THE INCOME TAX LAW IN CYPRUS
AND
ITS EFFECTS ON BUSINESS POLICY

by

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INTRODUCTION

Benjamin Franklin, a humorist as well as a statesman and philosopher, once observed that "in this world nothing is certain but death and taxes."[1] Time has lent emphasis to Franklin's words. The people of many countries pay taxes on their wages, salaries and other forms of income; business corporations pay taxes on their profits. Truly, no resident of a country escapes taxes in one form or another, any more than he escapes death. The majority of the people recognise that in a modern and progressive nation taxes are the sinews of the state, or, as the famous jurist Oliver Wendell Holmes said, "Taxes are what we pay for civilised society."[2]

Nowadays the purpose of the income tax goes beyond the simple collection of revenue, and includes many other economic objectives which the government of a country aspires to accomplish. The objectives of the tax imposing authorities and the taxpaying businessmen need not be the same, and actually in many cases they differ and conflict with each other.

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[1] Taxation in the United States, (United States Information Agency, Washington, D. C., 1965), p. 2 .

[2] Ibid., p. 3

The purpose of this study is to find out how the businessmen in Cyprus set their policies in response to the existing Income Tax Law in the island, and whether these effects on business policy are identical with the objectives of those who drafted the Income Tax Law.

For my information I have relied on questionnaires and the few interviews I could get. As I expected, the response was very poor indeed. Although my adviser, Professor Emile Ghattas, provided general letters of introduction which were used in requesting the completion of questionnaires, the refusal rate was very high. As a result the coverage of samples was reduced tremendously. Personal interviews by me were bound to receive a still lower rate of response, because nearly all businessmen in the island knew that I was an Income Tax Assessor. No promise could have made them believe that I would not use the information supplied against them in any way.

As a last resort I had asked some of my student colleages of this university to conduct some interviews and fill the questionnaires for me, but as it will be clearly understood from the following letter sent by one of them, they were not successful either and managed to fill only eight out of one hundred questionnaires. The letter read as follows: "... Unfortunately I found much more difficulty than what I expected, because the managers and businessmen whom I contacted were very suspicious on this subject. I hope you will still be able to complete your thesis, and so become a pioneer in this subject."[3]

Even those who volunteered to fill the questionnaires answered some of the questions, but refused to answer others, saying that such information could be given to the government. Therefore, under these circumstances I had to rely very heavily on the information I could gather from the reports and pamphlets published by various Ministries and Departments of the Cyprus Government, and a few books written about Tax Law. I relied less heavily on the questionnaires which were intended to be the backbone of this study. My three years' experience in the Income Tax Office in Cyprus helped me very much in tackling the very delicate and complicated topic of income tax. I hope that in the future some other researchers will find an opportunity to make similar studies on the subject under more favorable conditions and will make more valuable contributions to the very important subject of income tax.

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[3]Letter, dated July 20, 1966. Name of the writer not to be disclosed.

CHAPTER I

THE ECONOMY OF CYPRUS AND THE INCOME TAX

A Survey of the Economy

Without a detailed study of the economic structure of Cyprus it could not be possible to go into the subject of income taxation and try to find out the relations between the Income Tax Law and the policy followed by the business community. Therefore, the survey of the economy of Cyprus seems to be a prerequisite which must be undertaken before proceeding to the study of the Income Tax Law and its effects on the business policy in the island.

Cyprus is the third largest island in the Mediterranean with a population of about 600.000 which is composed of Greeks and Turks. Over 80 per cent of the population is literate. The average per capita income in the island was £ 205 at current market prices in 1964 which was higher than that in several neighbouring European and Mediterranean countries.[4] However, Cypriots have no reason to be complacent, nor can they afford to feel complacent about their present state of

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[4] Cyprus, Economic Report, The Statistics and Research Department, (Nicosia: The Printing Office of the Republic of Cyprus, 1965), p. 6.

economic and social development. First, even though their average per capita income may be higher than those in several other countries, it is still considerably lower than those in Western Europe, being less than half of those of Skandinavia.

Cyprus is a primary producing country deriving a substantial proportion of its gross domestic product from agriculture and mining. In 1954 contribution of agriculture and mining was more than 40 per cent, but later on, as other sectors expanded more rapidly, their share declined. Since 1957 it has been fairly constant at about one third.[5]

Agriculture.-- Agriculture is the main pillar of the island's economy giving employment to about 40 per cent of the economically active population, and is the most important foreign exchange earner which results from commodity exports. Its contribution to gross domestic product, however, does not exceed 24 per cent.[6] This situation is of course typical of countries which are still at a low level of industrialisation and points to extensive under-employment in the agricultural sector.

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[5] Ibid., p. 7.

[6] William L. Thorp, Cyprus, Suggestions for a Development Programme (New York: United Nations Publications, 1961), p. 19.

The following table shows the percentage contribution of agriculture to the island's gross domestic product for the period 1958-1964.

TABLE 1

CONTRIBUTION OF AGRICULTURE TO THE G.D.P.

(At Current Factor Cost)

FOR THE PERIOD 1958 - 1964

Year	Per Cent
1958	19.2
1959	17.6
1960	16.6
1961	19.2
1962	20.2
1963	18.3
1964	17.9

Source: Cyprus, Economic Report, 1964.

Although considerable progress has been made in this sector there is still much more scope for development. Agriculture in Cyprus is characterised by extensive underemployment and low productivity. Because of the declining share of mining in the gross national product and the depletion of mineral deposits, the economy of the island is thus still heavily dependent on agriculture. With such a high proportion of families bound to the soil, the level of living in Cyprus is expected to remain low as long as so much of the population is engaged in obtaining so low a return from the land. This is the largest producing element and the largest market. Its improvement is essential for any sustained economic growth.[7]

Mining.-- The importance of mining to the island's economy becomes apparent when it is considered that about 31 per cent of the island's total exports consisted of minerals in 1964.[8] Thus, it is of prime importance as an earner of foreign exchange. With respect to taxes, mining companies have been paying 20 to 25 per cent of all tax revenues and 55 to 75 per cent of the total income tax. As to employment, the number of workers reached 7,000 in 1955 but declined to 5,200 in 1964.[9]

The following table shows the percentage share of the value of minerals in the value of the island's total exports, and its percentage contribution to the gross domestic product, at current factor cost.

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[7] Ibid.

[8] Economic Report, op. cit., p. 41.

[9] Thorp Report, op. cit., p. 38.

TABLE 11

PERCENTAGE CONTRIBUTION OF MINERALS TO EXPORTS AND TO G.D.P.

Year	% Contribution to Exports	% Contributions to G.D.P. (At Current Factor Cost)
1956	62	11.0
1957	55	10.4
1958	52	8.2
1959	50	7.9
1960	51	8.7
1961	47	6.8
1962	37	5.6
1963	34	5.5
1964	41	5.1

Source: Cyprus, Economic Report. 1964.

The fall in the prices of minerals in the international markets and the expansion of agricultural exports which now occupy the first place are mainly responsible for this development. Realising the importance of this sector to the island's economy, the government, with the assistance of the United Nations' Special Fund, has made arrangements for a detailed survey of the island's mineral resources.

Manufacturing.-- The manufacturing industry is newly developing. Its output at current factor cost was £ 14.4 millions in 1963 as against £ 13.4 millions in 1962.[10] However, its contribution to the island's gross domestic product continues to be low. Manufacturing now is the second single industry in the economy in respect to its contribution to the gross domestic product. The government's policy of encouraging viable local industries has borne fruit, and in the year 1963, fourteen new industrial units were established.

Conditions Which Led to the Present Level of the Economy

Cyprus was a British Colony for 82 years, from 1878 until August 16, 1960, when it became an independent republic. Economically speaking, the decade preceding 1960 was an abnormal period. Between 1950 and 1957 the island enjoyed a great deal of prosperity. The real gross domestic product rose by more than 50 per cent. There was full employment and real wages increased by more than a third. However, this era of rapid expansion was not based on an expansion in the island's productive capacity. It was largely engendered by a very steep rise in the colonial government's military expenditures. Much of this expenditure was related to the creation of a military infrastructure and a trade sector of the economy rather than the development of some local industries. When these abnormal expenditures fell off in 1957 there was a marked decline in the economy.

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[10] Cyprus, Economic Report, 1962. p. 7.

