FEATURES OF TAX EXPENDITURES IN CORPORATE INCOME TAXATION

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Abstract: *The article deals with the features of the using of the concept of tax expenditures from the position of administration of tax incentives of corporate income tax. Analyzed the list of basic elements of the tax expenditures according to different views of foreign academic economists. Denoted main positive and negative aspects of tax expenditures. The definition of the corporate tax base using the Shantz-Haig-Simons concept is considered. Described some elements of the benchmark (normative) structure of corporate income tax, deviation from which are defined as tax expenditures. Main attention is given to tax rate, taxable unit, taxable period, accounting rules and avoidance of double taxation. As a result, indicated, that tax expenditures have a role to play and are employed widely.*

Keywords: *corporate income tax, tax incentives, tax expenditures, Shantz-Haig-Simons concept, benchmark (normative) tax structure, tax rate, taxable unit, taxable period, accounting rules, avoidance of double taxation.*

JEL classifications: *H25*

1 INTRODUCTION

The effectiveness of the state tax system is expressed by comparing tax revenues to expenditures: the larger tax revenue in relation to the costs of obtaining them, the more effective the tax system.

The principle of the effectiveness of the tax system in practice can be realized on the basis of two conceptual approaches (Kuklina, 2014):

- neutralistic – reduction of the tax rate and tax base expansion without using of tax preference items;
- interventionist – differentiation of taxes, using of numerous tax incentives at high general tax rates.

Today most advanced is the second approach, which provides stable priming of selective types of economic activities. In this regard, the issue of the needing to save tax incentives is actively discussed in the political and scientific spheres. This tendency is explained by the fact that the world and, partly, domestic experience of using tax incentives have shown that they can have a positive impact on economic activity and the social sphere. Recently, the main purpose of tax incentives is increasingly reduced to attracting investment in production, services, as well as stimulating the development of individual sectors of the economy.

Thus, during administration of tax incentives of corporate income tax there are four different types of expenditures, namely (Zee, Stotsky and Ley, 2002):

- resource allocation costs (for example, additional investments);
- tax compliance costs;
- costs associated with lack of transparency and high corruption;
- expenditure on budget revenues (including tax expenditures).

In view of this, the concept of tax expenditures, which, exists in world practice, is interesting to study.

2 THE CONCEPT AND CHARACTER OF TAX EXPENDITURES

The term “tax expenditures” was introduced in 1967 by Assistant Secretary for Tax Policy, Stanley Surrey, in a speech calling for a “full accounting” of them. Following his speech, estimates were prepared by the U.S. Department of the Treasury (Treasury) and later by the Joint Committee on Taxation (JCT).

In 1974, the Budget Act charged the House and Senate Budget Committees with the duty “to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies” to Congress on a recurring basis. The Budget Act further required that the annual President’s Budget include tax expenditure estimates (Payne, 2015).

According to article 2 of Congressional Budget and Impoundment Control Act of 1974 The term “tax expenditures” means those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability, and the term “tax expenditures budget” means an enumeration of such tax expenditures (Congressional Budget and Impoundment Control Act,1974).

Stanley Surrey and coauthor, Paul R. McDaniel, defined the concept thus in their 1985 treatise on the subject: The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class or persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance (Surrey, 1976).

3 BASIC ELEMENTS OF THE TAX EXPENDITURE

Like any instrument of the tax system, tax expenditures have a number of elements, the list of which in the historical retrospect has only been expanded and refined (Table 1).

