on their worldwide (local and foreign) income and non-residents are only subject to tax on domestic-source (local) income. Residence taxation is justified by the view that people and firms should contribute towards the public services provided for them by the country where they live, on all their income wherever it comes from.

### ***Tax Residency***

For one to be taxed on the basis of the residence principle, they have to be a resident of the taxing country within the meaning of the income tax legislation of that country. Generally, tax residency under income tax legislation is defined according to whether the taxpayer is an

individual (natural person) or non-individual. Tax residency is determined on a tax year-by-year basis (i.e., you only consider whether a taxpayer is tax resident in a particular tax year).

- (i) *Individuals*: Tax residency of individuals is commonly determined by the application of either of the following two methods: (A) the facts and circumstances (Closer Connection) approach; or (B) the number of days (Substantial Connection) approach. The income tax legislation of a country will specify whether one or both tests are used to determine whether an individual is tax resident in that country.

With the facts and circumstances approach, an individual will be considered as tax resident in a particular country if it can be demonstrated that, having regard to the facts and circumstances, the individual had a sufficiently strong personal connection to that country in the relevant tax year. In determining whether an individual had strong personal ties to a particular country, a number of factors will be considered including, but not limited to, the following:

- the location of the individual's permanent home, family, personal belongings
- the location of the individual's current social, political, cultural, or religious affiliations
- the location of the individual's business activities
- the jurisdiction in which the individual holds a driver's license
- the jurisdiction in which the individual vote

It must be noted that it does not matter whether a permanent home is a house, an apartment, or a furnished room. It also does not matter whether it is owned or rented by the individual, as long as it is a place that is available as one's home at all times, continuously, and not solely for short stays.

The number of days approach is a test that determines an individual's tax residency on the basis of the number of days that the individual spent in a particular country in a particular tax year. The income tax legislation of a country will specify the minimum number of days which, if spent in that country by an individual, will render such individual as having been resident in that country in the relevant tax year. In most countries that utilise this test, an individual will be considered as being resident in a particular country in a particular tax year if that individual was physically present in the relevant country for at least 183 days (either consecutively or cumulatively) during the tax year.

- (ii) *Non-Individuals*: Tax residency of individuals is generally determined by either the place of incorporation or registration of an entity, or the place of effective management of the entity. The place of effective management of an entity is the place where such entity is actually managed and controlled or the place where the decision-making at the highest level on the important policies essential for the management of a company takes place.

### ***Residence principle under the Income Tax Act***

Section 14(1) (b) of the Income Tax Act imposes tax on foreign-source interest and dividend income earned by Zambian residents. The provision reads:

“(1) Subject to the provisions of this Act, tax shall be charged at the rates set out in the Charging Schedule for each charge year on the income received in that charge year-

... (b) by any individual ordinarily resident in the Republic, or by every person, not being an individual, who is resident in the Republic, by way of interest and dividends from a source outside the Republic...

This provision charges tax on income received in a charge year by an individual or artificial person ordinarily resident or resident in Zambia if that income is from interest or dividends from a source outside of Zambia. In Zambia therefore the residence taxation principle only applies in respect of interest and dividend income.

Section 4 of the Income Tax Act provides for the tax residency rule. With respect to individuals, section 4(1) states that:

“(1) An individual is, for the purposes of this Act, not treated as a resident in the Republic who is in the Republic for some temporary purpose only and not with any view or intent of establishing his residence therein, and who has not actually resided in the Republic at one time or several times for a period equal in the whole to one hundred and eighty-three days in any charge year, but if any such individual resides in the Republic for the aforesaid period he shall be treated as resident for that year.”

With respect to non-individuals, section 4(3) states that:

“(3) In this Act, a person other than an individual is resident in the Republic for any charge year

(a) if the person is incorporated or formed under the laws of the Republic; or

(b) effective management and control of the person's business or affairs are exercised in the Republic for that year.”

Therefore, for tax purposes an individual is treated as resident in Zambia if the individual has resided in Zambia for a continuous period, or several periods, equal to at least 183 days in any tax year; whereas a person other than an individual is treated as resident in Zambia for any tax year if the person is incorporated or registered under the laws of Zambia; or the effective management and control of such person's business or affairs is exercised in Zambia for that year.