Government's Economic and Fiscal Policies

Cyprus, being an underdeveloped country and very desirous to develop quickly, is in need of foreign financial assistance, especially private foreign funds. This is very much dependent upon the environment which must/be favorable to foreign investment.[11] Moreover, there are some major economic problems ahead in reconstructing the island's economy in order to provide for the future, because at present a good part of the island's incomes are generated by exogenous forces that are subject to change at short notice, namely the military bases on the island.[12]

The following speech delivered by the Right Honorable Nicos Solomides, The Minister of Finance before the Economic Committee of the Council of Europe which convened in Cyprus in April, 1963, gives the most authoritative views and policies of the government in relation to the prospective policies designed for the development of the island's economy:

> ".... To reconstruct our economy we have to mobilise our resources, devise a sound strategy for development that will enable us to grow through making the best use of our productive capacities... Our immediate

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[11] Thorp Report, op. cit., p. 83.

[12] Economic Report, op. cit., p. 13.

task on attaining independence was to halt the flight of capital from the island and to end the uncertainty then prevailing about our intentions regarding the Cypriot pound." [13]

On the eve of independence the scare of devaluation of the Cypriot pound was haunting everybody. Most Cypriots who had savings in the Cyprus banks quickly transferred them to safer places abroad. This was not a healthy situation for a newly independent country desperately in need of capital funds. Fortunately, the government at that time, followed the appropriate and logical policy of staying in the Sterling Area, joining the International Monetary Fund and at the same time introducing prudent fiscal measures and economic policies. As a result of these the confidence in the Cypriot pound was restored and the outflow of capital stopped without the imposition of any restrictions. The rate of repatriation of Cypriot capital is now steadily increasing. This reversion of capital flow has been helped by putting encouraging provisions which exempt the income earned outside Cyprus by Cypriots and brought to the island from income tax.

In accordance with the suggestions contained in the Thorp Report prepared by four United Nations Experts headed by Williard L. Thorp, under the United Nations' Technical

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[13] Ibid., p. 13.

Assistance Programme, the Government of Cyprus devised a development program which recognised that:

(a) Cyprus as an island must rely a great deal on free foreign trade for her well being, and
(b) Cyprus has certain comparative advantages in location and climate.[14]

Pursuant to this program the government has the objective of capitalising on the advantageous location and climate and expand the island's tourist trade. Meanwhile, the government is providing funds for some of the tourist activities, particularly in hotel buildings, but the greater share of investment in this industry is left to the private sector, because the government feels that tourism is primarily the provinee of the private sector.

One can easily visualise the important role that can be played by the government in encouraging the private sector to expand, modernise, and set up new facilities to cater to the prospective increase in the tourist trade by offering incentives through the income tax law in the form of partial exemptions, increased depreciation allowances, and so on.

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[14] Thorp Report, <u>op. cit</u>., p. 96.

Industrial development.-- The government's plan for industrial development is based largely on reducing imports of consumer goods and encouraging the establishment of those local industries that utilise the island's own raw materials or process imported raw materials on the island where the added value is considerable.

The overall development program of Cyprus is ambitious. The government is aiming at achieving an annual growth rate of 5 per cent from a public and private investment program of about £ 118 million in five years.[15] It is expected that the major part of the investment program will be undertaken by private investors. This is particularly true of industry and tourism. It is also realised that there is a shortage of trained manpower. Cyprus lacks technicians in many spheres. The result has been that many of the development projects have been retarded because of a shortage of specialised personnel.[16]

Finally, difficulties have been encountered in implementing a systematic and centralised fiscal policy. From time to time the government authorities have stressed the fact that it is not their intention to utilise the country's resources alone, but, wish to encourage foreign firms to invest in Cyprus, and also plan to borrow from the international lending institutions.

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[15] Economic Report, op. cit., p. 17.

[16] Ibid.

In elaborating the basic governmental policies such as tax and budget policies, foreign exchange policy, agricultural policy, labor policy and so on, the government never lost sight of the fact that its object is to implement a national economic plan for a free enterprise economy.[17]

On the whole the government has shown great desire and effort in order to achieve the desired objectives which will lead to the prosperity of the island. Among these policies, the government's income tax policy can be of very much help in promoting a very healthy economic environment for more investment, more income and finally higher and more stable economic and social well being.

The Nature and Development of Income Tax

An income tax, under usual terminology, is a tax imposed upon net income, that is, on total incomes less expenses incurred in earning them. An income tax may apply to individuals (Personal Income Tax), Corporations (Corporate Income Tax) or both. Personal Income Tax typically applies to only income in excess of a certain figure, and thus low income groups are freed from the tax. Progression is particularly common with personal income taxes. An income tax may consist of a series of schedules applying to various forms of income as in Great

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[17] *Ibid.*, p. 18.

Britain and some countries of continental Europe, or it may apply to the aggregate income from all sources as in Cyprus.[18]

Tax revenue tends to be the mainstay of state and local government in many countries. Without this revenue , neither state nor local governments would be able to finance the services and the facilities the people require: armed forces for defence, mational highways and parks, public schools, police protection, public health services, and other benefits a government normally provides.

Income tax developed slowly, with many reverses. The merits of income taxation were recognised centuries ago, but fear that its administration would be difficult or impossible, a fear supported by evidence in many instances in which the tax was tried, delayed its widespread use. But the development of domocratic government gave important impetus to the income tax movement, as it increased awareness of the disadvantages of the other forms of taxation in terms of accepted social standards and the growing need for revenue as government expenditures increased. The income tax can effectively constitute a major source of government revenue only in a society with a high state of economic and political development and education.[19]

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[18] Encyclopaedia Britannica, Vol. 12, p. 18, 1965.

[19] Economist, March 26, 1966, p. 1241.

Credit for the establishment of the first successful income tax in the world is usually given to Great Britain. The British income tax was first introduced in 1799 by William Pitt, to aid the financing of the war against France.[20]

After the First World War the income tax became the most important source of tax revenue in many countries, particularly in the United States and Great Britain. When first introduced, income tax applied to a very few persons because lower and middle income people were exempted. As late as 1939, only about 10 per cent of the people of the United States were actually affected by the personal income tax. Drastic increases took place during the Second World War. At the beginning of the war the tax was converted almost overnight from a "rich man's tax" to one which reached down to the great majority of workers. In 1945, it applied to 80 per cent of the workers of the United States. Today four-fifths of federal revenue comes from the income tax on individuals and corporations.[21]

Additional corporation and individual income taxes were levied at the time of the Korean War in 1950 but were later

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[20]Encyclopaedia Britannica, op. cit., p. 19.

[21]U.S.I.A., Washington, D. C., op. cit., p. 6.

reduced when the war ended three years later. It seems that like many other taxes there is a positive correlation between the establishment of income tax or temporary increases in it and the existence of war in a particular country. The experience of England, United States and Cyprus tends to prove this assumption.

Income Taxation in Cyprus

Cypriot administrative institutions are impressive signs of its latest ruling powers' administrative methods and procedures. Although the whole history of the island was marked by foreign domination, the most important influence was exerted by the last two ruling powers, namely, the Turks and the British.

Cyprus came under Turkish rule in 1571 and remained as a Turkish Colony until 1878. During this long period stretching over more than three centuries, many kinds of taxes were introduced. But income tax as we know it now was not established. During this period great stress was laid on all forms of indirect taxes and a few poll taxes. The 307-year Turkish rule came to an end with the coming of the British who acquired the island in the form of a lease in 1878 and finally annexed it to the British Empire as a Crown Colony in 1923 under the Treaty of Lausanne.

The British administration in the island followed the taxation system established by their predecessors for a long time. But Sir Ronald Storrs, The Governor of the island during the thirties, had many plans for the reform of taxation in Cyprus. In 1932 he decided (in principle) that income tax should be introduced, provided that expert inquiry showed that it would be practicable under the conditions prevailing in Cyprus at that time. He believed that there were special difficulties in the way of income tax (these special difficulties were not mentioned). Seven years later these difficulties were overcome or by-passed, for in 1941, the most critical period of the Second World War, the island learned for the first time what it meant to pay income tax. Income tax was expected to raise £ 50,000 in its first year.[22]

Under the pressure of the Second World War, the taxation in the United Kingdom rose to unperecedented heights. Cyprus like other colonies was called on to assume its share of the burden; and the income tax was introduced for the first time in the island by the law No. 6 (April 28, 1941) and it came into operation from January 1, of that year.[23]

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[22]George Francis Hill, A History of Cyprus (Cambridge: University Press, 1952), p. 461.

[23]Ibid.