Table 1: The views of foreign academic economists on the possible list of tax expenditures

Author	Year of publication	List of elements of tax expenditures
S. Surrey	1985	1. tax exclusion; 2. tax deduction; 3. tax deferral 4. preferential tax rate 5. tax credit
Richard A. Musgrave, Peggy B. Musgrave	1993	1. tax exemption; 2. tax deduction (standard or item)

S. H. Rosen	1999	1. tax exemption; 2. tax deduction (tax allowance; tax credit; standard deduction is a fixed amount that is available to all taxpayers and it is inflation-linked)
H. Arbutina and K. Ott	1999	1. tax exemption; 2. tax credit; 3. tax deduction; 4. preferential tax rate.
D. Brümmerhof	2000	Thinks that it is practically impossible to cover tax expenditures in an appropriate manner. Tax expenditures can arise by changes in the tax base, tax rate or tax credits. Tax preferences can, further, be final or can take on the form of a postponement of payment, and in this case the tax preferences can be comprehended only partially, via the effects of the interest rate or the effect of the tax rate on the total tax due.
C. Sandford	2000	1. tax exemption; 2. tax allowance; 3. tax deduction or tax credit 4. preferential tax rate; 5. tax deferral
V. Bratić	2006	1. tax exemption; 2. tax credit; 3. tax deduction; 4. preferential tax rate; 5. tax deferral; 6. tax exclusion
R. Kimmons	2011	1. tax exemption; 2. tax exclusion; 3. tax deduction; 4. tax credit

Source: Surrey, Stanley S. (1976), Musgrave, Richard A. and Musgrave, Peggy B. (1989), Rosen, S. H. (1999), Arbutina, H. and Ott, K. (1999), Brümmerhof, D. (2001), Sandford, C. (2000), Bratić, V. (2006), Kimmons, R. (2011).

As can be seen from Table. 1 until the end of the twentieth century, according to the R. Masgrave and P. Masgrave, there were two main elements of the tax expenditures, namely: tax exemptions and tax deduction. Later, S. Rosen multiplied tax deduction and include tax allowance; tax credit; standard deduction is a fixed amount that is available to all taxpayers and it is inflation-linked. At the same time, it must be said that there were even thoughts (D. Brümmerhof) that it is virtually impossible to determine the components of the tax expenditures. However, since the 21st century, the list of elements of the tax expenditures began to expand considerably (S. Sandford, V. Bratić, R. Kimmons) and became more and more encompassing, approaching to the list, proposed in 1976 by S. Surrey (Stadnyk, 2017).

So, in Table 2 we describe main types of tax expenditures, which are using today in foreign tax practice.

Table 2: Main types of tax expenditures

Tax expenditure	Description
Tax exemption	Reduces gross income for taxpayers because of their status or circumstances.
Tax exclusion	Excludes income that would otherwise constitute part of a taxpayer’s gross income.
Tax deduction	Reduces gross income due to expenses taxpayers incur.
Tax allowance	Amounts deducted from the benchmark to arrive at the tax base;
Tax credit	Reduces tax liability dollar-for-dollar. Additionally, some credits are refundable meaning that a credit in excess of tax liability results in a cash refund.
Preferential tax rate	Reduces tax rates on some forms of income.
Tax deferral	Delays recognition of income or accelerates some deductions otherwise attributable to future years.

Source: Tax expenditures: background and evaluation, criteria and questions, 2012.

In literature, some findings expose the positive and negative impacts of these instruments both the economy and taxpayers. It is indicated that they should pursue at least one of four objectives, such as to improve progressivity within the tax system, provide greater efficiency for the tax structure, stimulate the consumption of merit goods or encourage investment in certain sectors or regions (regional development) (Villela at al., 2010). Thus in the table 3 we show main positive and negative aspects of tax expenditures.

Table 3: Main positive and negative aspects of tax expenditures

Positive effects	Negative effects
encouraging private sector participation in economic and social programs where government plays a main role	erosion of revenue bases, which limits the scope for tax rate reductions. Such government losses could be used for the financing of direct government expenditures and which limits the ability to reduce tax rates)
promoting private decision making rather than government decision making	providing open-ended government spending, which makes it more difficult to estimate tax revenues
reducing the need for close government supervision of such spending	adding complexity to tax laws, increasing the cost of enforcing them, and enables lobbying and using government to make additional rents
	increase of repressiveness of the tax system

Source: Bratić, 2006.

