

NEW CONCEPT OF INCOME TAXATION IN THE CONTEXT OF TAX REFORM OF THE SR

Ing. Ivona Ďurinová

Over the past two years there has been much discussion of the flat-rate tax not only in professional circles, but also among the lay public. As with every radical change, the flat-rate tax too has its proponents as well as opponents, its advantages and disadvantages, depending on one's point of view. The new concept of income taxation, the flat-rate tax, however became a reality for the Slovak Republic on 1.1.2004. We will attempt here to look at it in a comprehensive manner, in the context of Slovakia's tax reform. Since the tax environment affects not only taxpayers – employees, but also influences to a significant extent in particular the decision-making processes of businesses (affecting their choice of legal form for conducting business, their decision making on the allocation of capital, their selection of the optimal financial and capital structure of a business, their dividend policy, the size of their disposable profit, etc), tax-related issues most certainly cannot be judged unilaterally or taxes understood merely as income to the state budget or other public funds. It is necessary to take heed of the fact that every change in the tax system, as with any other economic change, usually brings about some reaction in most elements of the economic system. In creating the tax system, as well as in every tax change it is therefore necessary to take into consideration also the possible reactions of tax subjects, to proceed from an individual subject to general conclusions and to try to respect the main tax principles.

Main objectives of tax reform in the SR

The aim of the tax reform was in particular to simplify tax law as a whole. Its complexity was caused by the large number of amendments to previous legal regulations, where the existence of a number of exceptions and conditions caused ambiguity and reduced efficacy of the laws. Since many of these measures did not have a just effect, they in the end led to tax evasion and violation of the law. Various tax rates applied according to the tax base for type of income taxed, the possible advantaging of only certain investors or industrial sectors motivated tax subjects to distribute incomes over time or to shift incomes into other classification groups or to other more tax advantaged subjects. One of the objectives of the reform is therefore to replace this selective tax policy by a flat-rate policy, which at the same time creates favourable conditions for business and investment.

The creators of the tax reform worked from an evaluation of the tax system that operated in the SR from 1.1.1993, where in an effort to remove its shortcomings and deformations they formulated individual tax reform objectives, which may be summarised as follows:

- a more thorough application of the principles of taxation into the tax system of the SR, such as justice, neutrality, simplicity, efficacy,
- simplification of tax legislation, as well as the tax system,
- a fiscally neutral tax reform,
- a further shift of the burden of taxation from direct to indirect,
- a shift of taxation from income taxes to excise duties and property taxes,
- the implementation of a flat-rate tax.

Through the tax reform the Slovak government wants to achieve a neutrality and simplicity of direct taxation, which should fulfil an exclusively fiscal role. By shifting of the tax burden from direct taxes to indirect, which are from the aspect of tax collection more simple, incomes to the state budget from direct taxes are reduced, though this is compensated for by an increase in revenues from indirect taxes.

The concept of the tax reform also assumes that in the medium term the implementation of the flat-rate tax should positively influence the business environment, raising the inflow of foreign investment and increasing employment.

Positive and negative aspects of the tax reform

Taxes may best fulfil their mission provided that the tax system is created with reference to tax principles, which need to be understood as the fundamental rules of forming and applying a tax system. Tax practice has shown that applying the principles of taxation in creating a specific tax system is an extraordinary demanding task especially in view of their mutual contradiction. The tax system of every state therefore contains a number of contradictions and usually is a compromise and combination between a systemic solution and non-systemic elements, which are often incorporated into tax laws via amendments according to what practice or the policy of the government in power brings about.

The tax laws of the SR applicable from 1993 had, in consequence of frequent amendments, become so complicated, non-transparent, incomprehensible and ambiguous, that not only tax subjects, but also experts in tax practice,



i.e. tax authority officials, tax advisers, etc., had a problem to find their way through them. In this, it is clear that the simpler a tax system is, i.e. the fewer exceptions and reliefs it provides and the fewer tax laws it contains, the more transparent and thus the more controllable it is.

The principle of simplicity was therefore one of the main principles that the creators of the tax reform tried to reflect in the tax system. It may now be positively assessed that the tax system today is indeed simpler both from the aspect of the number as well as the content of tax laws. The tax on gifts and inheritance was cancelled and the taxation of incomes has been simplified through the implementation of a flat-rate tax. This tax no longer contains 21 different rates, but just one (19%), the number of exceptions has been reduced by approximately 80% and the text of the act has been shortened. Despite this, the text of the income tax act is still quite complicated and certain provisions of the Act are not wholly unambiguous.