Incomes up to Ⱡ 150 were exempt. From Ⱡ 150 to Ⱡ 2,000 they paid 10 per cent. The scale rose to 60 per cent or 12 shillings in the pound on incomes of Ⱡ 5,000 and up (CG. March 26 and April 19, 1941).[24] The rates on incomes over Ⱡ 2,000 were raised by later legislation (Law 26 of 1942, and 22 of 1943; by the latter 15 shillings or 75 per cent were levied on every pound in excess of Ⱡ 6,000). Law No. 9 of 1948 raised the exemption figure to Ⱡ 250, and considerably reduced the rates on lower incomes. The yield in 1943 was approximately Ⱡ 300,000 (Governor's address to Advisory Council, 1943, p. 6). In 1944, 1945 and 1946 it was Ⱡ 542,000, Ⱡ 536,000, and Ⱡ 489,000 respectively (Annual Report, 1946, p. 11).[25]

Contribution of Cyprus Income Tax to the Government Revenue.- In Cyprus, income tax is the second most important source of government revenue. When income tax was originally established in 1941 it was expected to bring Ⱡ 50,000; now the income tax revenue of the Cyprus Government is over 4 million pounds sterling.

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[24]CG stands for Cyprus Gazette, which is an official weakly gazette of the goernment .

[25]Hill, op. cit., p. 461.

The following table shows the income tax collected in absolute amounts and also as a percentage of the total government revenue.

TABLE 3

INCOME TAX COLLECTED BY THE GOVERNMENT

Date	Amounts Collected (£ 000)	% of Total Revenue
1958	4,452	20.4
1959	3,599	15.6
1960	4,314	19.7
1961	2,338	12.3
1962	1,695	8.4
1963	1,755	8.0
1964	3,755	20.4

Source: Cyprus, Economic Report, 1964.

The sudden drop in the amount of tax collected by the government after 1960 was due to the fact that only the collection from the foreigners and from the foreign companies went to the government treasury; the collections from the Greeks and the Turks went to their Communal Chambers.[26] Again,

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[26]According to the Constitution of the Republic of Cyprus, there are Greek and Turkish Communal Chambers to administer the communal affairs of the two communities respectively. Although originally income taxation was not vested in these institutions, as a result of a conflict between the two communities in 1961 while debating the income tax bill in the House of Representatives, both Communal Chambers promulgated their own income tax laws.

the sudden and more than doubling of the government collection in 1964 was the result of the abolition of the Greek Communal Chamber, and the transfer of the revenue collected to the Central Government instead of the Greek Communal Chamber as it was done in the year 1961 when the unitary income tax law was split into three different parts.[27]

The income tax was an imposition in every sense of the word, and the manner in which it was introduced was very unfortunate, because the people of the island had no real voice in the matter since the Legislative Council of the island was no longer in existence. The possibility of an imminent invasion was in everyone's mind, because the neighbouring island of Crete was occupied by the Germans in May 1941. Under these circumstances, as it would be expected, no thorough, careful, or effective examination of the proposals was possible.

In an editorial in the May 7, 1966 issue of the Economist, it was alleged that most tax changes in England were originally suggested by academicians or by newspapers, then they passed through a prolonged stage when officialdom say that they would be administratively impossible; they are enacted only after

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[27]The third income tax law applies to the foreign persons and corporations.

many of their naiveties have been ironed out in public discussions.[28] Unfortunately in Cyprus this normal procedure, accepted in the United Kingdom for introducing or changing tax laws, was not followed. Thus, the people of Cyprus were taken by a surprise by the imposition of the income tax law for whom even democratic representation was not recognised.

According to Charles W. Thacker, who had the first chance to study the income taxation in Cyprus, the introduction of the income tax in the island was a temporary measure to make good the loss of government revenue as a result of the drastic fall in the imports of the island owing to war. The expected proceeds were of the order of £ 50,000. This may seem incredible now, for it is universal experience that once income tax comes, it comes to stay, and (as Hamlet said of appetite) "Grows by what it feeds on." [29]

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[28] The Economist, May 7, 1966. pp. 559-60.

[29] Charles W. Thacker, Income Tax in Cyprus (Nicosia: Cyprus Federation of Trade and Industry., 1954), p.2.

CHAPTER II

GENERAL FEATURES OF INCOME TAX IN CYPRUS

Income Tax Laws

To understand how the existing tax system actually operates in a country requires considerable knowledge of the local organisations, legal institutions, administrative practices and the economic system prevailing in that country.[1]

The Republic of Cyprus is very similar to the Republic of Lebanon in relation to their constitutions which recognise specific rights to the constituent races or religious groups of these republics respectively. After a short period of smooth working of the Cyprus Constitution certain misunderstanding and suspicion arose among the Greek and the Turkish communities in the island. This misunderstanding and suspicion between the two communities caused them to introduce three different income tax laws in place of the one comprehensive income tax law which applied to the whole country until 1961. The new tax laws promulgated in 1961 were the following:

1 - Income Tax (Foreign Persons) Law, 1961. (The tax collected under this law accrues to the central government.)

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[1]Richard Bird and Oliver Oldman, Readings on Taxation in Developing Countries (Baltimore: The John Hopkins Press, 1964), p. 169.

2 - Personal Contributions Law of the Greek Communal Chamber (The tax collected under this law accrued to the Greek Communal Chamber until the Greek Communal Chamber was abolished in 1964.)

3 - The Personal Contributions (Income Tax) Law of the Turkish Communal Chamber. (The tax collected under this law accrues to the Turkish Communal Chamber.)

The above laws are exact translation of each other and are in English, Greek and Turkish respectively. The only difference is in the scale of rates applicable under each law as shown in page 35. The author has used mainly the Income Tax (Foreign persons) Law, because it is in English and can be easily compared with the previous Income Tax Laws.

The following table shows the revenue collected from income tax and its sudden drop in 1961 and 1962 as a result of the split in the income tax law as explained above:

TABLE 4

GOVERNMENT REVENUE FROM THE INCOME TAX
(in £ 000)

Date	Total	% Share in the Government's total revenue
1956	4,468	29.6
1957	5,602	25.0
1958	4,452	20.4
1959	3,599	15.6
1960	4,314	19.7
1961	2.333	12.3
1962	1,695	8.4

Source: Cyprus, Economic Review, 1962, p. 68.

As it is observed from the above table , the collection fell drastically during the years 1961 and 1962. These collections emanated from the income tax imposed on foreign persons and companied alone, in accordance with the provisions of the Income Tax (Foreign Persons) Law of 1961.

The role of income tax in the tax structure of a country and the effects which it can have upon the economy have become questions of major importance as the income tax has grown in importance. Income taxes have been primarily introduced to raise revenue in a manner which conforms most closely with the ability-to-pay doctrine of taxation. In those underdeveloped countries to which the British system of taxation has in part or in whole been exported, the tendency has been to rely somewhat more heavily on income taxation as for example in India, Pakistan and Cyprus.[2]

Being a system initiated during the British Colonial rule in Cyprus, it is naturally expected to be revenue oriented. At present there is a tendency to change the purpose of income taxation from being a simple revenue raising machinery, to an economic tool in the hands of the government to be manipulated for the purpose of improving the island's economy through its

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[2] Ibid., p. 26.

effects on consumption, distribution of income, stabilisation of the economy and so on. This tendency can be seen from the additions to and alterations in the income tax law after independence.

The Scope of Income Tax

In Cyprus, the income tax is paid at the rate or rates specified by the law, for each year of assessment upon the income of any person accruing in, derived from, or received in the Republic in respect of:

(a) Gains or profits from any trade, business, profession and employment.

(b) An amount equal to 4 per cent of the value of the property used by its owner is considered as income for tax purposes;

(c) Any dividend, interest or discount;

(d) Any pension, charge or annuity;

(e) Any rent, royalty, premium or other profit arising from property;

(f) Any profit from any farming or animal breeding business;

(g) Any annual profit or gain not falling under any of the foregoing paragraphs.[3]

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[3]The Income Tax (Foreign Persons) Law, 1961 (Nicosia: The Government Printer of the Republic of Cyprus, 1962). pp. 5-6.

To encourage Cypriots deriving their income abroad, to bring this income to Cyprus, the Section 5 (3) of the Income Tax Law exempts these incomes from income tax if they are brought to the island through a bank operating in the island.[4]

<u>The Basis of Assessment</u>.-- In assessing the income of the businessmen, the basis of assessment is the calender year preceding the year of assessment. If we consider the year of assessment to be the year 1965, the basis for this year of assessment will be the income earned by the businessmen during the fiscal year January 1, 1964 to December 31, 1964.

