

# DOUBLE TAXATION THROUGH DIRECT TAXES AND ITS ELIMINATION FOLLOWING THE 2004 TAX REFORM

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***In every country taxes are one of the most important sources of state budget income and thereby also a crucial source for covering expenditures on financing science, education, health care, culture, the social sector, etc. The sovereign right of each state is to set conditions for collecting taxes from its tax subjects, i.e. natural and juristic persons operating in its own territory, without limitation, i.e. regardless of the tax systems of other states. This fact can in practice lead to international disputes in determining the tax-legal relationship of a taxed subject and a respective state, the most common consequence of which is double taxation.***

The rules of tax systems of individual states are the result of a common, economic and legal code, economic development, historical development and traditions. Therefore tax systems differ between one another in the structure of taxes, tax proceedings and in the consequences of not meeting a tax liability, in determining incomes subject to taxation, setting the tax base, etc. Differences between tax systems of individual states are natural, however they require the solution of tax relations between them at an international level. A tax system may be oriented inwards to the state and precise and reworked to the greatest possible degree, if however it does not have international interconnections ensured, it might not at present, with regard to the high degree of international integration, succeed in securing sufficient resources for the state budget.

A general concordance exists at the level of theory as well as in practice that “international double taxation has a harmful impact on trade in goods and services, as well as on the free movement of capital, technology and persons” and “it is necessary to draw attention to the importance of removing the barriers that international double taxation represents for the development of economic relations between countries”.

Defining double taxation, or international double taxation at the theoretical level has consumed the thoughts of many authors. Often it is defined as “the imposition of comparable taxes in two or more states on the same taxpayer, where this concerns an identical income in identical tax periods”. Even this definition however is not sufficiently thorough. Double taxation needs to be understood in a broader context. In defining it we must differentiate between various forms of double taxation, these being legal double taxation and economic double taxation.

## Legal double taxation

Legal double taxation arises when one and the same income is taxed at the same taxpayer several times by the same or a similar tax.

Legal double taxation may occur at both the intra-state and international level. Intra-state legal double taxation can occur in the case of multiple-level income taxation in countries applying it. An example may be income taxed once at the federal level and once at the state level by the same (or similar) tax, or taxation of an income by a tax set exclusively for this type of income and in addition also by a tax afflicting the total incomes or assets of the same taxpayer. Legal double taxation at the intra-state level is however very unusual and in the case that such a situation does occur, this simply bears witness to a poorly constructed tax system.

Legal double taxation is ordinarily understood as international double taxation, which means that the same income is taxed once in the state of the source of the income and subsequently in the state of the recipient's residence.

### *Example:*

The activities of company A in Austria, which is resident in Slovakia, establish a permanent establishment under Austrian tax law. The result is that profits of the permanent establishment are taxed in Austria and the world wide profits of company A are taxed in Slovakia. In the case of no double taxation agreement existing between the countries, company A is subject to double taxation at the international level.

## Economic double taxation

This concerns double taxation in which two or more different taxpayers are taxed several times in relation to the same income or capital. Economic double taxation can occur at the domestic and international level.

An example of intra-state economic double taxation is the taxation of a business's profit and then once again of the dividends paid out to shareholders from this already taxed profit. Intra-state double taxation is the consequence of a chosen tax system in the framework of which various procedures and instruments are then used for its elimination.

A rough example of international economic double taxation can be given through the following example. Company A in state A and company B in state B are members of the same multinational enterprise. Company A sells goods to company B at a price of 100 units. The market price is 150 units. The tax authority in country A on the basis of legal provisions on the control of the transfer pricing adjusts the profit of company A by + 50 units. Economic double taxation then occurs, if the tax authority in state B does not reduce company B's profit by – 50 units. The transfer pricing difference (50 units) is taxed twice. Once in company A through the artificial increase on the basis of the application of the mechanism for eliminating transfer pricing, and the second time as a component of the trade margin of company B.

In connection with intra-state and international double taxation of incomes it is necessary to mention that in both cases, if we assess these incomes from the aspect of the recipients, this concerns double taxation or multiple taxation of the same entity or the same incomes.

## Elimination of double taxation

International double taxation represents a prohibitive tax burden and is a break on economic relations, and the movement of capital, persons, goods, etc. It adversely affects the development of economic and cultural relations, therefore every state endeavours to remove its negative influences. For eliminating double taxation states use unilateral intra-state measures and international multilateral measures by means of concluding double taxation agreements.

### Methods for limiting international double taxation

It is necessary to resolve the collision of tax systems in two directions. On the one hand it is necessary to adjust intra-state tax regulations through incorporating

methods limiting double taxation in the state of residence, and on the other hand it is also essential to conclude double taxation agreements and the international level.