## **Conflicts of Residence and Source Taxation**

### **(a) *Residence /Source Conflicts***

Most commonly, double taxation arises through the combined operation of the residence and source principles. Under the residence principle, residents of a country are taxed on their worldwide income and, under the source principle, non-residents are taxed on their domestic source income only.

Example: suppose a person resident in the U.S.A. has business or investment activities in Zambia. The U.S.A. adopts the residence principle and taxes income at a rate of 40%, while Zambia adopts the source principle and taxes income at a rate of 30%. If the person earns \$1,000 from his activities in Zambia, he will be liable to \$300 (i.e., 30% of \$1,000) in taxes in Zambia on the income arising from the activities in Zambia under the source principle and also liable to \$400 (i.e. 40% of \$1,000) in taxes in the U.S.A. under the residence principle. So, the person will pay a total of \$300 + \$400 = \$700 in taxes, paying an effective tax rate of 70%.

Residence/Source conflicts can be avoided by requiring the residence country to give tax relief for the source country tax. A double taxation agreement (DTA) between the two countries may for example provide for residence country only taxation of the income, i.e., the DTA precludes the source country from taxing the income earned by the non-resident from the source country. The DTA may alternatively provide for source country only taxation of the income, i.e., the DTA precludes the residence country from taxing the income earned by its resident from the source country.

(b) ***Source/Source Conflicts***

Similarly, while it is the international norm that countries can tax non-residents on income sourced within their jurisdiction, there is no internationally agreed set of source rules for this purpose. Instances of source/source conflicts can be found for almost all classes of income when more than one country claims that revenue was sourced from its territory.

Example 1: Some countries may regard business profits as sourced within the jurisdiction if the profits are attributable to a permanent establishment in the jurisdiction, while other countries may regard business profits as sourced in the jurisdiction if the place of contract is in the jurisdiction.

Example 2: Some countries may regard royalties as sourced in the jurisdiction if the underlying property giving rise to the royalty is used in the jurisdiction, while other countries may regard it as sourced in the jurisdiction if the royalty is paid by a resident of the jurisdiction.

Source/source conflicts can be avoided by a DTA effectively setting out a uniform set of source rules that are then applied by both countries overriding any conflicting domestic rules.

(c) ***Residence/Residence Conflicts***

Two or more countries may claim that a particular taxpayer is a resident of their tax jurisdiction. While it is now the international norm for countries to tax residents on worldwide income, there is not universal agreement as to how residence is defined.

Example: An individual with sufficiently strong personal connection to country A may also spend the specified number of days for tax residency in country B and therefore making him/her resident of both countries for tax purposes if country A uses the facts and circumstances approach and country B uses the number of days approach. Both countries would, therefore, have jurisdiction to tax the worldwide income of the individual.

Example 2: A company incorporated in country A but with its effective management and control in country B may make it a resident of both countries for tax purposes and therefore subject to tax on its worldwide income in both countries.

Residence/residence conflicts can be avoided by the residence provision in a DTA including tiebreaker rules that treat a person who is resident of both countries under each country's domestic law as a resident of one only of the countries for the purposes of the DTA.

Thus, the main effect of DTAs is to reduce double taxation that may result from the conflicts of the source and residence taxation principles. The degree to which this is done depends on each DTA: capital-exporting richer countries prefer the OECD model convention, which is

more favourable to residence, while capital-importing developing countries tend to favour the UN model convention, which is more favourable to source.

## **2.3 TAXABLE INCOME**

Generally, all income received is taxable unless it is specifically exempted by law. Income that is taxable must be reported on your return and is subject to tax. Income that is non-taxable may have to be shown on your tax return but is not taxable.

The concept of taxable income effectively defines the income tax base. The taxable income of a person for a tax period is commonly defined as the gross income of the person for the period less the total deductions allowed to the person for the period. The gross income of a person for a tax period is the total of amounts derived by the person during the period that are subject to tax. The gross income of a person, therefore, will not include amounts that are exempt from tax. The total deductions of a person for a tax period are the total of expenses incurred by the person during the period in deriving amounts subject to tax plus any capital allowances and other amounts allowed as a deduction on a concessional basis (e.g., charitable donations).