Prior to January 1, 1953, all incomes irrespective of their source were assessed on the previous year's basis, but since January 1, 1953 on which date the "Pay as You Earn" system came into force, remunerations from all offices or employments are chargeable on a current-year basis.

<u>Outline of Personal Income Tax Computation</u>

I shall briefly outline the steps followed in calculating the amount of income tax payable under the Income Tax Laws mentioned earlier, primarily to explain the nature of net income for tax purposes, and to lay the foundation for later analysis

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[4] <u>Ibid</u>., p. 6.

of problems of income tax theory and practise.

It is necessary to keep in mind that a tax imposed upon personal or business income requires a uniform definition of net income in both cases. The law must define the net income to mean essentially the same thing to the different tax payers who derive their income from different sources and in different forms. This definition must be stated in terms of the items included in gross receipts and the specific items deductible from gross income to arrive at a uniformly determined figure of net income.[5] The definition of net income must be logical and correct, so that its application accomplishes justice among taxpayers.

Therefore, the ascertainment of the net income, which

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[5]Philip E. Taylor, The Economics of Public Finance (New York: The MacMillan Company, 1961), p. 361.

is the first step and which is the basis on which tax is levied must be very carefully and uniformly determined for the purpose of achieving equity and justice among taxpayers.

<u>Submission of Returns</u>.-- It is the duty of every person to submit an income tax return to the income tax office on or before the prescribed date in any year of assessment. The Commissioner of Income Tax may also require in writing any person to furnish him within a specified time a schedule of his income and such particulars as may be required by the law with respect to any income for which such person is chargeable.[6] Section 37 (1) too requires every employer to submit a return for the persons employed by him. The notice to be submitted by the employer should indicate the names, addresses, remuneration payable to those persons and other relevant data.[7]

The provision of the Income Tax Law requiring the employers to submit returns of income with respect to their employees is complied with very satisfactorily so that practically no tax evasion takes place. On the other hand, individual persons who are self-employed and have chargeable incomes fail to comply with the law in submitting annual returns to the Income Tax Office. Therefore, it becomes the duty of

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[6] <u>The Incomes Tax (Foreign Persons) Law</u>, 1961. pp. 22-23.

[7] <u>Ibid</u>.

the Income Tax Office to search and detect the potential taxpayers. Section 71 stipulates that "any person who refuses, fails or neglects to give any notice, submit any return or furnish any particulars under the provisions of this law, shall be guilty of an offence against this law and shall be liable on conviction to a fine not exceeding one hundred pounds sterling or to imprisonment for a term not exeeding six months or both such fine and imprisonment unless some other penalty is specifically provided for such offence."[8]

The unwillingness on the part of the Commissioner of Income Tax to implement this provision of the law against the defaulting taxpayers has created an impression among the taxpayers that this provision is aimed at scaring them rather than actually penalising them when necessary. During the author's three years experience in the income tax office in Cyprus he has not witnessed any penalty being imposed on any one of hundreds of defaulters, or the existence on record of any such penalty previously imposed. This laxity in the implementation of the law creates an atmosphere very suitable and encouraging to widespread tax evasion among the individual proprietors and professional people. One can easily conclude that the law is well designed but it is not implemented in the proper manner.

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[8] Ibid., p. 36 .

Assessment.-- After receiving the income tax returns submitted by the taxpayers, the assessing staff of the income tax office start assessing the tax liability of each taxpayer.

Gross Income.-- The aggregate income derived from whatever source constitutes the gross income of a business. The following items of income are the constituent parts of the gross income: Income from trade and employment, dividends and interest, rent income, pension, 4 per cent of the land registry valuation of buildings used by their owners and all other incomes.

Adjusted Gross Income.-- Gross income is adjusted by the deduction of all the expenses wholly and exclusively incurred in the production of the income. The allowable expenses are: trade expenses, repairs, taxes, interest paid by the business, depreciation expenses and so on.

Deductions From Adjusted Gross Income.-- Having determined the adjusted gross income of the individual, various deductions are permitted by the income tax law before arrival at the chargeable or taxable income which is the tax base. The principal deductible items are:

1. Earned Income Relief. A deduction of 10 per cent is permitted on the earned income of the taxpayer. The Cyprus

Income Tax Law defines "earned income" to mean income derived from any trade, business, profession, vocation, employment, or annuity if such annuity is granted on account or in respect of employment."[9] All other incomes are considered to be unearned and not eligible to the earned income relief. So, the Cyprus Income Tax Law discriminates against those who earn their income from the investment of their capital rather than as a return for their effort and skill.

The effect of this discrimination against those who have unearned income is negligible, because the number of persons having unearned income or the amount of the unearned income is so small that this discrimination does not hurt people much. But, in spite of all these it is a clear discrimination and may discourage saving since the unearned income, that is interest, dividend, and rent are returns for saving and lending. The respondents to the questionnaires sent by the author indicated that the earned income relief had no effect on their desire to save more. But, its effect on individual savers is not known because the questionnaires were sent only to businessmen.

2 . Childrens' allowance. A taxpayer is allowed the following deductions in respect of his children:

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[9] *Ibid.*, Section 2, p. 2.

(a) £ 50 in respect of a child under the age of 16.

(b) £ 75 in respect of a child receiving full-time education in any school in the Republic.

(c) A deduction equal to the amount expended on maintenance and education, but not exceeding in any case £ 300, for a child receiving full-time education outside the Republic between the ages 16 and 27. [10]

Although the deduction of £ 75 allowed for a child under the age of 16 and attending a school in the Republic is very small and farfrom being satisfactory, the £ 300 deduction allowed for those studying outside the Republic tends to have a positive effect in encouraging parents to send their children abroad for higher education which is much needed in Cyprus. For a taxpayer, say in the £ 2500 - £ 3000 income bracket who pays 500 mils tax in the pound, this child allowance reduces the educational expenses of his son by 50 per cent which is and has been a big encouragement in this field. The 50 per cent is arrived at as follows:

£ 300 deductions allowed for the child.

£ 150 tax is saved since this particular taxpayer pays 500 mils in the pound.

Therefore, he saves half of his son's educational expenses in the form of a tax relief.

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[10] Ibid., p. 15.

3. Wife's allowance. According to Section 20, in ascertaining the chargeable income of any individual who is married and whose wife lives with him a deduction of Ŀ 50 shall be allowed in respect of his wife. If the wife derives income from letting buildings or income from any annuity not granted in respect of past services, such income will be added to the income of the husband, and the husband shall be allowed a further deduction equal to the amount of such income of the wife, but in no case exceeding one hundred pounds.[11]

Until 1961, the income of a married woman living with her husband was considered to be the income of the husband and was charged in the name of the husband. This provision of the law was contested by a group of taxpayers at the Supreme Constitutional Court which decided in favor of the taxpayers, whereby the husband and the wife could be assessed individually in respect of their separate incomes. This change caused a reduction in the government's income tax revenue, because the same income which was subjected to a higher marginal rate, now was split into two and fell into a lower bracket whereby a lower tax rate applied to each of them. In addition, both spouses were allowed an exemption of Ŀ 300 for minimum living expense.

At present both spouses are considered to be independent individuals as far as income taxation is concerned. The only

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[11] Ibid., p. 17.

exception is that the unearned income of the wife, namely, rent, interest, and or dividends, is aggregated with her husband's income and charged in his name. The decision of the Supreme Constitutional Court applied only to the earned income of the wives. This decision has been a strong inducement for the married women to enter the labor market. The effect was still higher for those women whose husbands fell into the higher income brackets. As a result there has been a big flow of female labor into the market, especially in the clerical field.

Although the change in the law in relation to separate assessment of husbands and wives did not take place as a policy decision to encourage the married women to take up employment, its effect has been of great significance. Also its timing was very appropriate, since Cyprus needed more labor during its first stage of development after independence in 1960. From a social and economic standpoint, it is undoubtedly desirable that the number of full-time women workers should be increased. The expansion of trade and industry in Cyprus during the last decade strengthened the case for giving such encouragement to married women through the means of the income tax law.

