INFORMATION NOTE

Goods and Services Tax/Value-Added Tax and Profits Tax in Overseas Jurisdictions

1. Introduction

1.1 The Panel on Financial Affairs at its special meeting on 1 March 2002 requested the Research and Library Services Division to follow up the briefing made by the Advisory Committee on New Broad-based Taxes on its final report to the Financial Secretary. The issues to be studied include:

(a) exemption/direct compensation arrangements for goods and services tax in overseas jurisdictions; and

(b) operation of the progressive rates for profits tax in overseas jurisdictions and any incidence of tax avoidance through multiple corporatisation.

2. Goods and Services Tax

2.1 Goods and services tax (GST) is an indirect, broad-based consumption tax levied on the supply of goods and services. It is generally charged and collected at each stage of the supply process, with the tax burden being ultimately borne by the consumer. This feature distinguishes GST from single-level consumption tax levied at only one stage of the supply process. Most developed countries have introduced consumption tax in the form of GST, due to lower administrative and compliance costs incurred than under the single-stage consumption tax regime. As such, this information note will focus on the operation of and exemption/direct compensation arrangements for the GST regime.

2.2 GST is also known as value-added tax (VAT) in some jurisdictions. For example, the United Kingdom (UK) and other European Union member countries use the term VAT while New Zealand, Canada, Singapore and Australia use the term GST. GST and VAT in these countries refer to the same consumption tax described above.

Operation

2.3 There are various methods of calculating GST/VAT liability, with the credit-invoice mechanism[1] being more commonly used. Under the credit-invoice mechanism, GST/VAT is collected as a multi-stage levy charged on the value added at each stage in the production and distribution of goods and services. Each supplier levies GST/VAT on the price charged to customers (output tax), which is equal to the value of taxable sales multiplied by the prevailing consumption tax rate. The suppliers are allowed to claim a full refund/credit of the GST/VAT that has been paid on the inputs supplied to their businesses (the input tax). The difference between the output tax and the input tax is paid to, or repaid by, the tax authorities. Since the final consumer gets no refund/credit of the GST/VAT paid, he/she bears the ultimate burden of the consumption tax.

Reasons for Adoption

2.4 GST/VAT was first introduced in France in the 1950s and has become a popular source of revenue in many jurisdictions. For example, of the 29 OECD countries, 28 currently impose GST/VAT[2], with the United States of America (US) being the sole exception[3]. In the Asia-Pacific region, major economies that levy GST/VAT include the Mainland, Australia, New Zealand, Japan, Singapore, Taiwan, Indonesia, the Philippines and Thailand.

2.5 Countries usually introduce GST/VAT upon their dissatisfaction with the existing tax structure. The introduction of GST/VAT serves to overhaul the prevailing consumption tax regime[4] and/or to develop a new source of tax revenue. A broad-based GST/VAT is believed to provide a more cyclically stable revenue source, which may in turn provide room for a government to reduce/abolish other indirect taxes, reduce income taxes and finance social benefit schemes to compensate low-income households.

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1 Other methods include the addition and sales-subtraction mechanisms.

2 Australia was the latest OECD country to set up a GST regime, which came into effect on July 1 2000.

3 The US does not impose any federal GST/VAT-type tax on consumption. Instead, some states charge a single-stage consumption tax at the point of sale to final consumers.

4 In some jurisdictions, consumption tax was initially imposed as a levy on all business turnover. At each subsequent turnover of goods, the taxes previously paid and the values previously taxed were again subjected to tax in a process often referred to as "tax-on-tax" or "cascading".

<u>Regressivity</u>

2.6 There are concerns over the perceived regressivity of GST/VAT, as the tax payment accounts for a larger proportion of the income of a low-income household than that of a high-income household. GST/VAT is in principle a broad-based tax levied on items including essential goods and services, on which low-income households spend a higher percentage of their income than more affluent households do. Accordingly, many countries have introduced GST/VAT together with some offset measures in the form of exemptions or direct compensation arrangements to ease the tax burden on low-income households, thereby increasing public acceptance of the tax.

<u>Exemption Arrangements</u>

Goods Exemption

2.7 Many countries have zero-rated and exempted certain categories of goods and services from GST/VAT, notwithstanding the general principle that the consumption tax should be broad-based in its application.

- Zero-rated sales

2.8 Zero-rated sales are taxable sales albeit levied at a zero rate. Suppliers of zero-rated goods and services bear no GST/VAT on their sales to consumers. In addition, they are entitled to claim a full refund/credit of all the GST/VAT included in the cost of inputs, thereby allowing consumers to purchase their goods and services free of any consumption tax.