The simplicity of tax legislation is also directly connected to the taxation's efficiency. The more complicated tax laws are, the greater the costs connected with taxation both on the side of the state as well as on the side of tax subjects. Besides simplifying tax laws, it is however necessary to simplify and improve the whole tax administration and inspectorate of the SR, where its efficiency at present is very poor. Tax offices in the SR for every SKK 1 of expenses collect SKK 59 of revenue, whereas for example in Estonia the figure for tax revenue is three times higher [2]. At present the tax administration has 102 offices, where for instance Holland, with 15 million inhabitants, has only 13 tax offices. Clearly this is just a rough illustration, since the number of employees, their salaries, etc. is also important.

It was the experience of Holland that was used as the basis for the new strategy of tax administration for 2004 – 2008, which has the aim of achieving a 92% level of tax liability fulfilment. It is necessary to reduce the volume of tax arrears, tax evasion and avoidance schemes, tax offences, corruption, etc. Fulfilling the aim should be supported for example by services aimed at individual groups of taxpayers, electronic tax returns, increasing the effectiveness of inspections with a focus on risk groups. To this should contribute changes in the information system which will allow the creation of an account for each client which will capture all relations of a taxpayer with other components of public finance. A reduction in the number of tax offices is also counted on. These commitments may be considered as positive, actual steps however will lag behind in time especially due to the fact that up until now attention has been focused in particular on taxes, i.e. on the income side of the state budget, where any meaningful focus on the expenditure side of the state budget has been lacking. A component of the tax reform should thus be the reform of the whole of public finance, aimed also at increasing the efficiency of tax administration and inspection with the aim of reducing the direct as well as indirect costs of taxation. In

this matter it is however as yet possible only to speak of strategic commitments.

The most radical and significant change in the tax field brought by the tax reform in the SR on 1.1.2004 has undoubtedly been the new concept of income taxes (Act No 595/2003 Z.z. on income taxes). The creators of the tax reform consider the new income tax act as the basic pillar of tax reform, which should bring about significant progress in Slovakia's economy. The flat-rate tax was conceived on the following fundamental principles:

- justice of taxation, which is applied through the flat-rate taxation on all types of income, as well as through the flat-rate taxation of all tax subjects,
- excluding the double taxation of incomes,
- simplicity and unambiguity of tax legislation,
- efficiency of the tax.

If we want to evaluate the new income tax act from the aspect of justice, it is necessary to respect two supporting principles: the benefit principle and the ability-to-pay principle. In the case of income taxes it is necessary to work from the ability-to-pay principle, which should take account of the taxpayer's ability to pay the tax. This ability is defined by dimensions of in particular horizontal and vertical justice [1], where three systems of paying taxes may be applied:

- absolute sacrifice (the application of an absolute turnover tax),
- relative sacrifice (the application of a proportional tax),
- marginal sacrifice (the application of a progressive tax).

It is clear that the higher income groups of the population will prefer systems according to an absolute all relative sacrifice and lower income groups will prefer systems according to a marginal sacrifice. From this it ensues that whatever construction of tax will never be considered as absolutely just for all groups of taxpayers. The question of justice is connected with the distribution function of taxation, i.e. in essence it solves the manner and degree of redistribution of a certain part of the created wealth of a society by means of tax rates, the manner of defining the tax base, the application of various supplementary elements of the tax method, which often have a social nature.

The new income tax act in the SR is based on a system of tax payment according to relative sacrifice (the system of progressive taxation has been replaced by proportional taxation at the single rate of 19%), from which it results that this system suits primarily the higher income groups of taxpayers. The non-taxable minimum has been increased to 19.2 times the living minimum from SKK 38 760 to SKK 80 832; a deductible item for a spouse, in the same amount, is and will be valorised; for a child a tax bonus may be applied in the annual amount of SKK 4 800, etc. so taxpayers with the lowest incomes are to a certain degree compensated. The taxpayers losing most in the new system of income taxation are middle-layer taxpayers with an income from approximately SKK 15 000 to SKK 23 000.



