AVOIDING DOUBLE TAXATION OF INCOME[1]

Introduction

Ukraine is in the midst of a decade-long tax reform process. This process has been marked by major reforms, followed by periods of little substantive change. The last major reform was in 1997, when new versions of the Value Added Tax (VAT) and the Enterprise Profits Tax (EPT) came into effect. Current legislation has sufficient momentum to make the period of 2002-2003 the next major leap forward in the tax reform process.

At the forefront of the current tax reform effort is an effort by both the Cabinet of Ministers and the Verkhovna Rada to implement a new Personal Income Tax (PIT). This effort is intended to replace the current PIT legislation, which has its roots in a Cabinet of Ministers decree of 1993. Competing versions of the PIT law will dramatically expand the tax base and adjust the rate structure.

In the movement to expand the tax base there is danger that certain types of income will be taxed incorrectly. Recent drafts have overlooked certain types of income, while other types of income have been included at multiple stages, resulting in double- (sometimes triple-) taxation of the same income. This note hopes to shed some light on these issues by providing some simple guidance on how income should be selected for taxation.

The Income Tax Base

In order to fully understand what is meant by double-taxation, we first should develop a consistent basis for tabulating income in Ukraine. National income accounting, as used for the tabulation of GDP, provides the necessary definitions, and we can use these definitions to clarify some common misunderstanding concerning income.

Definition of National Income

All students of economics are familiar with the concept of *Gross National Product* (GNP). GNP represents the value of final production of goods and services for a country.[2] GNP is an important concept for two reasons: Firstly, the GNP of Ukraine represents the amount of productive Ukrainian activity, providing a starting place for identifying the base available for taxation. Secondly, methods for calculating GNP are developed to avoid *double counting*. Procedures to avoiding double counting exist to ensure that GNP accurately reflects the amount of true economic activity in a country. While all transactions are important, not all are included into GNP. Intermediate transaction (sales of inputs into the production process) are excluded from GNP because the value of those transactions is carried forward and included in the value of the product that is finally consumed.

[1] By John Thissen.
[2] GNP is different than GDP in that it includes the productive efforts of Ukrainians working abroad. As Ukraine taxes Ukrainians on their worldwide income, this more accurately reflects the Ukrainian tax base.

What does this have to do with *income*? Income is derived from productive activity. For every sale there is a payment. The value of production is identically equal to the value of income. Thus, *Net National Income* (NNI) is defined by the national income accounting standards as being equal to GNP, with a few minor adjustments. NNI provides us with a foundation defining the income tax base. It includes the payments made for all productive efforts – all wages, dividends, interest, profits, etc. (see sidebar *GDP from Income Sources*).[3] It is important to emphasize that NNI does not include double counting. Just as all economic activity is counted once and only once, all of the income resulting from that activity is also included once and only once.[4]

GDP from Income Sources

	Compensation of Employees
+	Net Profits of Enterprises
+	Proprietor's Income
+	Rental Income
+	Net Interest
National Income (NI)	
+	Indirect Business Taxes and Misc.
Net National Income (NNI)	
+	Capital Consumption Allowances
Gross National Product (GNP)	
–	Net Factor Income from Abroad
Gross Domestic Product (GDP)	

Common Misconceptions

The most common misconception is that the income tax base is increased whenever a person receives or accrues money, goods, or services. If person 1(*P*) gives money to person 2 (*R*), should *R* be taxed? The answer depends on why the money is changing hands. Did *R* do something productive to deserve the payment? Did *R contribute to GNP*? If *R* did something useful, like providing labor services to *P* (the employer), then *R* is receiving income related to productive activity, and it should be taxed. So, wages should be taxed; this is not controversial.

There is a flipside to the issue, however. This income to *R* represents an *expense* to *P*. *P* should not have to pay tax on the labor contributed by *R*. Why? The productive effort associate with the labor of *R* generates income that belongs to *R*. This is the result of the framework provided by national income accounting – there is a strong linkage between productive activity and income. Allowing *P* to deduct the labor expense from taxable income is appropriate because the liability for this effort should fall on the taxpayer that contributed the labor: *R*. In this way, double counting is avoided. Thus, employers should be allowed to subtract wages from taxable income. Again, this is not controversial.

Example: Suppose a business sells UAH 2 million worth of goods, with a wage bill of UAH 1 million, and other costs of UAH 500 thousand, resulting in net income (profits) of UAH 500 thousand to be taxed under the EPT. The wage bill (UAH 1 million) is taxed under the PIT. If the business were not allowed to deduct wages from taxable income, it would have taxable profits of UAH 1.5 million. Considering that the wage bill is *also* to be taxed at under the PIT, a total of UAH 2.5 million would be subject to income tax, even though there was a contribution to GNP of only UAH 2 million.