4. Allowance for Insurance Premiums. The premiums paid by a taxpayer in respect of his life insurance policy is

allowed as deduction for ascertaining his chargeable income. In the same way contributions to funds approved by the Commissioner of Income Tax are also deductible in ascertaining the chargeable income of the taxpayer, provided that the amounts allowed as deduction in respect of insurance premiums cannot exceed 300 mils in the pound or 7 per cent of the capital sum or one-sixth of the chargeable income of the taxpayer.[12]

The increase in the amount of deductions in respect of insurance premiums from 300 mils to 400 mils has had a very great effect on the life insurance business in the island.[13] The insurance brokers utilised this increase in the deduction of insurance to their advantage and as a result there has been a boom in the sale of life insurance policies since 1961. On the other hand the allowance of the contributions to a pension or provident fund increased the number of funds established by individual firms for the benefit of their employees. This has reduced the labor turnover considerably and contributed to the development of a more satisfied labor force which is necessary for a developing country like Cyprus.

Taxable Income.— After deducting all the above mentioned allowances from the adjusted gross income, we arrive at the taxable income which is the actual base on which tax

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[12] *Ibid.*, p. 17.

[13] One Cyprus Pound is equal to 1000 mils.

rates are applied in order to ascertain the amount of tax payable by the taxpayer. Taxable income is defined by the Income Tax Law to mean "the aggregate amount of income of any person from all sources after deducting such sums as are permitted by or under this law".[14]

In addition to the above named deductions from the adjusted gross income, a personal exemption of £ 300 for the taxpayer and his dependents is subtracted in order to arrive at the taxable income, or the base of the tax . Allowance of personal exemptions provides a tax-free amount of net income supposedly adequate for the maintenance of a minimum level of living. Clearly, some allowance for living expenses must be made if the tax is to reflect ability to pay.

<u>Application of Tax Rates</u>.-- The tax liability of a taxpayer is ascertained by the application of the appropriate tax rate to his taxable income. Cyprus has graduated income tax rates applicable to individual incomes and a standard rate applicable to company profits. The former is progressive, beginning with 55 per cent for the first pound of the taxable income and rising as high as 850 mils or 85 per cent above the £ 10,000 of the taxable income. The latter is a flat rate of 425 mils in the pound or 42.5 per cent irrespective of the amount of profit.

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[14]<u>Ibid</u>., p. 3.

The following scale of rates is taken with some adaptation from the Income Tax (Foreign Persons) Law of 1961, Personal Contribution Law of the Greek Communal Chamber and the personal Contributions (Income Tax) Law of the Turkish Communal Chamber, and shows the scale of rates applicable in Cyprus to foreigners and Cypriots in 1961.

SCALE OF RATES OF TAX PAYABLE

ON TAXABLE INCOME

Taxable Income				Rate of Tax	
				Cypriots	Foreigners
On every £ not exceeding L 300				Nil	Nil
On every £ in excess of £300 but not exceeding L 350				50 Mils	50 Mils
"	350	"	500	75 "	75 "
"	500	"	1000	100 "	100 "
"	1000	"	1500	150 "	150 "
"	1500	"	2000	300 "	250 "
"	2000	"	2500	450 "	400 "
"	2500	"	3000	500 "	500 "
"	3000	"	3500	550 "	600 "
"	3500	"	4000	600 "	650 "
"	4000	"	5000	650 "	700 "
"	5000	"	6000	700 "	750 "
"	6000	"	10000	750 "	800 "
"	10000	"	----	750 "	850 "

1 - The bachelors and spinsters' tax liability shall be increased by 20 per cent. If the tax payable exceeds £ 120, the increase of such tax over £ 120 shall be 50 per cent; provided that the total of such increases shall not exceed £ 500 in any one year.

2 - Companies and all other bodies corporate or unincorporate shall pay tax at the rate of 425 mils on every pound of taxable income.[15]

As far as the personal income tax rates are concerned, the initial brackets falling under £ 1500 are narrower, which makes the progression more effective. Since the majority of the taxpayers fall within these lower brackets, more revenue can be collected from them. The very high rates in the top brackets are not of much significance from the revenue standpoint, because relatively few taxpayers fall in these brackets.

The following table shows the distribution of the taxpayers among different income brackets for the year 1962.

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[15]Ibid., p. 46.

[16]Charles W. Thacker, Income Tax In Cyprus (Nicosia: Cyprus Federation of Trade and Industry, 1954), p. 21.

TABLE 5

PERCENTAGE OF TAXPAYERS IN EACH INCOME BRACKET

Income Bracket			Per Cent
£ 0	-	£ 300	38
£ 0	-	1000	88
£ 0	-	1500	96
£ 1501	-	2000	2
£ 2001	-	3000	1.2
£ 3001	-	4000	0.3
£ 4001	-	5000	0.03
£ 5001	-	6000	0.08
£ 6001	-	over	0.07

Source: Ministry of Finance: Department of Inland Revenue, Annual Administrative Report for the year 1962. (Nicosia: The Printing Office of the Republic of Cyprus, 1964).

Bachelors and Spinsters. -- The bachelors and spinsters are subject to a surcharge. This surcharge puts them among the most highly taxed unmarried persons in the world. This unenviable distinction arises from the inequity of the Cyprus system of surcharge for a bachelor or spinster. Mr. Charles W. Thacker, a Fellow of the Institute of Taxation in England, says that he cannot think of any other country which surpasses

Cyprus in this respect.[16] The psychological effect is bad, even from revenues point of view! a "surcharge based on a primary scale of tax payable by married persons creates the impression that bachelors and spinsters are penalised for their unmarried status; whereas similar results can be achieved without giving rise to that conclusion, by granting higher personal allowance or deduction to a taxpayer who assumes the additional burdens and responsibilities of a married man".[17]

Notice to Persons Assessed.-- After the completion of assessment a notice of assessment is served on all persons assessed. This notice indicates the amount of taxable income and the tax payable by the taxpayer. If a person disputes the assessment he may apply to the Commissioner in writing to review and revise the assessment made upon him. Such application shall state precisely the grounds of his objection and shall be made within fifteen days from the date of the notice of assessment.

On receipt of a notice of objection, the commissioner may require the person giving the notice of objection to furnish or produce such particulars as the commissioner may deem necessary for the settlement of the objection. When the commissioner settles the dispute with the taxpayer, he amends the

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[16] Charles W. Thacker, Income Tax In Cyprus (Nicosia: Cyprus Federation of Trade and Industry, 1954), p. 21.

[17] Ibid., p. 22.

assessment accordingly and a new notice of assessment is served on the taxpayer which becomes payable within fifteen days.

Corporation Income Tax

Cyprus Corporation Income Tax applies to all corporate profits after deducting from gross receipts all ordinary business expenses. The corporation income is taxed at a standard flat rate of 425 mils or 42.5 per cent, irrespective of the amount of profit. But the amount of tax deducted from dividends is claimed back by the dividend recipients and they receive it back in the form of a refund or as a set-off against their current tax liability.

As it is observed from the above information, in Cyprus there is no corporation tax as it is known in the U.S.A. or other countries. What is known as a corporation tax in Cyprus is a personal income tax in a different form imposed through the medium of a corporation. In Cyprus there is no double taxation as a result of the corporation tax. The individual taxpayer pays his tax liability on what he receives in dividends, but dividends are not taxed twice both before and after they are paid to the stockholders.

Two ideas permeate the subject of corporation taxation. The first is that a company is nothing but "an aggregate of a assessment accordingly and a new notice of assessment is served on the taxpayer which becomes payable within fifteen days.

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Two ideas permeate the subject of corporation taxation. The first is that a company is nothing but "an aggregate of a number of stockholders banded together for the achievement of some common purpose under limited liability. It is sufficient to impose the (personal) income tax upon the shareholders .... and needless to impose the tax upon corporate income."[18] Cyprus follows this first idea and taxes the stockholders only instead of both the corporation and the stockholders on the same income. This method simply regards the corporation tax as a witheld tax; the same as the tax witheld by an employer from the earnings of his employees. This method is referred to as "the credit-to-stockholders method."[19]

Collection and Recovery of Tax

Every taxpayer becomes liable to pay the tax by the prescribed date after the receipt of the notice of assessment. But, if the taxpayer objects to the assessment or appeals to the Supreme Constitutional Court, the tax will not be collected from him until such objection or appeal is determined. In cases where the commissioner is satisfied that undue hardship will be caused if payment by the prescribed date of the whole of the tax assessed is insisted upon, he may allow the tax to be paid by instalments. If any tax is not paid on the due date a sum equal to 5 per cent of the amount of the tax payable will

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[18] Bird and Oldman, op. cit., p. 139

[19] Richard Goode, Progressivity in a Capital Poor Country, Reconstruction of a Foreign Tax Structure, New York: John Wiley and Sons Inc., 1951. p. 192.

be added to the original sum. If any taxpayer fails to pay his tax liability the commissioner may initiate court proceedings against him and may recover the tax payable.