- Exempt sales

2.9 Exempt sales are sales that the sellers are exempt from any GST/VAT charged on their value added. However, they are not entitled to recover any GST/VAT paid on the inputs used in the production of their exempt sales. In this connection, exemption is less advantageous than zero-rating to consumers, as they are still liable for the GST/VAT charged on the inputs used in the exempt sales. Appendix I shows how the retail price charged on a sale differs according to whether the sale is taxable, zero-rated or tax exempt.

2.10 Zero-rating/exemptions are often granted to essential goods and services on the grounds that subjecting these essentials to GST/VAT would affect low-income households disproportionately. They are also granted on considerations other than the regressivity of GST/VAT. For instance, supplies of financial services are tax exempt in many countries because of the complexities and difficulties in collecting GST/VAT from these services. In addition, some jurisdictions consider certain goods and services, such as education and health services, are so "meritorious" that they should be levied at reduced or zero rates[5]. Exports are also exempt from GST/VAT as countries typically define the jurisdictional reach of their tax regimes under the destination principle, that is, goods and services are taxed in the country of consumption.

Entity Exemptions

2.11 Apart from goods exemptions, there are also two different kinds of exemptions granted on an "entity" basis under various GST/VAT regimes. The first kind of exemptions is provided for sales made by an entity because of the nature of the entity. These include the exemption granted to sales by non-profit organisations.

2.12 The second kind is the small business exemption that does not depend upon the kind of goods and services provided by the sellers. An entity with its annual business turnover below a certain threshold will be exempt from GST/VAT. Exempted entities will be relieved of administrative and compliance costs since they need not register with the tax authorities nor keep records for GST/VAT. The exemption of small entities is based on the consideration of the cost-effectiveness of the tax administration, since the GST/VAT collected from these low tax-yield entities might not justify the high administrative costs incurred on administering the tax on them.

Concerns over Exemption Arrangements

2.13 Exemption arrangements not only cushion the poor from GST/VAT, but also allow the rich to benefit from the zero-rated and tax exempt goods and services. In addition, a wide coverage of zero rating/exemptions will inevitably narrow the tax net, and the ensuing revenue losses will have to be made up by a higher GST/VAT rate charged on other taxable goods and services. Furthermore, a supplier would incur high administrative and compliance costs if he/she supplies both taxable and zero-rated/tax exempt items.

5 Merit goods are those goods considered by a government as socially desirable to warrant its intervention to ensure individuals consuming a sufficient amount of such goods. The government will intervene through measures such as providing subsidies to allow the provision of merit goods at lower prices.

Direct Compensation Arrangements

2.14 Some jurisdictions have resorted to a broad-based GST/VAT regime with a uniform tax rate, in order to avoid any inefficiencies inherent in exemption arrangements. In addition, a broad-based, uniform-rate GST/VAT incurs lower administrative and compliance costs, and helps reduce the extent to which the consumption tax alters consumer preference by changing the relative prices that consumers pay for their goods and services. Nevertheless, the jurisdictions that adopt a GST/VAT regime with minimal tax exclusions often introduce some direct compensation arrangements, which are set out as tax and/or non-tax relief measures targeting at low-income households.

Overseas Experience: the United Kingdom, New Zealand and Singapore

2.15 There are different policy approaches to address the GST/VAT burden on low-income households when introducing the consumption tax. The following paragraphs will discuss the exemption/direct compensation arrangements in the UK, New Zealand and Singapore. In short, the UK has opted for provision of zero-rating and tax exemptions to ease the burden on consumers. Meanwhile, New Zealand and Singapore have both adopted a broad-based GST/VAT regime with a uniform tax rate. They have also implemented some direct compensation measures, with Singapore's package being more comprehensive than that of New Zealand.