International agreements, binding on Slovakia, contain two methods of the eliminating double taxation, firstly, the ordinary credit method, and, secondly, the exemption with progression method. The principal difference between them lies in the fact that the exemption with progression method is applied to income, while the ordinary credit method is applied to tax. Other tax systems also use the options of including taxes into expenses.

Abroad a tax subject receives income in a foreign currency, which prior to applying a method always needs to be converted to the domestic currency. The tax reform, which in 2004 introduced an exclusively proportional tax rate, the so-called flat tax, changed also the real impacts of methods for limiting double taxation.

Since some derived methods use solely the progression of the tax rate and in the case of a proportional rate they lose significance, for objectivity we show the results of the method both for the proportional tax rate (19%), as well as for the progressive tax rate applicable in Slovakia in 2003.

## Exemption methods

The essence of these methods is that in the resident's state the entity's income achieved abroad is excluded, or not included at all in the tax base. This method has two derived forms, namely complete exemption and exemption with reservation of progression.

### Complete exemption

In the case of this method income gained abroad is excluded from the overall tax base. In this way the state of residence yields its rights to taxation of foreign incomes completely. The method of complete exemption of foreign incomes is identical to freeing incomes from income tax in the state of residence. The term "freeing", as well as the use of the method of complete exemption are a component of certain older agreements on restricting double taxation. In newer agreements this method is replaced by the exemption method with reservation of progression.

#### *Example:*

A Slovak tax resident – a natural person achieved incomes abroad of SKK 500 000, where he paid tax on these of SKK 110 000. In Slovakia he had an income of SKK 200 000. In calculations we abstract from all deductible and non-deductible items to the tax base, as well as other tax technique elements used.



Solution – proportional tax rate in domestic state:

1.	Total of partial tax bases	SKK 700 000
2.	Tax base following the complete exemption of incomes from abroad (i.e. only domestic incomes)	SKK 200 000
3.	Tax liability in Slovakia $200\ 000 \times 19\%$	SKK 38 000
4.	Total tax liability (domestic and foreign, i.e. tax burden on the enterprise as a whole, where the tax burden abroad is 22% and in Slovakia 19%)	SKK 148 000
5.	Percentage tax burden on world-wide incomes (total tax / total income)	21.14%

Solution – progressive tax rate

1.	Total of partial tax bases	SKK 700 000
2.	Tax base following the complete exemption of incomes from abroad (i.e. only domestic incomes)	SKK 200 000
3.	Tax liability in Slovakia $27\ 000 + 28\%$ of 20 000 (progressive tax rate according to SR tax legislation in 2003)	SKK 32 600
4.	Total tax liability (domestic and foreign, i.e. tax burden on the enterprise as a whole)	SKK 142 600
5.	Percentage tax burden (total tax / total income)	20,37 %

### Exemption with reservation of progression

This is the most frequently used derived form of exemption. Though incomes from abroad in this method are not taxed, they serve for adjusting the tax rate for the taxation of the remaining incomes thus it uses the effect of a progressive tax rate.

For this purpose income from abroad is counted with other incomes, on the basis of which the specific tax band (or tax rate) is determined in which incomes from the domestic sources are to be taxed.

This method makes sense only in the case of a progressive tax rate, where the percentage tax burden increases with the amount of the tax base. In the case of a proportional tax rate the effect of this method is identical with complete exemption (tax relief). For the following calculations we have therefore used the progressive tax rate applicable in the SR in 2003, comparing it with the proportional rate applicable since 1 January 2004.

The method occurs in two forms. The first form is averaging, which is commonly used in modern double taxation agreements. The less common form is the upper layer method, which however has not been used in agreements concluded by the SR, therefore we will not devote further comment to it.

### Exemption with progression through averaging

In averaging, the average tax burden pertaining to the total of all incomes gained domestically and abroad is calculated and the domestic incomes are taxed by this. The consequence is that the tax from domestic incomes may be higher due to the influence of incomes from abroad.

*Example:*

We use the same example as in the case of complete exemption. A Slovak tax resident – a natural person has gained incomes abroad of SKK 500 000, where of these incomes he has paid tax of SKK 110 000. In Slovakia he has gained incomes of SKK 200 000. In the calculations we abstract from all deductible items.