It is observed in Cyprus that a great percentage of the taxpayers object to the assessment made on them, and also many of them default despite the 5 per cent penalty for non-payment within the prescribed date. No matter whether the delay is one day or 6 months the same penalty of 5 per cent is added. The main reasons inducing the above attitude are as follows:

(a) Taxpayers know that when they object to the assessment the collection of the tax will remain in abeyance until the objection is settled. The taxpayers are also very well aware of the shortage of the assessing staff in the Income Tax Office, as a result of which the settlement of some objections are delayed one, two or in certain cases, three years or more.

(b) A false impression has been created among the taxpayers that, because of lack of evidence or any other information relating to the amount of their income, except the very small amount declared by them, bargaining between the taxpayer and the assessing officer ends in the majority of cases in favor of the taxpayer, and the tax imposed in accordingly reduced.

(c) Some small merchants prefer to pay 5 per cent penalty by defaulting purposely and not because they are unable to pay, for they feel that they can earn more than 5 percent on the amount to be paid as tax, by using it in their business. For them this method seems to be a cheaper means of finance than borrowing from a bank.

The Pay-As-You-Earn System (P.A.Y.E.)

For many individuals the need for making payment of tax in one lump sum on income earned throughout the year proved to be a serious burden. To relieve the taxpayers from this burden a system of witholding tax was established in many countries. Employers were required by law to withold tax from the wages and salaries paid to their employees.[20]

Payment of the tax on income at the time of its realisation has for a long time been an integral part of the British Tax System. A.R. Prest says that "P.A.Y.E." is now treated as

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[20] John F. Due, Government Finance (Homewood, Illinois: Richard D. Irwin Inc., 1959), p. 161.

one of the established facts of life by the majority of workers in England.[21]

Cyprus, being a British Colony until 1960 and following the British Tax System very closely, introduced the "P.A.Y.E." system in 1952 to start effectively in 1953. P.A.Y.E. is mostly employed for witholding tax from the wages and salaries of the employees. The reasons for collection at the source were administrative, namely, to reduce the number of personal returns to a minimum and also to achieve partial collection of the tax at the time the income was realised. Thus, providing some current tax receipts for the Treasury. This was beneficial both to the government and to the taxpayers.

The P.A.Y.E. system of tax collection placed great responsibility upon the employers, who are required to act as agents for the taxpayers. The record keeping responsibility, its cost, the accumulation of data on witholding and issuing witholding receipts, imposed relatively heavy burden on them.

Advantages of the P.A.Y.E. System.-- The P.A.Y.E. system has several important merits. It lessens the burden on the taxpayer by insuring that the tax is paid as income is earned, and no larger liability is accumulated which could

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[21] A.R. Prest, "The Royal Commission on the Taxation of Profits and Income", Economica, Vol. 23, 1956, November. p. 368.

create very great hardships for the taxpayers. As a result of the introduction of the system, tax delinquency and evasion are reduced and tax payments respond more quickly to tax rate changes. This last consideration is of great importance in facilitating the use of incometaxation as an economic tool to deal with inflation and depression.

When income tax is deducted at the source, that is to say intercepted before the money income actually reaches the taxpayer, it is apt to be less keenly felt than if he first receives his income in full and then at a later date, when he has already spent most of it, receives a demand note from the tax collector.[22]

The author's experience at the Income Tax Office in Cyprus provides him with many examples which prove the correctness of the above argument. The author has had to hear the complaints of many taxpayers, usually by previous employees of the military bases. Because of no deduction or underdeduction from their monthly salaries under the P.A.Y.E. system, the income tax office required them to pay these underdeductions at a time when these employees were out of work. It was really a great hadship for them to be asked pay tax when they were

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[22] Hugh Dalton, Principles of Public Finance (London: Rentledge and Kegan Paul Ltd., 1961), p. 34.

unable to do so.

Although the P.A.Y.E. system has many advantages still there are some authorities who argue in the opposite direction: F.W. Paish, in his article in Economica, entitled, "Economic Incentives in Wartime" stated before the introduction of P.A.Y.E. in 1941," that .... the deterrent effect of high marginal taxation is probably substantially reduced by the present system of assessment ... for the time-lag probably prevents many taxpayers from realising clearly how much of their marginal earnings go in taxation."[23]

A similar line of argument was followed by H.S. Booker, in his article "Income Tax and Incentive to Effort"; he stressed the fact that the P.A.Y.E. brings forcibly the marginal tax to the notice of the taxpayer and he resents it.[24] He prefers the old method of deduction based on an earlier year's income which does not fluctuate with current income.[25]

In Cyprus, the application of P.A.Y.E. method has been successful especially among the employees. It has

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[23] F. W. Paish, "Economic Incentives in Wartime" Economica, August, 1941, p. 245.

[24] H.S. Booker, "Income Tax and Incentive to Effort, Economica, Vol. 12 1945, p. 245.

[25] Ibid.,

relieved the employees from the burden of paying their tax liabilities in a lump sum. The monthly deduction in a sense amounts to a kind of payment by instalment which is naturally easier than payment in one lump sum.

Administration of the Income Tax in Cyprus

The income tax law is administered by the inland Revenue Department of the Ministry of Finance. It is composed of two sections: the assessing section and the collection section. The former assesses the tax payable and the latter collects the tax assessed. There may be disputes about the tax assessed but once this is settled, the tax collector encounters little difficulty in collecting the tax payable. Nearly 95 per cent of tax collection is done without recourse to any enforcement action. In 1962, out of nearly 4500 assessments only 27 recourses to the Supreme Constitutional Court were filed. Five of these were settled outside the court between the taxpayer and the Inland Revenue Officials and the rest were determined by court decision.[26] Since 1961, all tax cases have been dealt with by the Constitutional Court, whereas previously District Courts dealt with them.

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[26] Annual Administrative Report, 1962 (Nicosia: Income Tax Office, 1963), p. 4.

The assessing department is short of staff as a result of which many of the assessments are outstanding, in certain cases for three to five years, which costs a lot to the Treasury and creates a big problem for the taxpayers when they have to pay all the arrears at one time when assessed.

The Inland Revenue Office makes all the assessments and collects the tax payable on behalf of the two communities under their respective income tax laws in return for a 5 per cent commission to cover its costs of assessment and collection.

Efficiency of Administration.-- When the individual taxpayer knows that the great majority of taxpayers are paying their proper shares of revenue, confidence is created in the Income Tax Office. A tax system based largely, if not completely, on voluntary compliance with the law grows out of this confidence. This is not done in Cyprus, because of the failure of the income tax authorities to penalise those taxpayers who evade the law or neglect to give the required information in relation to their income, to the income tax office. Most of the complaints by the taxpayers center around the allegations that such and such a person is richer than himself and pays no tax at all or pays much less than he should have paid. This is an unfortunate situation in the administration of the income tax law in Cyprus. This may be partly due to the insufficiency of staff and partly to the non-enforcement of the provisions of the law. Like many other well intentioned and appropriate provisions of law, this provision of the Cyprus Income Tax Law which could achieve satisfactory compliance is kept in the statute book without actual enforcement.

Tax Evasion and Avoidance in Cyprus

Differences in cultural background and in the tax systems are accompanied by differences in the attitude toward the extent of tax evasion and tax avoidance. Tax evasion, and avoidance is such a universal phenomenon that it was the topic selected for discussion at the meeting of the International Institute of Public Finance in Vienna in 1957.[27]

> "No tax can conform with accepted standards of equity if it cannot be administered with a high degree of effectiveness. If persons are to escape, by legal or illegal means, the tax to which they should logically be subject under the general scope of the tax, the theoretical equity of the tax is to a large extent lost."[28]

Evasion.-- The basic limitation of the income tax law is the fact that incomes of certain groups of people and the amounts claimed as allowable deductions cannot be

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[27] American Economic Review, Vol. 47, 1957, p. 194

[28] Due, op. cit., p. 162.

checked with a high degree of accuracy. In Cyprus the income accruing to this group constitutes 75 per cent of the total income assessed in 1962.[29] This group includes the small traders, farmers, and professional men who are able to escape with considerable underestimation of their income and overestimate their business expenses. The following constitute a fair estimate of tax evasion in Cyprus:

Salaries and wages -- especially of the government emplyees are reported correctly and accurately.

Interest recipients -- 75 per cent evasion.

Dividend recipients -- No evasion, companies declare them

Rent recipients -- 40 per cent evasion.