Consequently, there are three key elements in the definition of the tax base: first, the inclusion of amounts in gross income; second, the identification of amounts that are exempt income; and third, the allowance of amounts as deductions.

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

### **Gross Income**

Gross income is income received by a person from all sources, unless excluded by law. The inclusion of amounts in gross income will often be specified by reference to particular categories of income. For this purpose, income is commonly divided into employment, business, and investment income. There are often supplementary definitions of each category of income and, in the case of investment income, definitions of amounts included in investment income (e.g. dividends, interest, rent, and royalties).

However, not all amounts derived by a taxpayer will fit neatly into one of these categories. An issue arises, therefore, as to the specification of other amounts to be included in gross income. This is commonly done by separately listing out those amounts. Such a definitional structure means that any amount that does not come within one of the listed inclusions will not be included in gross income. This may be overcome by including a residual category of income. The residual category may itself be a separate category. Alternatively, the list of amounts included in gross income may be expressed to be inclusive only so that a general formula may apply for including other amounts in gross income.

### ***Exempt incomes***

There will be amounts that are not to be included in gross income. These amounts are usually identified as “exempt income.” While many different amounts may be treated as exempt income, such amounts can be classified into several broad categories.

First, an amount or an entity may be exempt for social compassion reasons. Examples of amounts that may be exempt on this basis are welfare payments, scholarships, and compensation payments. Examples of entities that may be exempt on this basis are religious, charitable, or education institutions of a public character.

Second, an amount may be exempt as a result of international convention, agreement, or practice. For example, a country that is a signatory of the Vienna Convention on Diplomatic Relations is obliged to exempt from tax the official employment income and foreign-source income of a foreign diplomatic officer, consular officer, administrative or technical employee of a diplomatic mission or consulate, consular employee, member of the service staff of a diplomatic mission or consulate, or a private servant of a diplomatic mission.<sup>3</sup> The exemption also extends to the foreign-source income of family members and consular staff. As a matter of practice (sometimes only on a reciprocal basis), a similar exemption may be extended to other foreign government representatives working in the country.

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

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

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

Section 15 of the Income Tax Act authorises the Minister of Finance, by statutory instrument, to exempt certain income or certain persons from tax. The income and persons exempted from tax are listed in the Second Schedule of the Income Tax Act and include the following:

- (a) *Exempt office holders:* The emoluments of the President are exempt from tax. The income of the Liwung of the Western Province as Liwung and the income of any Chief received as a Chief from the Government are also exempt from tax.
- (b) *Foreign exemptions:* the following are exempt from tax:
  - (i) the emoluments of any individual payable in respect of any office which he holds in Zambia as an official of any foreign government, if such individual is resident in Zambia solely for the purpose of carrying out the duties of his said office;
  - (ii) the emoluments of any domestic or private servant of any individual referred to in sub-paragraph (i) payable in respect of domestic or private services rendered or to be rendered by such servant to such individual, if such servant is not a Zambian citizen and is resident in Zambia solely for the purpose of rendering the said services;

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<sup>3</sup> See for example paragraph 3(a) and (b) of the Second Schedule to the Income Tax Act