If to this we add the effect of other changes in the tax reform, the reform's impact is and will be even harsher on these layers of taxpayers. The introduction of a flat-rate income tax was conditional upon the amendments being made in the field of value-added tax and excise duties. With effect as of 1 January 2004 a single tax rate of 19% has been introduced in the field of value-added tax in Slovakia and from the date of Slovakia's accession to the European Union a new Act on VAT has been in force with a fully harmonised system of taxation in accordance with the results of the accession negotiations in the chapter "Taxes". No document or EU directive however directs member states to move over to a single rate system, and besides Denmark, which applies a single rate in the amount of 25%, all member states use a double or multi-rate system of VAT. Since VAT is of a regressive nature, i.e. the higher taxpayer's income, the lower the share of his/her consumption and thus also the degree of payment of consumption taxes in the volume of his/her income, the application of a reduced rate at least for basic foods, medicines, health-care products, etc., may be considered as an effort to mitigate the impact of this tax on taxpayers with lower incomes, as well as medium-high incomes.

It may thus be said that the introduction of a flat-rate tax together with the introduction of a single rate of VAT at 19% will at least for a certain period cause a discernible reduction in the standard of living of medium- and low-income groups of the population. It is thus debatable whether the flat-rate tax can be considered as just.

Many taxpayers who had often received income taxed at the special tax rate of 10%, for example on the basis of work agreements performed outside an employment relation (provided that these fulfilled all the conditions set out in the act) will also be certainly negatively affected by the fact that these lower incomes have since 1 January 2004 been taxed in an advance payment manner at the rate of 19%. Again the disadvantage is for those who are financially weaker, because this method was used to a large extent in particular by pensioners, students, the unemployed, etc., in order to earn at least a little extra.

The new act however has cancelled the special tax rates, the manner of collecting tax via withholding however has not lapsed, it has only been partially modified, where a single tax rate of 19% is used. A new feature is that tax withheld from income, and which flows to a natural person – a resident, may be considered as an advance tax payment. The taxpayer can then deduct this advance payment from the tax in their tax return, they must however first include the respective income in the tax base. An advantage against the previous system lies in the fact that if the amount of the tax collected by withholding exceeds the resulting tax, the tax-

payer has a claim to the return of the overpayment. In practice then situations will arise where a tax administrator returns an overpayment calculated in the tax return, for example to an unemployed citizen to whom a lottery organiser withholds from winnings 19% tax, or to a business that reports a loss, where over the course of the year the bank has withheld tax on the interest on funds on the business's current account.

Since for a taxpayer – a natural person the act sets out the possibility to decide whether a respective income taxed by withholding at source is to be considered as an advance tax payment, it is undoubtedly necessary to emphasise that this possibility is advantageous in particular for taxpayers who for the tax period did not achieve any other taxable income. In the tax return it is thus possible to apply a non-taxable part of the tax base, to which he/she would otherwise not have a claim, or thanks to which he/she may in all likelihood suffer an overpayment for tax, thus tax withheld can by this method be returned to the taxpayer.

Despite the fact that through this change the basic philosophy, according to which the income forming an independent tax base taxed at a special tax rate is considered as settled in terms of tax (in the case of non-residents, taxpayers not established for conducting business, etc. this continues to apply), the tax rate has been increased and thereby also the administrative demands, it will for many taxpayer certainly be advantageous.

As regards the taxation of business subjects, besides the introduction of a single tax rate for various types of income (the previous 21 tax rates and 443 different types of income had led tax subjects in an effort to minimise their tax liability to reclassify individual types of income), the effort for the equal taxation of all tax subjects may also be seen in a positive light, i.e. natural persons and juristic persons, residents and non-residents. Since one of the objectives of the tax reform is the endeavour that taxation should not distort economic processes and influence to the least possible extent the decision making of economic subjects, these changes may be considered as incorporating the principle of neutrality.

For this reason, natural persons – entrepreneurs, for example, no longer have the possibility to exploit the special manner of taxing their income, the turnover tax. The turnover tax was introduced in particular for small craftspersons and entrepreneurs, however the sphere of subjects that could opt for the turnover tax was gradually expanded. The main reason of the proponents of this tax was the reduced administrative demands, though in fact tax subjects opted for this method of taxation especially when it was financially more advantageous for them. Since the tax base in the case of the turnover tax was formed by incomes and not incomes reduced by expenses, it may be said that the lower tax expenses applied, the higher savings on tax the taxpayer gained. Turnover tax (concurrently also benefits on turnover tax) as a non-systemic element did not get

¹ Value added tax shall be dealt with in more detail in a coming issue of this journal.



into the new act, which many entrepreneurs, or rather those using it, will certainly consider as a negative feature.