2.16 The salient features of the GST/VAT regimes in the UK, New Zealand and Singapore are summarised in the following table:

Table 1 — Comparative GST/VAT Features in the UK, New Zealand and Singapore

Country	Tax Rate / Registration Threshold	Notable Exemptions	Notable Zero Ratings	Notable Direct Compensation Arrangement
UK	• Standard rate: 17.5%. • Reduced rate: 5% on selected items. • Annual business turnover > £52,000.	• Postal services; • Certain financial services; • Education; • Health and welfare services; • Supplies of land and building; and • Certain fund raising events.	• Young children's clothing and footwear; • Most food; • Books, newspapers and periodicals; • Prescribed drugs and medicines; • Water and sewerage; • Passenger transport; • Specified aids for handicapped; • Certain supplies by or to charities; and • Exports.	• No direct compensation arrangements for low-income households.
New Zealand	• Standard rate: 12.5%. • Annual business turnover > N$40,000.	• Supply of fine metals; • Certain financial services; • Domestic rental accommodation; and • Donated goods sold by non-profit organisations.	• Exports of goods and services; and • Sale of a going concern.	• A wage supplement programme to ensure low-income earners to receive at least the minimum wage.
Singapore	• Standard rate: 3%. To be raised to 5% from 1 January 2003. • Annual business turnover > S$1million.	• Certain financial activities; and • Rental and sale activities of residential land and buildings.	• Exports of goods; and • Some specified international services.	• Comprehensive tax and non-tax direct compensation arrangements to offset the planned increase in GST rate, including: – reduction in income tax rates; – 1 200 shares of Economic Restructuring Shares worth S$1 each issued to Singaporeans aged 21 and above; – government to absorb GST payable on education and health services; – rebates on services and conservancy charges, and on rentals for public housing; – increase in public assistance and Singapore Allowance to the government pensioners; and – absorption of GST by public transport providers.

United Kingdom

Introduction of VAT

2.17 VAT was introduced in the UK on 1 April 1973. The introduction of VAT at the time was to facilitate the UK joining the European Community, which mandated all its member countries to adopt VAT. The new tax also replaced both the Purchase Tax, which was a wholesale sales tax, and Selective Employment Tax, a tax levied on people working in the service industries.

2.18 Although VAT was not introduced out of any immediate necessity for additional tax revenue, it has raised significant revenue for the UK government. VAT contributed to 16% of the total government tax revenue in 2001-02, compared with 5% in 1973-74.

Operation of VAT

2.19 VAT is calculated under a credit-invoice method and levied as a multi-stage tax charged on the value added at each stage in the production and distribution process. HM Customs and Excise is responsible for collecting VAT from taxable goods and services.

2.20 The standard rate of VAT in the UK is 17.5%, with a reduced rate of 5% on a number of goods and services, including the supply of fuel for domestic use, installation of energy-saving materials, women's sanitary products and children's car seats.

Exemption Arrangements

2.21 VAT was originally launched in the UK with numerous zero rating/exemptions in order to secure public acceptance of the tax. The exemption arrangements were made possible by the strong performance of the UK economy[6], which rendered no immediate need for the government to draw revenue from VAT.

6 The UK economy had grown rapidly by 8.4% in the first nine months of 1993 before the outbreak of the Middle East oil crisis moderated the GDP growth to 3.9% in the fourth quarter of the year.

2.22 The basic feature of the UK's VAT regime has hitherto remained unchanged with zero-rating/exemptions for a broad range of goods and services. The tax exclusions reflect the way in which the government has addressed the potential regressivity of VAT, not by directly compensating the adversely affected low-income households, but by providing comprehensive exemption arrangements. The wide-ranging tax exclusions cover many essential and merit goods, thereby easing the potential regressivity of VAT for low-income households.

2.23 The main categories of goods and services where zero rating applies are young children's clothing and footwear, most food, books, newspapers and periodicals, drugs and medicines supplied on prescription, water and sewerage for non-business use, domestic and international passenger transport, specified aids for handicapped people, certain supplies by or to charities, and goods exported to other countries. Meanwhile, many items are tax exempt from VAT, which include postal services, certain financial services, education, health and welfare services, supplies of land and building, and certain fund raising events.

2.24 Apart from goods exemption, entity exemption is given to companies with annual business turnover not more than £52,000. These companies are not required to register for VAT although they could do so on a voluntary basis.

Direct Compensation Arrangements

2.25 Zero-rating, exemptions and reduced rates for most essential goods have eased the burden of VAT on the general public[7]. As such, the government has not put forward any direct compensation arrangements to further compensate low-income households.

New Zealand

Introduction of GST

2.26 GST was introduced in New Zealand on 1 October 1986 when the tax system had been characterised by a heavy reliance on personal income tax levied at very high marginal rates of up to 66%. Additionally, the income tax system had featured many rebates and deductions as well as frequent tax avoidance/evasion owing to high marginal tax rates.

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7 It was estimated that 41% of consumers' expenditure was on zero-rated and VAT-exempted items in 2001. See Adam and Frayne (2001).