Solution – proportional tax base

1.	Total of partial tax bases	SKK 700 000
2.	Tax base following the exemption of incomes from abroad (i.e. only domestic incomes)	SKK 200 000
3.	Average tax burden prior to exemption $700\ 000 \times 19\% = 133\ 000$ i.e. $133\ 000 / 700\ 000$ (this rate serves only as a recalculation, in the case as a recalculation) of a proportional tax rate the average rate is equal to the nominal proportional rate)	19 %
4.	Tax liability in Slovakia 19% of 200 000 (i.e. the average rate calculated prior to exemption multiplied by the domestic incomes, or the tax base following exemption)	SKK 38 000
5.	Total tax liability (domestic and foreign)	SKK 148 000
6.	Percentage actual tax burden	21,14 %

Solution – progressive tax rate

1.	Total of partial tax bases	SKK 700 000
2.	Tax base following the exemption of incomes from abroad (i.e. only domestic incomes)	SKK 200 000
3.	Average tax burden prior to exemption $146\ 280 + 38\%$ of 136 000 = SKK 197 960 i.e. $197\ 960 / 700\ 000$ (this rate serves only as a recalculation)	28,28 %
4.	Tax liability in Slovakia 28.28% of 200 000 (i.e. the average rate calculated prior to exemption multiplied by the domestic incomes, or the tax base following exemption)	SKK 56 560
5.	Total tax liability (domestic and foreign)	SKK 166 560
6.	Percentage actual tax burden	23,79 %

From the recalculation it can be seen how by means of including incomes from abroad for the purposes of increasing progression the percentage tax burden has grown from 20.37% in the case of complete exemption to 23.79% in case of a exemption with reservation of progression through the form of averaging. In applying this method in the case of a proportional tax rate ("flat rate tax") there is no difference between the exemption with reservation of progression through averaging method and complete exemption, since the average tax rate and nominal proportional tax rate are the same.

It may be said that cancellation of progressive income taxation significantly makes advantageous and simplifies other processes of direct foreign enterprises of SR tax residents abroad. The state however loses the benefits of linking the exemption method and the progressive tax rate and thereby also the possibility of additionally taxing incomes of Slovak residents.

## Credit methods

In the credit method both domestic and foreign incomes are included in the tax base. The tax is calculated from the tax base as if from purely domestic incomes and from it is deducted the tax paid abroad. In comparison with the exemption method, where all foreign income is exempted from the total worldwide incomes regardless of whether tax has been paid on it or not, in the credit method gross foreign incomes are included in the tax base, i.e. including any possible taxes paid abroad. This applies also to cases where the income has been taxed by withholding tax and is held in the accounts in net form. Such income must be adjusted (increased) to the balance prior to taxation.

The credit method also has two basic forms, namely the full credit and the newer, modified form - the ordinary credit. Practice applied in international agreements however has brought also a derived form of the ordinary credit, which we have termed the ordinary credit with the option of off-setting fictive (unpaid) tax.

### Full credit

A rarely used method in practice is that of the full credit. According to this method the whole amount of taxes paid abroad is deducted from taxes calculated on the total incomes, regardless of the level of the tax rate applied abroad. A weakness of this method is the vulnerability of the resident state's budget, since in the case of a high tax burden on the foreign income it must return to the taxpayer the tax exceeding the average taxation in the resident's state. In this method the taxpayer is guaranteed taxation at the same level as if its incomes came from the domestic country, and is thus taxed on average as with any other domestic taxpayer.

#### Example:

Solution – proportional tax base

1.	Total of partial tax bases	SKK 700 000
2.	Preliminary tax liability in Slovakia (from world-wide incomes) SKK 700 000 x 19%	SKK 133 000
3.	Credit for tax paid	SKK 110 000
4.	Final tax liability in Slovakia	SKK 23 000
5.	Total tax liability	SKK 133 000
6.	Percentage tax burden	19 %

Solution – progressive tax rate

1.	Total of partial tax bases	SKK 700 000
2.	Preliminary tax liability in Slovakia 146 280 + 38% of 136 000	SKK 197 960
3.	Credit for tax paid	SKK 110 000
4.	Final tax liability in Slovakia	SKK 87 960
5.	Total tax liability	SKK 197 960
6.	Percentage tax burden	28,28 %

### Ordinary credit

The ordinary credit method resolves the problem of unequal tax rates in contracting states. Using this method we avoid the situation where the state of residence pays for the higher taxation in the source state of the income.

This method is founded on the principle of crediting tax paid abroad, though only up to the amount that would proportionally pertain to foreign income in the domestic country. In practice the ordinary credit is realised in two ways:

1. The portion method: this counts domestic and foreign income (to which the credit method is applied), and the tax before the credit is then calculated from this tax base. Then the proportion of the incomes in the overall tax base is calculated, from which the tax is then offset. The tax is also divided by this proportion prior to the credit into the part of the tax from domestic incomes and the part of the maximum offsettable tax. In fact, only the tax paid abroad may be offset up to the amount of this maximum offsettable tax.