[3] Actual data regarding the composition of GDP from the income side in Ukraine is scarce. Goskomstat reports that in 2001, 43% of GDP was attributable compensation of employees, 44.1% was attributable to net profits and misc. income, and 12.9% was net taxes.

[4] It is worth noting that GDP is calculated on a *cash* basis, while for tax purposes, income is calculated on an *accrual* basis. This will lead to minor discrepancies between the definition of the tax base and NNI. However, these discrepancies are the result of the *timing* of the payment, and not the *value* of the payment.

We concluded then, that the tax liability is best assigned to the person that makes the contribution to GNP.[5] If we do this, we will avoid double counting. So what about gifts? Suppose there is no labor involved; *P* simply gives money to *R*. Should *R* be taxed? The answer is no, because there is no productive activity; no contribution has been made to GNP, and so there is no income to assign to *R*. The gift should not be taxed as income.[6] Rather, gifts represent a *redistribution* of previously accrued income that has already been taxed.[7]

Current Issues in Ukraine

There are many kinds of income besides wage income. The current and proposed treatments of some of the major types of income deserve further attention.

Dividends

Dividends are payments made to persons or companies that invest financial capital into a company. The company uses this money to purchase physical capital (machinery, etc.). Physical capital is an important part of the production process, and thus, contributes to GNP. The income associated with this contribution is called *profits*, which can be distributed as dividends or kept by the company as *retained earnings*. Profits should be taxed as income.

For a number of reasons, company profits are taxed by their own, separate income tax (the EPT). But this does not mean that profits are different than other types of income. Income is income, and it should be taxed. A complication arises when dividends are paid, because profits are the subject of taxation of the EPT, while income paid to individual taxpayers is often income paid to physical persons, who are covered by the PIT. There is a need to coordinate these two taxes.

Current legislation in Ukraine includes a provision that is internationally known as an *Advanced Corporate Tax* (ACT). Under the ACT, a company is required to withhold tax on dividends paid, but is allowed to credit these withholdings against EPT liability. In this way, profits are divided into two separate, non-overlapping parts: dividends and retained earnings. Each part is taxed only once. There is currently a proposal in Ukraine to eliminate the ACT, taxing all profits at the EPT rate, and then *again* tax dividends at a withholding rate of 15%. In this way income paid in the form of dividends is taxed twice.[8] Such a policy will cause investors to carry a higher percentage of the tax burden than they contribute to GNP, which will reduce their incentive to invest.

Example: Suppose a business has current profits of UAH 500 thousand. It distributes half of this as dividends, and retains the other half as retained earnings. Under current law in Ukraine, both types of income are subject to tax at 30%. Shareholders would pay UAH 75 thousand in taxes on dividends, and the company would pay UAH 75 thousand [9] in EPT. Total income subject to taxation is UAH 500 thousand. If the EPT credit was not allowed for taxes on dividends paid, then all UAH 500 thousand would be subject to taxation under the EPT, plus, UAH 250 thousand in dividends would be subject to taxation. The end result is

[5] This is actually an allocation issue. Income to an employee is best taxed at the level of the employee. However, it is certainly possible to tax that income by shifting the liability to the employer. It is simply convenient to allocate the tax liability to the person that is productive.
[6] This viewpoint is potentially inconsistent with what is commonly called the Haig-Simons definition of income. Within the context of that definition, gifts are generally considered income. However, even proponents of the HS definition of income tend to exclude gifts from the income tax base, instead preferring to tax them under a special regime.
[7] Such redistribution can best be taxed using a separate tax on gifts and inheritance.
[8] In modern tax systems, such a policy exists only in the United States and the Russian Federation.
[9] 30% of UAH 500,000 is UAH 150,000. The business would receive a tax credit of UAH 75,000 for taxes paid on dividends, bringing the total liability to UAH 75,000.

UAH 750 thousand subject to taxation, where only UAH 500 thousand was earned as profits.[10]

Employee Benefits

Double taxation most often arises in cases where there is a lack of integration of the PIT and the EPT. While the double-taxation of dividends is one such subject, there are other important issues to address with respect to possible double taxation, most notably *employee benefits*. Employers pay their employees in a number of different ways; salaries are no longer the only option. Employers can make pension contribution, pay for insurance policies, provide company owned automobiles, housing, etc. The compensation package can be quite complicated. All of these benefits (as well as wages) should be viewed as income linked to the employee's contribution to GNP, and taxed as income.

