COLLEGE OF ACCOUNTING

TAXATION | BASIC

Video Transcription: Taxation Terminology

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Hi, my name is Riley Carpenter and in this video I will be discussing the importance of using the correct tax terminology.

In disciplines such as tax and financial reporting, words communicate a very specific understanding. So why is this a problem? For many of you, you are introduced to tax after being introduced to financial reporting. Therefore you are already familiar with financial reporting terminology and this informs how you communicate. Your understanding of financial reporting impacts on how you explain tax concepts. Students also, for example, use VAT-specific terminology when thinking about or discussing income tax.

A further terminology issue happens when students believe that, because terms such as deduction, reduction, exemption and rebate all relate to income tax, they can be used interchangeably, i.e that they have the same effect, from a tax perspective.

However, taxation, like many professional disciplines, has a specific language that you need to become familiar with, understand and be able to apply. This language has been developed through legislation and law and it is important to use the correct technical terms when talking or writing answers in tests or exams. So, in a tax situation, using financial reporting terminology will incorrectly explain, not fully explain or not show your understanding of tax.

Business, Enterprise, Trade and In the Production of Income

When we refer to a business, from a financial reporting perspective we refer to an organisation providing goods, services, or both to its consumers and it is the entity for which we report. Similar concepts in tax are enterprises, trade and in the production of income. Enterprise is specifically defined in the VAT Act and is the VAT equivalent to business.

An enterprise is defined as any continuous or regular activity that occurs in or partly in South Africa. It does not matter whether the enterprise has a profit motive, but a consideration (similar to a payment), must be charged. Because there is no definition of business in the VAT Act, you would not be correct in using the term business.

Trade and "in the production of income" are terms used with respect to income tax and not VAT. While it would seem as if we could use the terms business, trade or in the production of income as substitutes for each other (in other words that they mean the same thing), this is not the case. We have seen that enterprise is specifically defined in the VAT Act. In a similar way, the terms trade and in the production of income are specifically related to the Income Tax Act. So, not only can we not use financial reporting terminology to explain tax terms, we also cannot use income tax terms to explain VAT terms.

Expenses and Deductions

An expense from a financial reporting perspective is recognised when the net asset value of a business decreases, and this decrease is not due to a transaction with the owner. Expenses are recognised on the income statement, and reduce profit.

A deduction is the tax equivalent of an expense. Does this mean that it is correct to use the term expense (and therefore its financial reporting meaning) within the application of the Income Tax Act? No.

While deduction is not specifically defined in the Income Tax Act, each allowable deduction is driven by the specific rules found in each relevant section in the Income Tax Act. A deduction is an amount that decreases income. Deductions therefore lower the overall tax liability. So while some deductions might use the word "expenses", for example, section 11(c) legal expenses, there is no definition of expense in the Income Tax Act.

It is also important to note that not all items recognised as an expense in financial reporting are also considered to be a deduction, for example, depreciation. While you could use the terminology tax expense, it is better to call it a deduction.

Exemptions and Deductions

Income, from a financial reporting perspective, is recognised when net assets increase, and this is not due to a transaction with the owner. Income, in the Income Tax Act however, is the amount remaining after exemptions have been subtracted from gross income. An exemption is an incentive provided by SARS to earn the gross income to which the exemption applies. For example, the interest exemption incentivises you to save or invest to earn interest, as the interest you earn won't be taxed (up to a certain level).

An exemption can therefore never be greater than the income to which it applies. For example, if the interest exemption limit is R23 800 and you earn R1 000 interest from an investment, the maximum exemption applicable to you is R1 000. In other words, you cannot end up with a negative income amount because exemptions are not treated the same as deductions and cannot create a tax loss. Remember, a deduction is subtracted from income to determine your taxable income. All deductions are allowable provided they are considered to be a deduction in the section they apply to. Deductions could be greater than income. i.e. deductions can result in a tax loss, where taxable income is negative.

Reductions, Deductions and Rebates

Remember, the terms reductions, deductions and rebates cannot be used interchangeably.

While reduction is not defined in the Income Tax Act, where the Income Tax Act states that one amount is "reduced" by another amount, the stated reduction can never be greater than the original amount. In other words, you can only reduce something to zero. An example is the travel allowance. There is a potential reduction to the travel allowance, but this reduction can never be greater than the allowance itself.

Remember, while deduction is not specifically defined in the Income Tax Act, each allowable deduction is driven by the specific rules found in each relevant section in the Income Tax Act. The deduction can be greater than income and result in a tax loss.

While rebate is also not specifically defined, a rebate is a reduction of the tax liability owing by a taxpayer. Therefore the rebate is always applied after the tax tables and rates are used. Once again, this rebate cannot result in a negative tax liability i.e. SARS cannot owe you exclusively due to the rebate.

Depreciation and Allowances or Deductions

Depreciation from a financial reporting perspective is the allocation of the cost of the asset over the asset's useful life and is reflected on the income statement as an expense. However, depreciation is not mentioned in the Income Tax Act.

While a tax expert may understand what you're talking about when you refer to tax depreciation, using these words will not get you the marks in a test or exam. You are not demonstrating an understanding of the Income Tax Act, where the correct terminology to use is a wear and tear allowance or a capital allowance. It is important to recognise that there are a number of important distinctions between capital allowances and depreciation, so the term depreciation cannot be used interchangeably with capital allowances.

Accrual Basis and the Earlier of Receipt or Accrual

The accrual concept from a financial reporting perspective refers to recognising a transaction in the period in which the asset or liability is recognised. The earlier of receipt or accrual in income tax means that an amount is included in gross income in the tax period in which either happens first, the receipt of cash or the accrual of income. Within the Income Tax Act the accrual of income requires unconditional entitlement, that is, a legally enforceable right to the income.

With respect to deductions, an amount is only deductible when it meets the requirements of the specific section to which it applies, for example this is usually only when there is a legal obligation to make payment.

Accounting Profit and Taxable Income

Accounting profit is determined by applying generally accepted accounting principles while taxable income is determined by applying the Income Tax Act.

Profit on Sale of Asset and Recoupments or Disposal Allowances

From a financial reporting perspective, the profit on disposal is recognised when the amount generated on disposal is greater than the carrying amount of the item. A loss on disposal is recognised when the amount generated on disposal is less than the carrying amount of the item. The profit or loss on disposal is reported on the income statement and included in profit for the year.

With respect to the Income Tax Act, when a capital asset is disposed of, no profit on sale is recognised. With respect to income tax, there are always two effects that need to be considered, the potential recoupment or disposal allowance and the capital gains tax effect. A recoupment is an addition to gross income whereas the disposal allowance is an allowance, a reduction of taxable income.

This video has highlighted some of the areas where tax and financial reporting terminology may refer to similar types of items or transactions. However, within each discipline the terms have very particular meanings and can therefore not be used interchangeably. So in exams, it is important that you ensure that you are have the correct understanding and are using the correct terms that relate to the section or subject area you are being tested on, for example, financial reporting, income tax or VAT.

So, I have chatted through some examples where terminology is an issue, I would suggest that you think about how the term property is used in a financial reporting and tax context and what it means as well as recognising the difference between allowances as compared to fringe benefits in the Income Tax Act.

I hope you enjoyed watching the video.