2.27 The introduction of GST was part of a tax reform package aiming to reduce the economic inefficiencies embodied in the "narrow-base, high-rate" tax regime. In particular, GST replaced the wholesale sales tax (WST) which contained numerous exemptions and multiple rates. Meanwhile, GST was levied at a high rate in order to more than offset the shortfall resulting from the abolition of WST. The extra revenue from GST was used to reduce personal income taxes, and help finance the direct compensation arrangements for low-income groups.

2.28 The introduction of GST and the subsequent reductions in personal income tax rates have contributed to a reduced reliance on direct taxes. In 2001-02, 25% of the total government tax revenue was derived from GST, with an additional 10% from other indirect taxes. In 1985-86, indirect taxes only accounted for 25% of the total government tax revenue.

Operation of GST

2.29 GST is calculated under a credit-invoice mechanism and charged on the value added at each stage in the production and distribution of goods and services. The Inland Revenue Department is responsible for collecting GST from taxable goods and services.

2.30 GST is charged at a standard rate of 12.5% on all goods and services which are not zero-rated or tax exempt[8].

Exemption Arrangements

2.31 The New Zealand GST tax regime was initially structured with a uniform rate levied on virtually all goods and services. The present regime continues to feature such a principle: GST is levied at a single rate of 12.5% with very few exemptions and zero rating.

8 For the provision of long-term accommodation services for individuals in a commercial dwelling (such as hotel, motel, etc), the standard rate of 12.5% applies only to 60% of the value of the supply. In other words, the GST will be charged at an effective rate of 7.5%.

2.32 Zero-rating applies principally to exports of goods and services in order to maintain the price competitiveness of New Zealand's exports in international markets. The sale of a going concern is also zero-rated in New Zealand[9]. Tax exemptions are limited primarily to the supply of fine metals, certain financial services, domestic rental accommodation and donated goods sold by non-profit bodies. Financial services are left out of the GST scheme because of the difficulties in valuation. Domestic rent is exempted on the grounds of fairness as GST does not apply to owner-occupied housing. For entity exemption, a business entity with annual business turnover of not more than NZ$40,000 is exempt from registration for GST.

Direct Compensation Arrangements

2.33 The New Zealand GST regime was deliberately designed with minimal tax exclusions to avoid inefficiencies inherent in exemption arrangements. Nevertheless, the government has sought to compensate low-income households through direct compensation arrangements in the form of both tax and non-tax relief measures. For example, social welfare benefits were increased at the time of the introduction of GST to adjust for the impact of the consumption tax on the real income of low-income households. In addition, an income maintenance package has been put in place to ensure low-income earners receiving at least the minimum wage. The package is currently provided through a wage supplement programme - the Family Tax Credit - to allow families earning less than NZ$18,368 a year receiving that amount through additional payment by the Inland Revenue Department. Furthermore, the successive reductions in personal income tax rates since the introduction of GST have made the overall tax payment less of a burden for the general public.

Singapore

Introduction of GST

2.34 GST was introduced in Singapore on 1 April 1994, following the release of a White Paper in 1993 proposing the implementation of a broad-based GST. The introduction of GST aimed to shift more of the tax burden to indirect taxation, thereby reducing Singapore's reliance on direct taxes. The broadening of tax base was intended to provide room for subsequent reductions in corporate and income tax rates to enhance the competitiveness of Singapore's economy.

9 The sale of a going concern is the sale of a business that is capable of being carried out by the purchaser as a taxable activity. The zero-rating of the sale of a going concern is to ease the funding requirement in business acquisition.

2.35 Unlike many other countries, Singapore has seen a smaller contribution of consumption tax to the government's coffers. GST has consistently contributed some 7-8% each year to the total government tax revenue between 1994-95 and 2001-02.

Operation of GST

2.36 GST is calculated under a credit-invoice mechanism and levied as a multi-stage tax on the value added at each stage of the production and distribution process. The Inland Revenue Authority is responsible for collecting GST from taxable goods and services.

2.37 The Singapore government introduced GST at a low tax rate of 3%, thanks to the favourable economic environment prevailing at the time of its introduction[10]. The GST rate has remained unchanged, reflecting the government's intention of not considering GST as an immediate source of revenue, but of developing it as a potential avenue for additional revenue when required.