More staff and greater seriousness on the part of the Income Tax Officials can reduce the amount evaded tremendously.

Avoidance. -- Tax avoidance involves the act of finding loopholes in the law and taking advantage of them. This requires a good knowledge of the income tax law. The author's experience in the income tax office and his contacts with some accountants have revealed the fact that tax avoidance is helped by the accounts, who are familiar with the existing loopholes in the law and the practices of the assessors in the interpretation of certain provisions of the income tax law. The high integrity and professional standing which characterise the

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[29] Annual Administration Report, 1962, op. cit., p.5.

accounting profession do not apply to certain accountants in Cyprus who are not qualified accountants but are merely approved by the Ministry of Finance to perform the duties of an accountant.

CHAPTER III

EFFECTS OF THE DEPRECIATION ALLOWANCE PERMISSIBLE BY THE INCOME TAX LAW ON BUSINESS POLICY

"Depreciation can be defined as a systematic cost assignment procedure, determined primarily by the use-life expectancy of assets."[1] Capital equipment purchased by the businessmen in one period may be used over a period of years. The businessman has to allocate the cost of the equipment to each year in which the equipment has been used and has benefited the business; that portion of the cost of the equipment allocated to each year is known as the depreciation expense. A portion of the gross receipts of a firm each year consists of the return or recovery of invested capital which is obviously an expense and not income since it does not constitute an economic gain to the owners; the latter is simply a recoupment of a part of the capital sunk in the form of equipment. Failure to exclude it from income would result in an inflation of income and in taxing the owners of the business on receipts which represent merely a change in

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[1] Finney and Miller, Principles of Accounting-Introductory (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1964), p. 203.

the form of assets rather than income.[2] Actually what is happening is the conversion of the asset into cash through its earning capacity in the form of income.

The words most commonly used to describe such systematic assignment of fixed costs to expense are:

(1) Depreciation, which is the systematic assignment of the cost of tangible assets other than natural resources to expense.

(11) Depletion, which is the systematic assignment of the cost of the natural resources to expense.

(111) Amortisation, which is the systematic assignment of the cost of intangible fixed assets to expense.

Problems of Determining Depreciation

Among the deductions allowed to the businessmen by the income tax law, the most controversial one is depreciation. The major problem relating to depreciation centers around the question of allocation of the total capital over the life of the equipment.[3] Depreciation charges over the life of the equipment must equal the original cost of the equipment. It is impossible to estimate, with any high degree of certainty,

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[2] John F. Due, Government Finance (Homewood, Illinois: Richard D. Irwin, Inc., 1959), p. 168.

[3] *Ibid.*, p. 146.

the usable life of the equipment. Thus any figure chosen is an estimate, and if it proves to be longer than the actual life of the asset the depreciation charges will be inadequate. In a sense, a business firm can never be certain of the correct depreciation charges for any particular year, and thus what it shows as a profit in its final accounts is the nearest approximation possible to the correct profit for the year.

In some cases the allocation of depreciation by year is not very significant, since the method of allocation will affect merely the tax payment in a particular year, but not the total tax to be paid over a period of time. But, in other cases depreciation methods are very insignificant. If the carry-over of losses from one year to another is severely restricted, and earnings fluctuate sharply or are subject to significant upward or downward trends, the allocation method will influence the tax liability. In a year of heavy losses, depreciation charges will not be covered, and thus portions of the firm's capital will not be recovered. If the equipment suddenly becomes obsolete in years of losses the same will be true. If tax rates or earnings fluctuate substantially and tax rates are progressive, the tax to be paid in the long-run will be affected by the method used to allocate capital costs over the various years.[4]

Inflationary trends in many countries during the last decade have created more problems in relation to depreciation. The traditional historical cost depreciation method does not seem to be very suitable any more and has lost much of the support given to it both by the accounting profession and by the business community. From a longer-run viewpoint historical cost depreciation in a period of inflation is likely to result in a smaller amount of capital formation than would replacement-cost depreciation.[5] Some authorities argue that the replacement-cost basis can be justified for tax purposes only as a deliberate policy of facilitating the task of a firm in obtaining additional capital necessary to replace worn out capital equipment.

Accounting and Tax Concepts of Depreciation

Section 12 (2) of the Income Tax law states that in ascertaining the chargeable income of any person engaged in

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[4] Due, op. cit., p. 169.

[5] Cary E. Brown, Effects of Taxation-Depreciation Adjustment for Price Changes (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1952), p. 52.

trade, business, profession, vocation or employment there shall be allowed:

> "A deduction of a reasonable amount for the exhaustion and wear and tear of property arising out of the use and employment of such property in the trade, business, profession, vocation and employment during the year immediately preceding the year of assessment, or in so far as persons in employment are concerned, during the year of assessment."[6]

Precisely what the law means by "reasonable" has depended heavily on the definition of depreciation supported in the accounting profession. At one time depreciation was regarded as an amount set aside for future asset replacement. Accountants now are sharply critical of this view. They hold that depreciation can take place whether or not funds are set aside equal in amount to depreciation and whether or not the asset is replaced in future.[7] The newer attitude towards depreciation recognises the inevitable using up of an asset in the productive process. This using up process does not take place because cash was set aside, nor because the asset might be replaced in the future. There are still differences of opinion as to whether depreciation represents a decline in the value of the asset, or, instead, simply an

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[6] Income Tax (Foreign Persons) Law, 1961. Section 12 (2).

[7] Brown, op. cit., p. 2.

allocation of cost against revenues attributable to these costs.[8]

Evidence for the triumph of the cost allocation theory can be seen in the statement on accounting principles and in the report issued by the Committee on Terminology of the American Institute of Accountants from which the following currently valid quotation is taken:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital asset, less salvage (if any), over the estimated useful life of the unit in a systematic and rational manner. It is a process of allocation, and not of valuation.[9]

It is important, in terms of the general intent of income taxation, that firms be permitted to recover all capital tax free. Failure to do so is not only inequitable and discriminatory against firms with fluctuating earnings, but may impede investment unnecessarily. On the other hand complete freedom on the part of the firm to allocate depreciation by year would result in deliberate tax avoidance in many cases, since a pound of deduction represents more tax saving to a firm in one year than in another.

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[8] Ibid.

[9] Committee on Accounting Procedure, American Institute of Accountants. Accounting Research Bulletin No. 22, Report of Committee on Terminology-Depreciation, May 1944, p. 179.

Methods of Depreciation

There are numerous methods of depreciation among which the following four are the most widely used both for accounting and taxation purposes.

1 - Straight-line method.
2 - Sum of years' digits method.
3 - Diminishing balance method.
4 - Replacement cost method.

Income tax considerations are an important factor in the selection of the depreciation method in countries where this option is available to businessmen. Unfortunately, in Cyprus, businessmen have to apply the straight line method because it is the only method accepted by the income tax law.

In view of the high level of tax rates, the amount and pattern of depreciation deductions have an important effect on the cash position of a business. It is very likely that this may not be a permanent saving, because during the life of an asset the depreciation deductions cannot exceed its cost. But, for a new and expanding business in particular, and for all businesses to some extent, a postponement or deferment of income taxes is attractive, because it may permit an earlier retirement of debts created to finance the purchase of the asset being depreciated, or may permit the use of such cash for additional equipment. This is still more important for small and newly established businesses which find difficulty in borrowing in the financial markets.[10]

The Straight-Line Method.-- This is the simplest and the most commonly used method. It results in spreading the total depreciation equally over the life of an asset, unless the periodical charge is adjusted because of abnormal operating activities.

In Cyprus the Income Tax Law allows only the straight line method to be used by the businessmen. It specifies very clearly and rigidly the depreciation rates applicable to all assets. In this way no room is left for the businessmen to interpret the law. This provision of the law makes it very rigid and static by not taking into consideration specific situations under different conditions and in different industries. It is a fact for example that buildings and machinery in certain industries are liable to depreciate more quickly because of the nature of that industry.

One of the problems of determining depreciation is the estimation of the working life of an asset. Therefore, if the law fixes the working life of an asset and if it proves to be longer than the actual life of the asset, the depreciation

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[10] Brown, op. cit., p. 3.

charges will be inadequate. Thus, this will result in a loss to the businessman, because he will not be able to recover the whole cost of the asset. This runs contrary to the provision of the Cyprus Income Tax Law which specifies that an asset must be depreciated 100 percent.

The following disadvantages are suffered by the businessmen when the actual life of an asset falls short of the estimated life on which the rates are fixed by the income tax office.