So, let's try to give examples that according to S. Surrey will be tax incentives from the point of view of tax expenditures, and will be considered as a part of the basic (normative) structure of the corporate income tax.

4 TAX INCENTIVES OF CORPORATE INCOME TAX ACCORDING TO THE TAX EXPENDITURES CONCEPT

So, the tax base of corporate income tax – "net income" S. Surrey proposed to determine on the basis of the concept of Shantz-Haig-Simons (S-H-S). This concept was developed by Georg von Schanz, applied by Robert Murray Haig, and specified by Henry Simons. The S-H-S definition is very broad. According to the concept of S-H-S, income is an increase of net economic prosperity between two time points plus consumption during this period. However, this approach to income definition covers only the main aspects and have an eye for only some details, while not taking into account a number of current problems. In addition, elements such as self-service, gifts and inheritance, income in the form of movable property and capital gains, which fall within the definition of the income of the S-H-C concept, are traditionally excluded from the definition of income for tax purposes. Therefore, for the use of S-H-C income as the tax base of the corporate income tax should be regulated under the "generally accepted structure of income tax, based on the principle "ability-to-pay" (Surrey, 1979), according to which the tax burden is distributed according to the level of income. Therefore, to the income, calculated with using of S-H-C concept, should be used additional amendments, because in the context of corporate income tax, the aspect of consumption is not significant (Surrey and McDaniel, 1985).

Essentially, the concept of a normal (or normative) income tax structure was one of applying a rate schedule against the taxable unit's net income base – ascertained by including all items of gross income and deducting all expenditures associated with the production of that income, with capital expenditures allocated over time in accordance with generally accepted accounting practices (Surrey and McDaniel, 1976). However, due to the using of separate accounting principles such as the principle of matching and prudence, that out of contact with tax rules, taxable profit cannot be calculated directly from the Balance Sheet or the Profit and Loss Statement. In practice S-H-C income is the starting point for most countries in formulating of a benchmark tax base.

Also, we should to say, that S-H-S definition provides no guidance on the rate structure, the proper taxpaying unit, the relationship between a corporation's income and its shareholders' tax liability, or the proper accounting period. According to Bittker, Surrey's silent incorporation of his own judgments on these structural elements into his "accepted concept of net income" succeeded in "bringing some issues to the fore only to conceal others (Bittker, 2009).

But no country uses this concept in its pure form, but provides a wide range of rationalizations about why their national tax base structure should (and sometimes significantly) diverge from this theoretical model.

Thus, in practice, according to the OECD methodology benchmark tax system identity by three approaches (Tyson, 2014; OECD, 2010):

- Conceptual approach, in which an "optimal" tax system is used as the norm created on the basis of theoretical taxation concepts in different areas of the economy (income define with using of S-H-C concept);
- Legal approach, based on the country's own tax laws in order to indicate differential or preferential treatments (tax expenditures);
- Expenditure subsidy approach, in which tax expenditures are the amounts that may be replaced by public subsidies (budget expenditures).

Conceptual benchmarks are based on clearly stated principles and so there is less room for subjective judgements. But, in practice, there are significant distinctions in stipulating the tax benchmark within both economists' and national reporting. Thus, current tax law benchmarks are more subjective but have the advantage that they are more closely related to the current tax system, so that the estimate of the cost of a tax expenditure is equivalent to estimating the revenue gain of removing the corresponding legal provision. This is not true of a conceptual benchmark if the general provisions of the tax law do not correspond to the benchmark.

Now try to study main elements of the corporate income tax in case of using tax expenditure concept.