2.38 In relation to the low GST tax rate, it is relevant to consider the contribution of the Central Provident Fund (CPF) to the government's strong fiscal position. CPF was originally set up in 1955 as a pension scheme, and it has since evolved into a comprehensive social-security savings scheme which allows its members to use their CPF savings before retirement for housing, medical expense, education, insurance and investment[11]. This flexibility in the use of CPF savings[12] has in effect made wage earners contribute to their own expenditure on housing, education and medical services, and the government could then bear a reduced fiscal burden on providing these social services[13]. For instance, medical and health services, housing and education accounted for 4.0%, 9.8% and 17.9% respectively of Singapore's total government expenditure in 1999[14]. The corresponding figures for Hong Kong were 11.8%, 17.0% and 18.7%.

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10 Singapore introduced GST at a time when the economy grew briskly and the government's fiscal position was healthy: an average annual growth of 9.4% and consecutive years of budget surplus during 1991-94.

11 The contributions to CPF are credited into three types of accounts: Ordinary, Medisave and Special. The savings in Ordinary Account can be used to buy a home, pay for insurance, and finance investment and education. Medisave Account savings are for the payment of hospitalisation expenses and approved medical insurance policies. The savings in the Special Account are earmarked for retirement, contingency and investment in retirement-related products.

12 This is a stark contrast to the pension schemes in the UK and New Zealand where pension is payable to those people reaching the pension age. In the UK, the Retirement Pension is a weekly benefit payable to women from the age of 60 and men from the age of 65. In New Zealand, the New Zealand Superannuation is a public pension system under which pension is paid by the government to most New Zealand residents from age 65 until death.

13 Another factor contributing to the government's reduced fiscal burden is the sizeable contribution made by Singaporeans out of their income to CPF. For example, employees up to the age of 55 are required to contribute 20% of their income to CPF.

14 See Census and Statistics Department (2001).

Exemption Arrangements

2.39 Singapore's GST regime has been modelled on the New Zealand system, with the consumption tax levied practically on all goods and services, including even health services and basic food. At present, zero-rating is limited to exports of goods and some specified international services, while tax exemptions are confined to the rental and sale of residential land and buildings, and certain financial activities. In addition to the tax exemptions for commodities, a business entity with annual business turnover not exceeding S$1 million is not obliged to register for GST.

Direct Compensation Arrangements

2.40 With minimal zero-rating/exemptions, the Singapore government complemented GST with a comprehensive direct compensation package. The package announced in the 1993/1994 Budget included GST-related property tax rebate, as well as rebates on services and conservancy charges[15], and rentals of public housing. In addition, Singaporeans were entitled to receiving a GST-related income tax rebate of up to S$700 in 1993-94. Many of these compensatory measures are not one-off and have continued into the ensuing years.

Latest Development: Increase in GST Rate

2.41 The Singapore government has recently made the first ever adjustment to GST since the inception of the GST regime in 1994. On 4 May 2002, the government announced in its 2002/2003 Budget that it would raise the GST rate from 3% to 5% with effect from 1 January 2003. The increase is to make up for the revenue losses resulting from the successive cuts in corporate and personal income tax rates to be implemented from the Year of Assessment[16] (YA) 2003 onwards. Corporate income tax rate will be reduced from 24.5% in YA 2002 to 22% in YA 2003, while the top marginal personal income tax rate will be slashed from 26% to 22% over the same period. The government aims to reduce both tax rates to 20% within three years, barring any major changes in the political and economic climate.

15 The monthly service and conservancy charges are levied for the maintenance of common areas in public housing.

16 The Year of Assessment refers to the tax year for which income is assessed. In addition, corporate and personal incomes are assessable on a preceding-year basis. Therefore, the tax paid for the Year of Assessment 2003 is based on the income earned in 2002.

2.42 For Singaporeans who pay income tax, the reduction in income tax rate will offset, fully or partially, the increase in GST. In any event, the government has also put in place a comprehensive five-year relief package to offset the increase in GST, as it did when the consumption tax was first introduced. These offsets are expected to cover the increase in tax burden for most households who will be no worse off after the GST increase for at least five years. The direct compensation measures include:

(a) Issuance of bond-like Economic Restructuring Shares (ERS) totalling S$3.6 billion to all Singaporeans. These ERS, which serve as the major part of the GST compensation package, will pay a guaranteed minimum 3% dividend per annum for five years during 2004-08. In addition, bonus dividends equal to real GDP growth of the preceding year will be declared annually. Singaporeans can cash in ERS with the government at any time at S$1 per share;

(b) Direct grants will be provided to hospitals and polyclinics to offset completely GST payable on subsidised healthcare services;

(c) Absorption of GST payable on education by increasing the government's subsidy to the state education system;

(d) Rebates on service and conservancy charges, and rentals for public housing will be extended for another five years from 1 April 2003;

(e) Increase in public assistance and Singapore Allowance to the government pensioners[17]; and

(f) Absorption of GST by public transport providers.