Instead of the turnover tax however tax subjects with incomes from business, other self-employment and from letting can apply turnover expenses in the amount of 25% of incomes or 60% of incomes. They may be applied only by a taxpayer who is not a value added taxpayer. It may be assessed as positive the fact that if a taxpayer opts to apply expenses set as a percentage of incomes, he/she need not keep single- or double-entry bookkeeping, i.e. it is not considered as an accounting unit. Under the Income Tax Act they are however obliged to keep a record of incomes in time sequence, of supplies and of receivables. A taxpayer who applies this set percentage of expenses may, moreover, apply insurance and other compulsory contributions, but he/she must however be able to prove them. Expenses in the amount of 60% of the incomes may be applied only by those taxpayers who have incomes only from the performance of craft activities according to annex 1 of the Trades Licensing Act.

In order to respect the principle of neutrality and the principle of justice there have also not appeared in the new act provisions concerning the advantaging of certain of groups of tax subjects, for example tax reliefs, or legislatively governed possibilities for the application of tax credits for businesses – juristic persons, which were from year to year becoming ever more complicated and non-transparent, and which led to the situation that their stimulatory objective in practice did not have a favourable response on the part of business subjects. Constant changes and the growing number of conditions that it was necessary to fulfil in applying for these stimuli induced mistrust and in the end results led to a loss of efficiency. Besides this, they operated in a discriminatory manner towards business subjects of the SR.

Important changes have been made also in the manner of calculating the tax base, which together with the tax rate influences the tax burden on business subjects. Out of a number of changes the following in particular may be viewed positively:

- the reduction in the number of items recognised as tax expenses only after their payment (the condition of payment required further administrative costs brought about in connection with recording these items),
- the expansion of tax allowable expenses due to their clear connection with the achieving of the business subject's incomes (for example advertising expenses, which under the previous legislation were recognised as tax allowable expenses only after meeting complicated conditions and even then in a limited amount, the cancellation of the limiting of depreciation levels in the case of certain types of personal automobiles),

² §§35, 35a, 35b, 35c of Act No 366/1999 Z.z. on income taxes as amended.

- simplification in applying depreciation, the shortening of the depreciation periods,
- a significant shortening of the criterion of the period after the due date of receivables, on the basis of which the creation of provisions for receivables may be included in tax expenses, etc.

The removal of certain limits and restrictions in the application of tax expenses may be considered a significant benefit for practice.

With two exceptions, the condition of payment does not relate to incomes and expenses arisen after 1 January 2004. The condition of payment applies only in the case of contractual penalties, fees and interest on arrears and in the rent and commission payments to a natural person – a non-VAT payer for intermediation.

Business subjects certainly appreciate the greater room provided for applying expenses for advertising in calculating the income tax base. It is no longer necessary to divide these into expenses allowable in the full amount (basic advertising) and expenses which could be deducted from the calculated tax base in the respective manner (further advertising). What is decisive is that these expenses are connected with the taxpayer's activity with the objective of achieving, ensuring, maintaining, or increasing the taxpayer's income.

Significant changes have also been made in the depreciation of assets. It may be assessed positively that the new act no longer limits the depreciation of personal automobiles. Many tax subjects by the end of 2003 in the case of having purchased a more expensive automobile could apply a tax appreciation only from the amount of SKK 800 000. Limits have also been cancelled for the inclusion of leasing instalments from personal automobiles, where in financial leasing a taxpayer could include in the tax base as a recognised tax expense leasing instalments only from the amount of SKK 950 000.

A new feature in the act is also the term "economic owner" which means that a tangible asset may be depreciated also for tax purposes by the person who receives the economic utility from it, even if ownership according to the applicable legal regulations has not yet passed to the user.

