Principles 6 and 7

Anticipating and postponing tax

Introduction

Given their close connection, both principles are studied under one chapter. Indeed they both aim to stabilise taxable income. However, this does not exclude other considerations. For example, postponement can be a means to save on interest rates, to become subject to a different tax regime, while anticipation can be used to retain the current tax regime. In the case of capital gains tax, extending the asset holding period can result in degressive tax rates in many jurisdictions.

The income of individuals is studied under section 1, inheritance and gift tax under section 2 and profit tax under section 3.

1. Income of individuals

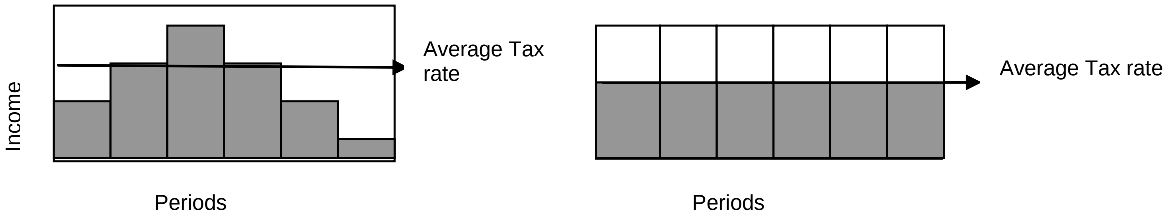
1.1 <u>Stabilising tax rates</u>

Most Western countries have adopted the progressive rate taxation system, seen as more equitable since the individual's tax liability is commensurate with his true contributing capacity. Instead of a flat tax rate, taxable income is subject to a rate which increases with the basis of assessment.

This should result in equal sacrifice in terms of contributing capacity. For instance, a 20% tax rate would be more difficult to assume for a small than for a major taxpayer. As a result, revenues fluctuating from one tax period to the other are treated unfavourably, since the marginal fraction of income is liable to a higher tax rate than the remaining income.

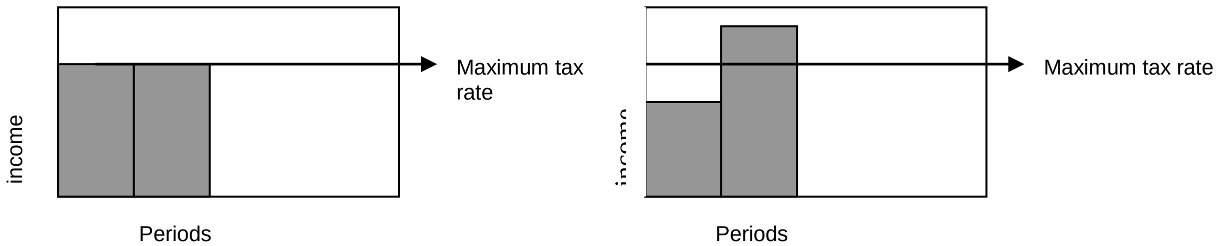
It is therefore advantageous for a taxpayer in a low phase of the revenue cycle to anticipate income and to postpone charges to future periods. Conversely, during a high phase of the revenue cycle, the taxpayer should postpone income and anticipate deductible charges (see figure 1 hereunder: The average tax rate is lower when the income is stable all along the tax periods; this is due to the tax progression).

Figure 1 Income evolution and tax rate



Taxpayers with a high marginal rate of taxation enjoy a reduced, or even nil operating margin. This is why tax savings require postponing income and anticipating charges sufficiently to reach levels below the maximum rate . Tax savings might then be reached because of the tax rate progression . The strongest the progression is, the highest is the tax saving. (see fig. 2 hereunder where the income is anyway reaching the maximum tax rate in the two periods: Anticipating charges and postponing profits allows to get under said maximum rate for one period).

Figure 2. Income Evolution by highest tax rate



As we see, if the tax rates would have been proportional, there would be no difference in the total tax burden over the periods. However, the question of the interest saving ("better to pay the highest tax as late as possible") still remains.

However, an income stabilising strategy can only be implemented within the limits defined by the tax authorities. One cannot arbitrarily select the time of realisation of a given income, or ascribe charges to a given period on the sole basis of fiscal opportunism.

Taxpayers may, to a certain extent, determine the tax date for income collection. Depending on the legislation, the determining criteria is the realisation of income, i.e. the moment when taxpayers may freely dispose of the income, whether by receiving it or by having an absolute right to it. In liberal professions, the time factor is usually based on the date of enrichment. In the case of businesses, registering an increase in value in the accounts affects the tax situation.