- (iii) the emoluments payable to any individual who is not a Zambian citizen and who is temporarily employed in Zambia in connection with any technical assistance scheme provided by any foreign country, any international organisation, or agency, any foreign foundation or any foreign organisation, if the exemption of such emoluments or such part of the emoluments as may be specified is authorised under the terms of an agreement entered into by the government of such foreign country, international organisation or agency, foreign foundation or foreign organisation with the Government of Zambia;
  - (iv) the emoluments of any individual in respect of service with any international organisation or any agency of a foreign government or any foreign foundation or organisation, which organisation, agency or foundation is approved by the Minister of Finance by order in the Gazette and such individual is not a Zambian citizen and is resident in Zambia solely for the purpose of rendering the said service or secondment to any Zambia organisation, agency, or foundation; (v) the income of any international organisation, any agency of a foreign government, or any foreign foundation or organisation; as is approved by the Minister of Finance by statutory order in the Gazette.
- (c) *Exempt organisations:* The incomes of the following organizations are exempt from tax:
- (i) local authorities;
  - (ii) registered trade unions;
  - (iii) agricultural society, mining or commercial society (whether corporate or unincorporated), or any other society having similar objects, not operating for the private pecuniary gain or profits of its member;
  - (iv) a club, society or association organised and operated only for social welfare, civil improvement, pleasure, recreation or like purposes, if its income, whether current or accumulated, may not in any way be received by any member or shareholder;
  - (v) approved fund or medical aid society or approved share option scheme;
  - (vi) employees' savings scheme or fund, if approved by the Commissioner-General;
  - (vii) political party registered as a statutory society under the Societies Act;
  - (viii) a statutory body;
  - (ix) a collective investment scheme to the extent to which the income is distributed to participants in the scheme;
  - (x) a non-resident person derived from the carrying on of the business of ship owner, charterer or air transport operator, where the country in which such non-resident person is resident extends a similar exemption to ship owners, charterers and air transport operators who are not resident in such country but who are resident in Zambia;
  - (xi) any organisation, partnership or body corporate, or such part of the income as is specified, where the objects and activities within Zambia of such

organisation, partnership or body corporate are to assist in the development of Zambia and such exemption of the income, or such part thereof as is specified is approved by the Minister of Finance by Statutory Order;

- (xii) any charitable institution or of any body of persons or trust established for the promotion of religion or education, or for the relief of poverty or other distress, if, in relation to the people of Zambia, the income may not be expended for any other purpose;

(d) *Exempt income:* There following incomes are exempt from tax:

- (i) income by way of lump sum payments withdrawn from an approved pension fund at retirement age or death or on the beneficiary becoming permanently incapable of engaging in an occupation or such sums withdrawn from an approved fund which the Commissioner-General determines cannot be enjoyed by the member until he attains retirement age;
- (ii) income received as a war disability pension, or as a war widow's pension, or as an old age pension paid out of public funds, or as a benefit paid under any written law in respect of injury or disease suffered in employment;
- (iii) income received in conjunction with the award of military, police, and fire brigade decorations for distinguished or good conduct or long service;
- (iv) income received by an individual or his dependants or heirs, being on account of his injury or sickness, from any approved fund or registered trade union or medical aid society or under any policy of insurance;
- (v) income received as a local overseas allowance by any member of the Defence Force of Zambia while on service officially declared to be active service;
- (vi) income received as an allowance paid for service outside Zambia by the Government or a statutory corporation in respect of an excess of living expenses due to such service;
- (vii) income in respect of a scholarship or bursary, for the purposes of education and maintenance during such education;
- (viii) income by way of alimony, maintenance or allowance under any judicial order or decree in connection with matrimonial proceedings, or under any separation agreement, to the extent of the amount of the alimony, maintenance or allowance that has not been allowed as a deduction to another individual under the Income Tax Act;
- (ix) income prescribed under the Ministerial and Parliamentary Offices (Emoluments) Act, and which, pursuant to the provisions of that Act, is exempt from tax;
- (x) income by way of grant as compensation for loss of office or disturbance by an officer admitted to the permanent and pensionable establishment of the Government;
- (xi) income by way of any education allowance or passage value payable to a public officer or payable in respect of his wife and children or in respect of his wife or children;

- (xii) income received by a person designated as an enterprise under the Zambia Development Agency Act, 2006 who has been granted the incentives provided under that Act, to such extent and for such period as the Minister of Finance may prescribe;
- (xiii) income by way of pension received by an individual from an approved fund;
- (xiv) income by way of a dividend declared from farming income for the first five years the distributing company commences farming;
- (xv) income received by an individual by way of sitting allowance for attending a council meeting;
- (xvi) ex-gratia payment made to a spouse or dependant on the death of an employee;
- (xvii) income received by a person designated as a micro or small enterprise under the Zambia Development Agency Act, 2006;
- (xviii) income received by way of a dividend declared by a company listed on the Lusaka Securities Exchange (LuSE) to an individual;
- (xix) income received by way of a lump sum payment paid to an employee on loss of office or employment on medical grounds;
- (xx) emoluments received by a former President of Zambia; and
- (xxi) interest on any public loan raised by Government or a statutory corporation, where the terms of the loan provide that the interest thereon shall be exempt from tax; and interest on any bond issued under or in respect of a public loan raised by the Government or a statutory corporation.