There are two ways that benefits can be taxed. The first is to treat all benefits as wages, include them into the tax base of the PIT, and place the liability squarely on the employee. If administratively feasible, this is the preferred approach because it is the employee who is making the contribution to GNP. *Alternatively*, employers could be prohibited from deducting the benefits from taxable income under the EPT. By disallowing the deduction, the payment becomes subject to the EPT rate, and the liability falls upon the company. Still, it is income, and the EPT is an income tax, so taxing it in this way is acceptable.[11]

Problems arise when the benefit is taxed both under the EPT (by disallowing the deduction) *and* the PIT (by including it into taxable income). *Example:* Current Ukrainian law double taxes voluntary contributions into life insurance policies made by employers on behalf of employees. This practice is continued under proposed legislation.

In addition, problems arise when the benefit is not taxed under either the EPT *or* the PIT. *Example:* Current Ukrainian law does not tax mandatory pension contributions made by employers on behalf of employees.[12] The contributions are deductible for EPT purposes, and the contributions are not included into taxable income. In addition, future benefits are not included into taxable income. This practice is continued under proposed legislation.

Savings

Individuals save a portion of their after-tax income. Thus, the principle balance that is placed on account in a bank can never be anything other than income that has already been accrued. To the extent that it has already been taxed, it would be inappropriate to tax it a second time. However, it is possible for taxation to be *deferred*. This is the case when individuals are allowed to save using *pre-tax* income; the income is saved prior to tax being levied, and then taxed when the principle is withdrawn from the account. An example of such a system is the 401k retirement savings plan in the US, where employees are allowed to save a limited amount of income on a pre-tax basis in preparation for their retirement years. Such plans can result in significant reductions in current revenue into the budget, and thus are strictly regulated.

[10] To be clear, while there is only UAH 500,000 in income, the UAH 750,000 is subject to taxation.

[11] The wrong person is paying the tax, but the tax is uniquely assigned. If the employer can shift the tax burden to the employee by lower their wages or benefits to compensate, then the incidence of the tax will end up being correct. If there are different marginal tax rates in the EPT and PIT, then the tax burden will be incorrectly calculated. This is the best way to tax benefits that are difficult to administer or quantify. The use of company automobiles is such an example. Ukraine currently broadly disallows deductions for operating expenses of automobiles.

[12] This exclusion is currently justified for purposes of social equity. However, under a well-designed system, low-income pensioners would be excluded from the tax system by provisions for low-income tax relief. High-income pensioners should be taxed on all of their income.

In all cases, the interest that is earned on the saved principle is income. This income can be tied to the financial services sector, where the service of providing temporary access to financial capital represents a measurable contribution to GNP. As such, it should be taxed either immediately or upon withdrawal from the account.

Insurance Benefits and Pensions

Not all instances of double-taxation arise from a lack of integration of the PIT and the EPT. In some cases it is possible to double tax income exclusively within PIT. For example, the taxation of insurance benefits or pensions should be addressed with some caution. Consider what many types of insurance and pension plans are: saving plans. The owner of the policy or fund makes payments into an account, and submits (or not) a claim against that account in the future. The insurance company earns profits by receiving more payments in premiums than they pay in benefits, and of course these profits should be taxed. But should insurance or pension benefits, paid to the policyholder, be taxed?

Like savings, the answer depends on whether the premiums or contributions were paid with pre-tax or post-tax income. If such payments are made by the individual using income that has already been taxed, then it would be inappropriate to tax the benefit. This would also be true if the premiums or contributions were paid (as a whole or in part) by the employer, and then included into the employee’s taxable income. On the other hand, if the employer’s contributions are excluded from taxation, or the taxpayer is allowed a deduction from taxable income for the premiums or contributions paid, then it would be appropriate to tax the benefit.

No distinction should be made as to whether the pension or insurance policy is compulsory or voluntary. Further, interest or dividends earned on certain types of insurance polices or pension plans would represent income as described above, and should be taxed accordingly, either upon accrual or withdrawal.

Conclusions

All income should be taxed, and taxed only once. How to decide what to tax? There are two criteria that will clarify the issue 99% of the time:

- Can the payment be tied to some contribution to GNP, either in the current or previous periods? Is there an identifiable economic reason for tax liability?
- Has the income already been taxed? If it has, it should not be taxed again.

These criteria include into the tax base things like wages, benefits, dividends, interest, and current retained earnings. It excludes payments like gifts, inheritance, and the principle on savings accounts. While this does not clarify all issues, it is a good decision rule for clarifying the issues currently being debated in Ukraine.