Similarly, expenses or charges are deductible from the time when they become due. Taxpayers enjoy nevertheless a certain operating margin, which varies according to their nature as salaried employees, businesses or liberal professions. In the first case, ideally, the employer should co-operate with a view to stabilising the salary. However, in reality salaries increase on a merit basis in most companies. Companies are usually reluctant to anticipate or even postpone extraordinary gratuities in order to favour their employees' tax situation.

Salaried employees will therefore obtain better long term results by concentrating on planning their pension and provident funds, especially when their contributions can be deducted from a rather high income and when life insurance payments occur at a time when their income is lower, for instance as a result of their future pensioner status. Many working professionals expect this situation. However, various events can modify their expectations : a late inheritance (increasingly frequent) generating additional income, a cold progression resulting from inflation, a change in tax regulations or tax rates for example.

Prior to implementing any fiscal planning strategy based on provident fund, it will be necessary to examine the situation from a global, and not merely fiscal, perspective. This temptation is all the greater as this is often the only major tax planning strategy open to some executives.

Individual property owners can often anticipate or postpone deductible charges. For instance, they may spread maintenance costs over several fiscal periods. Anyway, they are often not fully admitted when included in the same tax period, as when they are subject by law to a certain forfeitry amount or to the real or presumed yield of the property.

Finally, the real estate owner may wish to bring forward the realisation of a gain, either by selling it before the regulations change to his disadvantage or by giving it to hisr descendants prior to a market boom.

2. Inheritance tax –v– gift tax

As previously stated, given that donations and bequests do not always carry identical tax liabilities, one strategy consists of making fully or partly tax exempt donations, rather than waiting for the less advantageous rates applicable to inheritance tax. In other words, inheritance tax is postponed until the death of the donee. Several options may be envisaged and this type of tax planning can be linked to other fiscal strategy principles. In addition to modifying the category of taxable income (principle 1), the taxpayer may also benefit from increased exemptions or deductions (principles 4 and 5), he may split taxable assets (principle 8) or relocate them, say by gifting a property located in a different jurisdiction (principle 12).

In some jurisdictions, one way to anticipate tax liability is to modify the regime of matrimonial property rights. Since such modifications relocate the assets from one spouse to the other, they usually have fiscal consequences. Whether or not they carry a retroactive effect depends on the marriage contract and on the regulations and common practices of the relevant tax authorities; some of which will wait until the death of the first spouse before taking into account the new regime of matrimonial property rights.

Tax consequences obviously differ depending on which spouse predeceases, and fiscal planning could lead to unexpected results.

In the *United States*, it is possible to skip a generation by creating a *trust*. In this structure, the trustee periodically distributes the whole annual income and American beneficiaries are fully taxed in accordance with standard tax rates. However, inheritance tax can be postponed until the next generation. Let us recall that non distributed income is heavily taxed, since the *Internal Revenue Service* will levy a compound, forfeiture tax of 9% per day which rapidly reaches the maximum rate of 100%.

3. Enterprises

More options to postpone and anticipate tax are open to enterprises rather than individuals.

As seen earlier, the assessment of assets and charges through accounts offers a greater operational margin. Companies may thus either postpone the tax burden by making provisions or anticipate it by dissolving them. Provisions can cover risks as varied as currency exchange, debtor insolvency, stocks of goods, repair or maintenance costs (more or less predictable), loss of law suits and many more.

Modifying the stock assessment methods may also lead to anticipate or postpone the tax burden; the FIFO (*First In First Out*) method could thus be applied at the beginning of a sustained period of price increase. The entrepreneur can also physically inflate or reduce stocks and modify the provisions accordingly.

Similarly, in terms of amortisation, a company can, to a certain extent, select the accounting method most appropriate to certain circumstances. Activating certain assets such as goodwill or immaterial rights (in-house trademark, for instance) can give rise to a new amortisation in the appropriate fiscal period.

Sales of shares or movable and immovable investments whereby capital gains or losses are made in the favourable period, sometimes combined with buying back the relevant goods at the appropriate time, are part of the same strategy.
In many jurisdictions, the tax authorities are bound by their acknowledgement of an increase of value in the accounts. Furthermore, very often losses are admitted from the beginning of their existence, whereas gains only become taxable upon realisation.

Entrepreneurs can usually monitor deadlines in matters of investment, financing and even sales policy. Some transactions carry a one time incidence, while others have a more or less durable effect. Nevertheless, tax is obviously not the major consideration. In practice, a company's requirements in terms of policy, financing and relations with its commercial partners outweigh fiscal considerations.

Finally, as we shall see later, in an international context, a parent company may postpone tax by abstaining from dividend repatriation.

Conclusion

Any time dependent strategy involves a measure of speculation and can become obsolete due to the unforeseeable evolution of legal or other conditions. A shrewd taxpayer will therefore list all foreseeable changes, including even the most unlikely ones, before assessing their consequences on his tax planning decisions.