### ***Personal exemptions***

When calculating a taxpayer's income tax liability, a taxpayer may under the income tax legislation of a country be entitled to certain exemptions known as „personal exemptions“ which are dependent on the personal circumstances of the taxpayer, as well as the economic, social and political goals of a particular society. The whole structure of these exemptions is linked to one's ability to pay – when taxes are imposed, they impose different burdens on different sectors of society, e.g., a tax may impose a greater burden on a taxpayer with a large extended family to support than on a taxpayer with a small nuclear family. Personal exemptions usually take the form of a fixed amount given to a qualifying taxpayer as tax free income.

Personal exemptions are deducted from the taxpayer's income to arrive at the taxable income, thereby providing some form of tax relief to the taxpayer.

Examples of personal exemptions include the following:

- (a) **Married allowance:** a tax system may allow a married taxpayer to deduct from their taxable income a certain amount as a married allowance. The justification for a married allowance is that when one gets married, his/her living expenses increase and therefore the allowance provides some tax relief in order to allow such a person have a bit more income to spend.

- (b) **Child allowance:** a tax system may allow a taxpayer to deduct from their taxable income a certain amount as a child allowance in respect of each child that the taxpayer has. Such an allowance is made available on the understanding that the cost of raising children is high and therefore the allowance provides allows the taxpayer to have a more income to spend on his/her children.
- (c) **Dependant allowance:** similar to the child allowance, a deduction may be allowed to a taxpayer who has dependants in his/her care. In countries where the allowance is available, the tax laws usually define who is a dependant and an age limit is usually set to prescribe who qualifies to be a dependant for purposes of the allowance. In most cases, a dependant has to be an unmarried relative of the taxpayer or of the taxpayer's spouse.
- (e) **Old age allowance:** this is a personal exemption that may be given to a taxpayer of old age and in receipt of an income. The rationale for such a tax relief is that such a taxpayer is most likely drawing on his/her savings or that his/her ability to earn income is relatively precarious compared to other taxpayers of younger age.
- (f) **Handicapped allowance:** this is a personal exemption that may be given to a handicapped taxpayer; the rationale being that such a taxpayer's earning ability is lesser than able-bodied individuals.

In certain instances, personal exemptions may be additive, i.e., a taxpayer may be entitled to more than one personal exemption. For example, a person who is both handicapped and aged may be entitled to two exemptions: handicapped allowance and old age allowance.

Example:

John Sangwapo is married to Mailesi. John has been blind since birth; and he and Mailesi have four children, the oldest being 10 years old. John is a technician at Zamtel and his gross salary is K10,000. If the tax system provided for a flat income tax rate of 25% for individuals, a married allowance of K1,500, child allowance of K400 per child and a handicapped allowance of K800, John's tax liability would be determined as follows:

|                        |         |
|------------------------|---------|
| Gross salary:          | K10,000 |
| Personal exemptions:   |         |
| Married allowance-     | K1,500  |
| Total child allowance- | K1,600  |
| Handicapped allowance- | K 800   |
| Total                  | K3,900  |

$$\text{Taxable income} = \text{K}10,000 - \text{K}3,900 = \text{K}6,100$$

$$\text{Tax payable} = 25\% \text{ of } \text{K}6,100 = \text{K}1,525$$

The determination of the nature and amounts of personal exemptions that a government may wish to extend to its taxpayers depends on many considerations. For example, societies where large families are held desirable or where extended family systems subsist, child and dependant allowances may be substantial. The other consideration

for the grant of personal exemptions may be from an administrative point of view. The cost of taxing very little income may be proportionately high relative to the revenue yield and therefore a government may find it much more practical to exempt a certain level of income from tax in order to eliminate large numbers of taxpayers who earn little income and pay little tax thereon.