So, there is no clearly defined normative corporate income tax rate that would be recognized as a benchmark. This is due to the fact that the tax rate scale is determined on the basis of fiscal policy of the government and political goals. However, once a benchmark national tax rate is established, any special (reduced or increased) rate, that is different from the adopted (base) rate, will be considered as tax expenditure (Surrey and. McDaniel, 1985). Some countries offer a lower tax rate for small and medium-sized businesses. Whether this constitutes a tax expenditure depends on the country’s policy and the intention of the government when they first introduced this rate Usually, if the special rate is given to provide incentives, or to assist certain industries or activities, it should be treated as a tax expenditure. Likewise, a rate higher than the benchmark suggests a negative tax expenditure.

Also, we should to note that, according to international definitions negative tax expenditure is a provision in the tax law, motivated by a social or industrial policy, that increases tax liability of a taxable entity in order to discourage a particular activity.

Definition of taxable unit – taxpayer (subject of taxation) is important in determining of tax expenditures. In the case of corporate income tax, if the tax unit is an individual company, then any intra-group loss set-off is a tax expenditure. The corporate tax unit could also be more specific, for example small and medium enterprises versus large companies, or special tax treatment for special lines of business such as insurance and banking. As a result of these specific tax units, any different tax treatments involving different tax units are considered part of the benchmark and do not give rise to tax expenditures or negative tax expenditures.

During determining the benchmark (normative) structure of the corporate income tax, one must also take into account such a general reference as avoidance of double taxation both in international transactions and, for example, in paying dividends. So, if tax incentives in international taxation using to avoid double taxation, then such benefits are not tax expenditures (Stadnyk, 2017).

S. Surrey (1985) also suggested to use accounting rules as the benchmark (normative) tax structure for several elements, that are not covered by the S-H-S income concept, especially in the definition of the taxable period. Tax must be calculated over a specified period. As the S-H-S income concept does not specify the period, the standard practice for taxation follows the accounting practice, to calculate income (and therefore tax) over a period of 12 months. Other elements that relate to the use of accounting period should also be included in the benchmark, such as the allocation of income and expenditure to appropriate periods (Yussof, 2013). Nevertheless, S. Surrey (1985) also pointed out that the use of the standard accounting rules should be tempered by resort to practical concerns of tax collection and tax administration. With this point of view, we fully agree.

One example is the issue of deductibility of expenses to be incurred in future years. Thus, there are several controversial points between financial and tax accounting: in tax accounting expenditures determines ex post, while in financial accounting requires a current assessment of such the expenditures, that will be incurred in the next accounting period. The different treatment in financial accounting and taxation results in deferral of deductions to a future period, which is negative a tax expenditure. However, if the government takes the view that this deviation is due to the concerns over tax collection and tax administration, then the deviation does not constitute a tax expenditure (Surrey and McDaniel, 1985).

Hence, we see, that significant importance in determining of tax expenditures in corporate taxation is not only the compatibility of tax incentives with generally accepted characteristics according tax expenditure concept, but also the domestic policy of the country and government goals.

5 CONCLUSION

Tax expenditures are enacted because there are perceived legitimate reasons for their use. Tax expenditures have a role to play; they are employed widely, and there are few, if any, suggestions that all tax expenditures should be repealed. The main advantages of tax expenditures are the greater flexibility in operative terms which results in a faster provision of resources to beneficiaries, and the absence of government interference with the choice of projects.

But in practice, tax codes and tax systems are differently defined in different countries, which make them difficult to compare. Just as there is no single accepted definition of tax expenditure, so there is also no broadly accepted methodology for calculating it. According to the majority of methodologies used, all items that are in fact a certain deviation or change from the existing tax system are considered tax expenditures.

The plurality of views on the definition of tax expenditures generates the uncertainty and possibilities for manipulation of the tax legislation in own interests. In this regard, the issue is not so much in reviewing and reducing the number of tax incentives of corporate income tax. The main thing in reforming should be unification, construction of a clear logical scheme for their using in order to improve the administration and monitoring processes. To summarize, tax expenditure analysis can and should serve as an effective and neutral analytical tool for policymakers in their consideration of individual tax proposals or larger tax reforms.

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