Principle 5

Maximising deductions

Introduction

Earlier on we differentiated between tax exemptions and deductions, the latter being amounts which reduce taxable income. Tax law makes a further distinction between so-called 'organic' deductions (linked to obtaining the income) on the one hand and social exemptions and deductions on the other hand.

Tax rebates, i.e. amounts directly deducted from the tax liability, are allowed in some jurisdictions and will also be dealt with in this chapter.

The development of forfeitry deduction results mainly from an attempt to simplify administrative procedures. The tax authorities admit an amount determined on the basis of gross income without the taxpayer needing to present any justification. In the second system, charges may only be deducted provided they are duly justified.

In both cases, the basic strategy will consist in putting the taxpayer in a position to maximise deductions.
Salaried employees and companies are examined separately, under sections 1 and 2, respectively.

1. Salaried employees

Deductions granted to Individuals vary considerably from one tax system to the other, which adds to the complexity of comparing international tax liabilities.

In *France*, a 10% forfeitry deduction is allowed on salaries; the taxpayer may choose to deduct a higher amount of actual costs; at a second stage, a 20% rebate is automatically granted by the tax authorities. To illustrate, a declared income of FRF 200,000.-- results in a taxable amount of FRF 144,000.--.

Special forfeitry deductions are sometimes applicable. In 1998, approximately 74 professions benefit from additional deductions varying between 5% and 40% depending on the trade, with a maximum limit of 50%. Let us note, however, that these privileges are being questioned and that their abolition is discussed in the *loi des finances 1999.*

In the *United States*, taxpayers first assess their net taxable income by subtracting all expenses incurred in obtaining or maintaining such income. Expenses linked to a professional activity usually cover a wide range of costs. However, these rules change according to political or economic fluctuations.

In *Belgium*, taxpayers may also choose between actual costs and forfeitry deductions, the latter being subject to an upper limit; life insurance premiums and employee shareholdings benefit from tax privileges.

In *Switzerland*, some 26 different cantonal tax laws are still in force in addition to the federal tax system. The tax harmonisation law contributed to filling the gaps by providing a complete list of deductions, whether of the organic type or not, for which the cantons may, to a certain extent, determine tariffs and rates. However, their discretionary powers are greater in the case of exemptions and social deductions. Salaried taxpayers should make an inventory of all the deductions they may claim.

The tax authorities will usually specify the deductions available to the taxpayer in the documents distributed with the tax return forms. Nonetheless, taxpayers would be well advised to consider systematic tax planning with a specialised advisor. It will often be necessary to compare the immediate deduction of expenses with the tax treatment of future benefits and this exercise requires a global perspective, sometimes extending over several generations. Legal changes scheduled for the coming years must also be anticipated.

2. Companies

Own name companies and partnerships require that assets be first of all split into private and company assets, depending on whether they were acquired for business purposes and of their actual use to the company.

The assessment margin in terms of deductible charges is considerably wider in the case of companies. This is due firstly to the very status of a company : the fulfilment of a company's objectives or statutory aims require that it maintains the necessary material and human resources. Furthermore, it is not uncommon for some public communities to attract them through flexible charge and provision regulations. Lastly, the tax authorities can afford to be generous since several deductions aim solely to defer taxation.

As we saw earlier, in principle an *amortisation* is a deduction from profits which takes into account the reduced or depreciated value of a company asset. Neither the taxpayer nor the tax authorities can determine the actual depreciation with total accuracy. Many tax systems therefore use forfeitry amortisation rates; usually calculated with a wide margin, these rates allow for overvalued amortisation amounts, which in turn lead to hidden reserves.

The same reasoning applies to *provisions*, only they do not relate to asset reduction but to increased risk. A provision is an amount removed from the profits made over a certain period with a view to sustain either a charge or a future asset depreciation or loss, neither of which are effective at the end of the tax period in question but which are likely to take place in future tax periods.

Maximising *interest* charges affects the whole capital structure of the company. Obviously, fiscal criteria are not major factors in company financing. Other considerations such as the return on investment, liquidity, safety, flexibility or company independence take the lead. We have seen that the tax authorities often limit such deductions by imposing certain minimum financing ratios (own/external funds) together with interest rate regulations compatible with market conditions. Notwithstanding the above, loan financing allows for reduction of the tax liability by maximising deductible charges, whilst reducing the tax liability on stock capital common to several jurisdictions. However, tax planning will address the global tax system of the company. The problem becomes more complex when the company is part of a group or when international tax elements come into play, such as admissible profit transfer, withholding tax recovery or application, etc.

There are countless types of general expenses, i.e. expenses which do not result in asset acquisition : tax charges and operation losses, fees, brokerages and commissions, office rents and other rental costs. Classical acquisition costs also include travelling and advertising expenses, packaging and production costs, insurance against material and personal damage, electricity and heating costs, equipment costs, shipment, encashment and maintenance costs. All expenses should be justified by commercial or professional usage and, to the extent possible, they should be related to acquiring the income concerned.

Gratuities may include benefits in kind in favour of company employees : meal, travelling, accommodation, legal assistance, crèche, library or multimedia library costs, as well as discounts on goods and services, amongst which privileged mortgage conditions. Use of golf courses, participation in entertainment evenings, educational or leisure trips, as well as clothing allowances are often classified under "representation costs" in the ledgers.

Extending these gratuities to employees who are also important shareholders raises the issue of hidden profit distribution. Unless justified by commercial practice, not only might they not qualify for tax deduction, they might be considered as dividend.

Gratuities in favour of non-shareholding employees are considered as revenue in kind and therefore taxable.

It is always difficult to distinguish between professional expenses and private benefit. This has sometimes led the tax authorities to admit forfeitry amounts. However, as a general rule, their generosity diminishes as the practice grows in high taxation countries.

Conclusion

When an entrepreneur maximises the admitted tax deductions, he starts a chain reaction which influences other tax planning strategies. Sometimes, this maximisation will create hidden reserves and postpone tax payment or convert it into tax on liquidation proceeds; sometimes it will result from splitting the taxable income or finding an advantageous structure where expenses are mirrored by income in another jurisdiction. A company's global tax planning strategy will often use these in combination.