There are essentially four functions that personal exemptions are said to perform:

- (1) They keep the total number of taxpayers within manageable proportions and particularly keeping out from the tax base, persons whose tax liabilities are lesser than the cost of collecting taxes from such persons;
- (2) Freeing from tax, income needed to maintain a minimum standard of living;
- (3) They help achieve a smooth graduation of effective tax rates at the lower end of the scale; and
- (4) They differentiate tax liability according to personal circumstances such as family size.

Prior to 1 April 1989, Zambian income tax laws provided for married allowance, family allowance, single allowance, child allowance, insurance allowance and handicapped allowance as personal exemptions. However, with the abolishment of the concept of the family as a taxpaying unit in 1989, these married allowance, family allowance, single allowance and child allowance were abolished leaving only a primary allowance, insurance allowance and handicapped allowance as the provided personal exemptions. With effect from 1 April 1993, the Income Tax Act only provided for an individual tax credit, which is now provided under section 14(2) of the Income Tax Act. This provision reads:

“(2) Subject to the other provisions of the Act, in the case of an individual, the amount of tax which, apart from this subsection, would be charged in respect of any income received by that person in that charge year shall be reduced by the amount of the tax credit appropriate to such person for that charge year as specified in the Charging Schedule and that person shall be liable to pay tax for that charge year an amount equal to that reduced amount...”

Under Paragraph 1(b) of the Charging Schedule of the Income Tax Act, a tax credit is provided for in respect of individuals with disabilities. Therefore, the only personal tax relief currently provided under the Income Tax Act is the tax credit provided under the Charging Schedule to persons with disabilities.

## **Deductions**

The third element in the determination of the tax base is the allowance of amounts as a deduction.

A deduction is a reduction of income that is able to be taxed, and is commonly a result of expenses, particularly those incurred to produce additional income. Deductions, like exemptions, therefore, reduce taxable income.

Generally, income tax legislation will allow a deduction for expenses to the extent to which they are incurred in deriving amounts included in gross income. Therefore, while exemptions are dependent on personal circumstances of the taxpayer as well as a particular society's economic, social and political goals, deductions on the other hand are dependent on amounts

actually spent by the taxpayer and may include items such as life insurance premiums, medical expenses, charitable contributions, capital allowances (such as depreciation and amortization provisions) etc. Therefore, a taxpayer who does not incur such expenses has no basis for claiming any such deductions.

Deductions are said to be necessary for the following reasons:

- (1) to relieve the hardship created by the impairment of ability to pay particularly through heavy, unsought and unavoidable expenditure;
- (2) to allow the deduction of certain items that are costs of obtaining non-business income or that are hard to distinguish from such costs;
- (3) to promote the achievement of social, economic objectives desirable by the government.

There are a number of deductions that various countries allow their taxpayers and the amount depends on the policy objectives that a government attaches to each. Some of these include:

- (a) **Standard deduction** – a standard deduction is a specified portion of a taxpayer's income which the law may allow the taxpayer to deduct from their income in arriving at their taxable income. In some countries such as the U.S.A. the standard deduction is available to taxpayers who do not wish to itemize specific allowable deductions when calculating their taxable income. The amount of one's standard deduction may be based on factors such as the taxpayer's filing status, age, and whether they are disabled.
- (b) **Medical expenses** – a deduction of expenses incurred in seeking medical treatment is common in those countries where there are limited or no free medical services. It is designed to take care of expenses that are usually high and represents a degree of hardship that could seriously impair the ability to pay. The attitude appears to be that a person has little control over the amount of his medical expenses and that these expenses are unforeseeable and sometimes catastrophically large.
- (c) **Charitable contributions** – the main argument in favour of the deduction of charitable contributions is essentially that of a social and economic expediency in the achievement of a 'public good.' Since these contributions finance education, religious, cultural and welfare activities, the cost of which would otherwise be assumed by the government. In other words, such contributions relieve the government of what ordinarily would be its responsibilities. The deduction is therefore meant to be an incentive aimed at stimulating philanthropic contributions.
- (d) **Savings** – apart from relieving hardships, deductions can be used as an incentive deliberately designed to encourage or stimulate certain kinds of economic behaviour among taxpayers, such as savings. Many countries place great reliance on tax deduction to influence saving schemes and cultures among its taxpayers.
- (e) **Home mortgage interest deduction** – this allows taxpayers who own purchase homes using a mortgage facility to reduce their taxable income by the amount of interest paid on their mortgage loan. Such a deduction is meant to encourage home ownership. Most developed countries do not allow a deduction for interest on personal loans, so countries that allow a home mortgage interest deduction have created an exception to those rules. The Netherlands, Switzerland, and the United States each allow the deduction.