This means that if the foreign income represents 40% of the tax base, the maximum amount of tax that may be offset will be 40% of the tax calculated from the total tax base, but only in the case that the tax paid abroad is lower. In the case that it is lower, only the tax actually paid abroad is recognised for the credit.

2. The same result is achieved through calculating the average rate (of the tax percentage for the purposes of the credit) and subsequently calculating the maximum limit of the offsettable tax as a multiple of the foreign incomes and the average rate calculated. We deduct the tax actually paid abroad, but only up to the amount of the calculated maximum offsettable tax.

The tax return mechanism in the SR for income tax on natural persons has so far used the second method of calculation, i.e. calculation with the help of an average rate. In other countries however we often encounter the proportion method of calculating the offsettable tax.

#### Example:

Solution – proportional tax base

1.	Total of partial tax bases (of which SKK 500 000 income from abroad – applied credit method, SKK 200 000 domestic income)	SKK 700 000
2.	Tax paid abroad	SKK 110 000
3.	Preliminary tax liability in Slovakia (tax calculated from world-wide incomes) SKK 700 000 x 19%	SKK 133 000
4.	Portion of foreign incomes in total incomes (500 000 / 700 000)	71,43 %
5.	Maximum possible credit SKK 133 000 x 71.43%	SKK 95 001,90
6.	Tax recognised for credit	SKK 95 001,90
7.	Final tax liability in Slovakia	37 998,10
8.	Total tax liability (from world-wide incomes)	SKK 147 998,10
9.	Percentage tax burden	21,14 %



Solution – progressive tax rate

1.	Total of partial tax bases	SKK 700 000
2.	Tax paid abroad	SKK 110 000
3.	Preliminary tax liability in Slovakia (tax calculated from world-wide incomes) SKK 146 280 +38% of 136 000	SKK 197 960
4.	Portion of foreign incomes in total incomes (500 000 / 700 000)	71,43 %
5.	Maximum possible credit SKK 197 960 x 71.43%	SKK 141 402,80
6.	Tax recognised for credit	SKK 110 000
7.	Final tax liability in Slovakia	SKK 87 960
8.	Total tax liability (from world-wide incomes)	SKK 197 960
9.	Percentage tax burden	28,28 %

In the case of a proportional tax rate of 19% the average taxation at home is lower than that abroad (22%), therefore the maximum credit is lower than the tax paid abroad. The difference between tax paid abroad and tax recognised for a credit in the state of residence we term the excess tax burden of international trade.

Tax paid abroad – Tax recognised for credit = Excess tax burden of international trade

If we use a progressive tax rate, taxation at home is higher than that abroad. The calculated proportional part of the tax which may at maximum be off-set is higher (SKK 141 402.80) than the tax paid abroad (SKK 110 000). This in principle means the infusion of foreign income at home (in the amount of SKK 31 400 – the difference between the maximum offsettable tax and the tax actually paid abroad). In this form this method is the most disadvantageous for the taxpayer, although in the example shown the average tax burden is equal to that in the case of a full credit (in the case of a progressive tax rate). This method is advantageous exclusively for the state budget and its adverse impact on the taxpay-

er is minimised in the case of equal taxation conditions (mainly deductible items and tax rates) in both states.

### Conclusion

In conclusion it is necessary to state that the tax reform in 2004 brought significant benefits not only for foreign investment in Slovakia, but also for the direct business activity of Slovak firms abroad.

The benefit accrues mainly to natural persons, who prior to the tax reform had been taxed progressively and their foreign incomes were, thanks to the higher level of taxation in Slovakia, taxed additionally. The introduction of the proportional taxation of incomes eliminates the negative impact of the exemption with reservation of progression method and the low tax rate excludes the additional taxation of incomes from abroad in the ordinary credit method in the case of both natural as well as juridical persons. The measures adopted facilitate the direct conduct of business by Slovak tax residents in countries with which the Slovak Republic has a double taxation treaty concluded.

A component of the tax reform however is also the significant disadvantaging of direct business conduct by Slovak tax residents in countries with which the Slovak Republic does not have a double taxation treaty concluded.

Incomes from such business are included in the tax base of the Slovak resident without the possibility of using method limiting double taxation, which essentially means their full double taxation. This approach is however standard in OECD countries, which also protect their economies in this way against the outflow of taxable bases to third countries, which in many cases we can classify as tax havens with unfair methods of tax competition.