2.43 The latest direct compensation arrangement is comprehensive and covers a wide spectrum of the general public. For example, the S$3.6 billion ERS scheme will allow all Singaporeans aged 21 and above each to receive an allocation of 1 200 ERA shares from the government[18]. Meanwhile, the rebate on service and conservancy charges, and on rentals will benefit most Singaporeans, as 85% of them are currently living in public housing. In addition, the compensation package contains many non-tax reliefs to cater for those low-income households paying little or no income tax.

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17 The Singapore Allowance is an ex-gratia allowance given on top of the pensions that the government pays to pensioners residing in Singapore.

18 People living in properties with annual values not exceeding S$10,000 will be allocated 1 200 shares. These people account for 90% of households in Singapore. For those living in properties with annual values greater than S$10,000, they will receive a smaller allocation of 600 shares.

3. Progressive Profits Tax

3.1 Profits tax, also known as corporation tax in some jurisdictions, is charged on profits of a corporation arising in each accounting period. It can be classified as progressive, proportional or regressive according to the proportion of profits that an individual corporation would pay in taxes as its profits change. A tax that is a larger percentage of a corporation's profits as its profits increase is called a progressive tax[19]. Small companies are thus taxed at lower tax rates under a progressive profits tax regime. This preferential tax treatment is to help foster the growth potential of small companies, since they depend more on retained earnings as a source of funding. This is particularly so as the sheer size of small companies makes them more difficult to borrow from the financial markets when compared with large corporations. However, the progressive tax structure might entice a corporation to split up into several smaller companies to benefit from lower tax rates.

3.2 Profits taxes are progressive in many countries. The following paragraphs will study the corporation tax regimes in the UK and the US - two different approaches in charging corporation tax on a progressive basis. In the UK, corporation tax rates vary according to the level of taxable profits earned. Profits fall within a particular tax bracket will be charged at the flat rate levied on that bracket. It is a progressive tax since the flat tax rate moves up as the profits tax bracket grows. In the US, corporation tax is progressive in the sense that incremental profits earned by a corporation are subject to successively higher tax rates and hence a proportionately greater amount of tax.

United Kingdom

3.3 In the UK, there are three rates of corporation tax for 2002-03:

(a) the main rate of 30% charged on profits above £1.5 million;

(b) the small companies' rate of 19% charged on profits between £50,001 and £300,000; and

(c) the starting rate of 0% charged on profits up to £10,000.

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19 A tax that is the same percentage of a corporation's profits regardless of the level of profits is called a proportional tax. A tax that is a smaller percentage of a corporation's profits as its profits rise is a regressive tax.

3.4 For a company with profits between the limits stipulated under 3.3(a) and 3.3(b) (i.e. between £300,001 and £1.5 million), the profits are first subject to the main rate of 30%. The amount of tax so calculated is then reduced by a tax relief, known as marginal relief, so that the effective tax rate will be between the main rate and the small companies' rate. Similar marginal relief applies to firms with profits between the limits stipulated under 3.3(b) and 3.3(c) (i.e. between £10,001 and £50,000). Marginal relief helps provide a smooth graduation of a firm's tax liability from lower to higher tax rates. Appendix II shows how to calculate marginal relief for a company with profits between £300,001 and £1.5 million.

3.5 To discourage a corporation from dividing into smaller units to take advantage of lower tax rates, the Income and Corporation Taxes Act 1988 stipulates that when a corporation has one or more associated companies, all the rate thresholds for calculating marginal relief are divided by the number of companies associated with each other. In other words, marginal relief that could be enjoyed by each company will become smaller. An example showing the calculation of corporation tax for associated companies is given in Appendix III.

3.6 The Inland Revenue is responsible for the assessment and collection of taxes on income, profits and capital, and stamp duty. It has implemented various tax compliance measures to further discourage a taxpayer from taking advantage of the progressive tax regime. For example, a tax-related penalty will be imposed on a company if it fraudulently or negligently delivers an incorrect return in connection with a claim for an allowance, deduction or margin relief in respect of its tax liability. The maximum penalty for incorrect tax return is the difference between the original tax due and the revised figure.