While exemptions and deductions provide relief from tax that may be desirable, tax exemptions and deductions may produce some undesirable results. Such reliefs erode or narrow the tax base to a considerable extent and in an effort for the government to maintain a certain amount of revenue from taxes, this erosion of the tax base could lead to the few taxpayers being subjected to higher tax rates. Higher tax rates may lead to increased pressure for more tax relief.

### ***Allocation and apportionment of deductions***

Generally, income tax laws will only allow a taxpayer a deduction of expenditure that was incurred in the production of the relevant income that is liable to be taxed. For example, deductions from business income may only be allowed in respect of expenses that were incurred for purposes of the business. Therefore, if a single expenditure was incurred for business and non-business purposes a problem would arise when dealing with the deductibility of such an expenditure incurred for a dual purpose.

Also, the categorization of income into different classes may require that expenses incurred in deriving a particular class of income are only deductible from that particular class of income. For example, if one taxpayer earns business income and rental income, expenses incurred in deriving the business may only be deductible from the business income, whereas expenses incurred in deriving the rental income may only be deductible from the rental income. A problem may arise where it is not possible to clearly determine whether an item of expenditure was incurred in deriving one class of income as opposed to another. Further, some allowable deductions (such as deductions for charitable donations or contributions to pension funds) do not relate to the derivation of any income and, as such, may present a problem as to which income they should be deducted from if the taxpayer had earned different classes of income.

The income tax laws of a country may, therefore, provide for rules relating to the allocation and apportionment of expenses for deduction purposes. Such rules will specify how a taxpayer is to allocate expenses to their relevant incomes for deduction purposes. For example, where a single item of expenditure was incurred for a duality of purposes, the rules may specify how to allocate part of the expenditure, which was incurred in deriving income, as taxable expenditure, and another part of that expenditure, which was not incurred in deriving income, as non-deductible expenditure. For expenses such as charitable donations which are not incurred in deriving income the rules may provide for the apportionment of such expenses rateably among each class of income derived by the taxpayer for purposes of deductions.

In the absence of statutory rules relating to the allocation and apportionment of expenses for purposes deductions, taxpayers and revenue authorities may be faced with a challenge as to how to deal with single indivisible amounts that are incurred for more than one purpose, or during the course of earning different classes of income. In the South African case of *CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A), 45 SATC 241*, Corbett JA as he then was, suggested that fair and reasonable apportionment offers a practical solution to what otherwise could be an intractable problem and, in a situation where the only other answer, i.e., disallowance of the whole amount of expenditure or allowance of the whole thereof, would produce inequality or anomaly one way or the other.

### ***Recouped Deductions***

Tax laws generally have an inclusion rule in respect of recouped deductions (i.e., expenditure or losses for which a deduction has been allowed that are subsequently recouped in whole or in part). It is common to find such rules in specific contexts, such as the recovery of amounts written off as bad debts or capital allowances recovered on disposal of the relevant asset; though a general rule is considered preferable to ensure that all possible situations are covered.

Generally, expenditure or loss (including a bad debt) that has been allowed as a deduction in

one tax period but is recovered by the taxpayer in whole or in part in a later tax period must be included in the gross income in that later period to the extent of the amount recovered. The recouped amount normally takes the character of the income to which it relates. For example, the recovery of a previously deducted bad debt incurred in carrying on a business would be treated as business income.