Since 1 January 2004 the act has set only four depreciation groups for depreciating tangible assets, the fourth and fifth depreciation groups have been combined into one depreciation group with the depreciation period of 20 years. As a matter of interest it may be said that although in 2003 depreciation groups in the Slovak Republic and in the neighbouring Czech Republic were unified, the opposite trend has prevailed in the Czech Republic and the number of depreciation groups has since 1 January 2004 been increased to six. The depreciation period in the sixth group is up to 50 years, covering hotel buildings, department stores, schools, universities, cultural monuments, etc. This trend is depicted in the following table:

**Depreciation groups in Slovakia and the Czech Republic**

| Depreciation period (in years) Depreciation group | 2003 SR and CR | 2004 | |
|--|-------------------|------|----|
| | | SR | CR |
| 1. | 4 | 4 | 4 |
| 2. | 6 | 6 | 6 |
| 3. | 12 | 12 | 12 |
| 4. | 20 | 20 | 20 |
| 5. | 30 | – | 30 |
| 6. | – | – | 50 |

The act again offers the option of choosing between the two depreciation methods, straight-line and accelerated depreciation, however compared to the wording of the act applicable up until the end of 2003 the procedure in depreciating tangible assets by the straight-line method has been simplified so that the taxpayer will in each year apply straight-line depreciation in the same amount.

The application of semi-annual depreciation has been cancelled, with regard to its complicated application in the past. This means that for the respective tax period a taxpayer has the right to apply only an annual depreciation from each tangible asset accounted for on the last day of the taxation, or accounting period. In the case of decommissioning tangible assets during a taxation period the taxpayer does not have a claim for applying any depreciation, i.e. annual or half-yearly. This disadvantage is compensated for by the complete recognition of the residual value of the tangible or intangible asset upon its decommissioning as a tax expense.

The new manner of amortising a tax loss may also be assessed as positive. Every tax loss within the directly preceding five years may be deducted, but now without the obligation of straight-line accrual in the amount of 1/5 annually and without the obligation to re-invest the deducted tax loss. So a tax subject may deduct a tax loss on a straight-line basis or on a non-straight line basis, depending on the amount of the reported tax base. The reported tax loss may be deducted from the calculated tax base immediately in the following tax period, provided that the reported tax base is sufficiently high. If not, the balance of the reported tax loss may be applied in following tax periods, at latest in the calculation of the tax base for the fifth tax period following the tax period in which the tax loss was reported. The possibility to deduct a loss or its part in the third, fourth or fifth year is no longer conditional upon a minimum amount of the tax base following deduction of the loss, i.e. SKK 150 000.

We can gain a better understanding of the amortisation of a loss through the example of a taxpayer who in 2003 reported a loss of SKK 400 000. The following table shows the tax

| Year | Tax base | Proportional part of the deducted tax loss | Tax base following deduction of the loss | Balance of the non-deducted individual years |
|--------------|----------|--|--|--|
| 2004 | 70 000 | 70 000 | 0 | 330 000 |
| 2005 | 150 000 | 150 000 | 0 | 180 000 |
| 2006 | 40 000 | 40 000 | 0 | 140 000 |
| 2007 | 110 000 | 110 000 | 0 | 30 000 |
| 2008 | – 30 000 | x | – 30 000 | x |
| Spolu | | 370 000 | | 30 000 |

bases achieved over a 5-year period, i.e. over the years 2004 to 2008 (in 2008 the taxpayer again reports a tax loss), and also the course of amortising the tax loss.

The taxpayer in the respective 5-year period does not amortise the whole amount of the tax loss, i.e. SKK 400 000, but only SKK 370 000. The deduction of the loss in the amount of SKK 30 000 may no longer be carried over to the sixth year. The loss in the fifth year may however begin to be deducted over the period of the following five years (2009 – 2013).

Since one of the fundamental principles of the new law's conception was the exclusion of double taxation of incomes, it may be assessed as positive the fact that shares in profit following taxation, dividends, and similar fulfilments are no longer the subject of tax. It may be expected that together with a reduction in the 19% income tax rate this fact will motivate business subjects towards achieving a profit.

In conclusion it may be stated that the new income tax concept with a proportional rate of 19% should, together with the 19% VAT rate, despite the negative impact on the standard of living of low- and medium-income groups of taxpayers, may on the other hand through the application of a flat-rate tax for all business subjects, the elimination of double taxation and other positive changes lead to increased interest in conducting business, to an inflow of foreign capital and thus to overall economic growth.

The tax environment in the SR has thanks to the new concept of income taxation certainly become attractive also for foreign investors. This is borne witness to for example also by the interest of several Czech and other foreign firms (the well-known case of the construction of the large Korean automobile factory) to move their head offices or at least a part of their production to Slovakia. Firms, besides more advantageous taxes, are attracted to Slovakia also by lower production and wage costs. Naturally, the stability of the political system, infrastructure, transparency, rate of corruption, rule of law, etc. is also of interest to foreign investors.

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