United States of America

3.7 According to Section 11 of the Inland Revenue Code (IRC), every US corporation computes its taxes according to a schedule consisting of four income brackets with rates of 15%, 25%, 34% and 35%. The rate schedule also includes two surtaxes: 5% on income between US$100,000 and US$335,000 and 3% on income between US$15 million and US$18.333 million. The 5% surtax recoups the benefit of the 15% and 25% on the first US$75,000 taxable income. The 3% surtax recoups the benefit of the 34% on the first US$10 million taxable income.

3.8 The system of multiple rates provides an incentive for a large corporation to partition into multiple corporate entities to benefit from a lower average tax rate. Section 1561 of IRC helps deter this tax avoidance strategy. The Section provides that members of a controlled group of corporations must share the amount of income in each tax bracket. For example, if a person divides his business into four corporations, only US$12,500 (one fourth of the first US$50,000 of taxable income) for each of the four related corporations would be taxed at 15%. Appendix IV describes the criteria used by the Inland Revenue Service (IRS) to define a controlled group of corporations.

Table 2 — Corporate Tax Rate Schedule (US$)

Over	But not over	Tax is:
$0	$50,000	15%
$50,000	$75,000	$7,500 + 25% x (TP[a] - $50,000)
$75,000	$100,000	$13,750 + 34% x (TP - $75,000)
$100,000	$335,000	$22,250 + 39%[b] x (TP - $100,000)
$335,000	$10,000,000	$113,900 + 34% x (TP - $335,000)
$10,000,000	$15,000,000	$3,400,000 + 35% x (TP - $10,000,000)
$15,000,000	$18,333,333	$5,150,000 + 38%[c] x (TP - $15,000,000)
$18,333,333	-	$6,416,667 + 35% x (TP - $18,333,333)

Notes: (a) = Taxable Profits
(b) = 34%+ 5% surtax
(c) = 35% + 3% surtax

3.9 Section 482 of IRC provides a further safeguard against tax avoidance through multiple corporate structure. The Section allows the Commissioner of IRS to reallocate income, deduction or other items among controlled corporations, if necessary, to prevent evasion of taxes or to clearly reflect their income.

3.10 In addition, a tax assessor will impose accuracy-related penalties on a taxpayer, should he/she conclude that the taxpayer does not make a good faith to compute the correct tax for the year under examination. In such case, IRS may impose an administrative penalty on the taxpayer. IRC contains dozens of different penalties, each of them being designed to discourage a particular type of misconduct. A frequently imposed penalty is the negligence penalty, which equals to 20% of any underpayment of tax attributable to (i) negligence or disregard of rules and regulations, (ii) substantial understatement of tax liability, (iii) substantial valuation overstatement or (iv) substantial valuation understatement.

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Appendix I

Difference in Retail Price for Taxable, Zero-rated and Tax Exempt Goods

I. Assuming that a retailer has a value-added of $600,000 and pays $400,000 on inputs (exclusive of GST/VAT), the retail price he/she charges on the consumer will depend on whether the sales are taxable, zero-rated or tax exempt.

	Taxable (no zero rating/ exemption)		**Zero Rating**		**Exemption**	
Value-added (a)		$600,000		$600,000		$600,000
GST/VAT* charged on value added (b) = (a) x 10%		$60,000		0		0
Inputs purchased exclusive of GST/VAT (c)		$400,000		$400,000		$400,000
GST/VAT paid on inputs (d) = (c) x 10%	$40,000		$40,000		$40,000	
Refund of GST/VAT paid on inputs (e)	0		$40,000		0	
Net GST/VAT paid on inputs (f) = (d) - (e)		$40,000		0		$40,000
Consumer pays (a) + (b) + (c) + (f)		$1,100,000		$1,000,000		$1,040,000

Note: * assuming a 10% GST/VAT rate

Appendix II

Calculation of Marginal Relief

I. As discussed in paragraph 3.4, marginal relief is provided to firms with annual profits between £10,001 and £50,000, and between £300,001 and £1.5 million. Marginal relief is calculated based on the following formula:

> marginal relief fraction x (the upper limit of the relevant corporation tax bracket - chargeable profits)

where marginal relief fraction is set by the government; and

upper limit = £50,000 for companies with profits between £10,001 and £50,000,
= £1.5 million for companies with profits between £300,001 and £1.5 million[20].

II. To illustrate the calculation of the corporation tax paid by firms with profits between £300,001 and £1.5 million, assume that Corporation A has chargeable profits of £370,000. Its corporation tax liability is calculated as follows:

	£
Corporation tax at 30% on £370,000	111,000
Less: Marginal relief	
11/400 x (£1,500,000 - £370,000)	(31,075)
Corporate tax payable:	79,925

[20] The calculation of marginal relief will be more complex if a corporation receives dividends from other UK companies. The dividends so received are not taxed for corporation tax purposes in the UK, because they will be paid out of profits which have already borne corporation tax in the paying company. As such, marginal relief is calculated as:

> marginal relief fraction x (the upper limit of the relevant corporation tax bracket - total profits) x taxable profits/total profits

where taxable profits = total profits minus dividends received from other UK companies.

Appendix III

Calculation of Corporation Tax for Associated Companies

I. The Income and Corporation Taxes Act 1988 stipulates that when a company has one or more associated companies, all the rate thresholds for calculating marginal relief are divided by the number of companies associated with each other.

II. To demonstrate the calculation of corporation tax liability for associated companies, assume that Corporation A in Appendix II changed its company structure and has two associated companies. Corporation A will be entitled to marginal relief calculated as follows:

The upper limit is divided by the number of companies associated with each other: £1,500,000 x 1/3 = £500,000.

	£
Corporation tax at 30% on £370,000	111,000
Less: Marginal relief	
11/400 x (£500,000 - £370,000)	(3,575)
Corporate tax payable:	107,425

III. As a result of the adjustment of the upper limit by the number of associated companies, marginal relief received by Corporation A is £3,575 and the corporation tax payable amounts to £107,425, while the corresponding figures are £31,075 and £79,925 if no adjustment has been made to the upper limit[21].

IV. The Income and Corporation Taxes Act 1988 also stipulates that associated companies are broadly those where one company has control of the other, or both are under a common control. When determining if companies are associated, the following principles apply:

(a) Control is established by holding:

- over 50% of the share capital; or
- over 50% of the voting rights; or
- being entitled to over 50% of the distribution income, or net assets on a winding up;

(b) An associated company is counted even if it is associated for only part of the accounting period; and

(c) An associated company is disregarded if it has not carried on any trade or business at any time in the accounting period, or the part of the accounting period when it is associated.

[21] See Appendix II for the derivation of these two figures.

Appendix IV

Definition of a Controlled Group of Corporations

I. Section 1563 of Inland Revenue Code defines the types of controlled groups that are governed by Section 1561. A controlled group of corporations includes mainly parent-subsidiary groups and brother-sister groups.

Parent-Subsidiary Group

II. A parent-subsidiary controlled group is a chain of corporations headed by a parent corporation in which at least 80% of either the voting power or value of each subsidiary's stocks is owned within the chain. For example, Corporation A owns 80% of the voting stocks of Corporation B, and Corporation B in turn owns 80% of the voting stocks of Corporation C. Corporations A, B and C constitute a controlled group in which Corporation A is the common parent and Corporations B and C are subsidiaries.

Brother-Sister Group

III. A brother-sister controlled group consists of two or more corporations in which five or fewer shareholders meet two ownership tests. Under the first test, the shareholders collectively own at least 80% of the voting power or value of each corporation's stocks. Under the second test, the shareholders collectively own more than 50% of the voting power or value of each corporation based on each shareholder's identical ownership of each corporation's stocks. Identical ownership refers to a shareholder's lowest ownership percentage in any corporation in the group.

IV. As an example showing the application of the two ownership tests, assume that shareholders X, Y and Z own the stocks of Corporations A and B in the following proportion:

	X	Y	Z	Total
Corporation A	40%	50%	10%	100%
Corporation B	15%	20%	65%	100%
Identical ownership	15%	20%	10%	45%

Appendix IV (cont'd)

V. Corporation A and Corporation B are not a brother-sister controlled group. X, Y and Z collectively own more than 80% of the stocks of each corporation and this passes the first ownership test. However, taking their identical stock ownership into account, X, Y and Z own not more than 50%. In other words, Corporation A and Corporation B fail the second ownership test. If the share holding of Corporation A owned by X drops to 34% and that owned by Z increases to 16%, then Corporation A and Corporation B constitute a brother-sister controlled group.

	X	Y	Z	Total
Corporation A	34%	50%	16%	100%
Corporation B	15%	20%	65%	100%
Identical ownership	15%	20%	16%	51%

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