If an asset is estimated to have a working life of 10 years by the law and the asset costs £ 1000, £ 100 will be written off every year. If the asset becomes useless after 6 years, at that date only £ 600 of its cost will have been recovered. The businessman will dispose of it and in accordance with the law, will submit a balancing statement to the income tax office to claim a balancing deduction. If he disposes of this asset at £ 100, he will be allowed a balancing deduction of £ 300 in the year immediately preceding the year of assessment.

This will be disadvantageous to him because he will get higher depreciation allowance at the end of the working life of an asset, unlike the accelerated depreciation method which permits higher depreciation allowances during the earlier years of an asset, accelerated depreciation is recommended for the encouragement it gives for investment and growth. Therefore, the prevailing method of depreciation seems to be very conservative and not suitable for a developing country, where incentives of this kind are needed for boosting the capital expansion in the island.

Secondly, if the above assumed firm is a single proprietorship or partnership and not a corporation, and if this business had a very low income in the year in which the balancing deduction is to be made, then this firm will fall in a very low income bracket and will be subject to a low rate of tax. Under these conditions the firm will be loosing some advantages, whereby if the deductions were normally allowed in the earlier years when the earnings were high, it would have saved some more taxes for the firm. Actually the effect of the straight-line method on the Cypriot business policy is that the businessmen tend to dispose of their assets at a time when these assets can be of use to their business, especially during successful years when they have high profits which could be reduced by the balancing deduction resulting from the sale of assets.

The following results are ascertained from the views of the Cypriot businessmen in relation to depreciation as indicated in the questionnaires sent to them by the author. Only 35 per cent of the respondents mentioned that they are aware of the depreciation allowances. They also mentioned that they use the straight-line method because it is the only method permitted for income tax purposes. Most of the respondents are generally bigger firms which keep proper books of accounts and submit audited accounts to the Income Tax Office. Sixty-five per cent of the respondents said that they do not know or understand anything about depreciation. When one takes into consideration the great percentage of taxpayers who do not keep books or submit accounts or even returns to the Income Tax Office this answer must be accepted as normal.

Another important effect of depreciation allowance on the business policy is that it encourages businessmen to keep proper books and have them audited for the purpose of submitting them to the Income Tax Office. This is done because no depreciation allowance is granted unless proper books are kept and audited accounts are submitted. The keeping of proper books is advantageous to businessmen since it shows them the true and fair view of the state of affairs of their business.

"There is no historical justification for straight-line depreciation."[11] This method of depreciation has two

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[11] Symposium on Income Tax Administration, <u>National Tax Journal</u>, Vol. 4 (Harrisburg, Pensylvenia: September, 1954), p. 124.

very bad effects; firstly, under this method, when the tax rates are high and the depreciation rates are low, taxpayers may often be financially unable to make the necessary replacement when it becomes evident that their existing assets are obsolete.

Secondly, the bad effect will become evident just as soon as the average taxpayer realises that the easiest way for him to increase his depreciation is to retire ruthlessly any asset for which there is no need in the immediately foreseeable future.[12]

The government can prevent the ruthless waste of capital equipment in a developing country like Cyprus by allowing other methods of depreciation to be used. Cyprus can follow the tendency of moving towards accelerated depreciation methods which are suitable for developing countries where a fast increase in investment is desirable.

Many accountants believe that either the declining balance method or the sum of years' digits method are acceptable and preferable to the straight-line method. They argue that "the logical method of depreciation would seem to be one which would relate the cost of the asset to the revenues produced

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[12] Ibid., p. 126.

by them. In most cases accelerated methods do this."[13]

Initial Allowance and its Effects

The initial allowance is an additional depreciation allowance with respect to particular machines, equipment or buildings, given to their owners in the first year of their use. Thus, they reduce taxation on the income or profits of the first year. They represent a permanent tax relief to industry and a permanent cost to the treasury. But, they are only given in return for new investment, e.g. the purchase of a machine or building. Thus, initial allowances sustain the desire to invest better than any other forms of tax relief.[14]

The Cyprus Income Tax Law allows twenty per cent initial deduction for plant and machinery and ten per cent on buildings in the year of assessment in which they are acquired and first used. The law further specifies that total deductions, namely depreciation plus initial allowance, shall not exceed the capital expenditure incurred in acquiring the asset. In other words, the initial allowance is a kind of accelerated depreciation allowed in the first year of the use

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[13] American Economic Review, Papers and Proceedings, Vol. 50, 1960. p. 489.

[14] Hugh Dalton, Principles of Public Finance (London: Routledge and Kegan Pau Ltd., 1961), p. 84.

of an asset. It gives the relief for the year of purchase when it is most needed, at the cost of reducing the allowances in the subsequent years.

The need for modern industrial equipment and buildings in Cyprus is imperative for the development of the country. The fact that a country cannot continue to compete successfully with its rivals unless its plant and equipment are completely up to date, applies with equal force in Cyprus too. The direct incentives to modernise industrial plant, equipment, and buildings, and the consequent benefit to the island as a whole is invaluable, especially at this present stage of its development. Although there have been previous reports and suggestions, both during the colonial days and later, the low rates of initial allowances permitted in Cyprus have not changed for more than a decade and stand at the same figure they were when initially introduced. Although most of the suggestions put forward by Thacker Report in 1954 have been incorporated in subsequent laws, the initial allowances have not been changed.[15]

Although the present rates of initial allowance used are not high, still they have certain positive effects on

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[15]Charles W. Thacker, Income Tax in Cyprus (Nicosia: Cyprus Federation of Trade and Industry, 1954), p. 34.

investment in the island. The author's interview with the director of the Ish Bank in Nicosia, on December 28, 1965 in Beirut, revealed the following effect on their policy: He believes that 20 per cent initial allowance on plant and machinery induces mechanisation, e.g. using more accounting and calculating machines and labor saving devices in substitution for labor. He mentioned that as a result of this policy their investment in capital assets has been increased and he feels that higher initial allowances may induce a policy of more and more investment in the mechanisation of the bank.[16]

Whether this increased mechanisation is to the benefit of the island's economy or not is doubtful; while there are so many graduates from high schools in the labor market looking for jobs, substituting machines for labor does not seem very appropriate, in an island which is so much in need of capital. Therefore, it seems logical that these allowances should be given selectively to certain industries which will improve the island's productive and competitive capacity rather than encouraging the substitution of a scarce factor of production for an abundant factor of production. This is a kind of misallocation of resources which tends to have harmful effects on the economy, which must not be encouraged.

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[16] Interview with Ali Vasif, Director of Ish Bank, Nicosia. Beirut, December 28, 1965.

The respondents' replies to the question of whether the initial allowances encourage them to use more machines instead of labor indicate the following results:

Thirty-three per cent of the respondents replied that initial allowances have a positive effect on their investment policy, that is, they are encouraged to invest more or change old equipment more frequently than they should otherwise have done without the initial allowance.

Thirty-three per cent replied that their investment policy is not influenced by initial allowances.

Thirty-three per cent replied "we do not know"; to the writer this implies that either they do not care for the income tax law or they are not well versed in the technicalities of depreciation methods and allowances.

The results obtained from the questionnaires are indicative of the fact that only a small portion of the taxpayers are well aware of the existence of some allowances in the income tax law which can be used to their advantage. Most of the firms mentioning the favorable effects of the initial allowance tend to be big firms keeping proper books and submitting audited accounts to the Income Tax Office.

Depletion and Its Effects on Business Policies

"Depletion is the exhaustion of the cost or value of a wasting asset, such as a mine, a timber tract, or an oil well, resulting from the conversion of the natural resources into inventory."[17] These enterprises, in addition to normal depreciation deductions on their capital equipment are allowed an annual deduction, known as depletion. This deduction is designed to reflect the declining value of an exhaustible asset. Firms in these industries are given the option of choosing either cost or percentage depletion, the latter typically being the most advantageous. The cost method involves dividing the number of recoverable units of output into the value of resources owned, and multiplying this figure by the year's output. The percentage depletion on the other hand permits the deduction of a specified percentage of gross income for tax purposes, year after year without end. If liberal provisions are permitted for depletion, it reduces the taxes of the companies in these fields. Some authorities allege that general depletion allowances granted to Texas oil producing companies made the statement that millonaires grow only in Texas more a fact than fiction.[18]

These allowances are defended as being essential for continued exploitation and development of the natural resources of a country. On the other hand they are bitterly condemned as

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[17]Finney and Miller, <u>op. cit</u>., p. 323.

[18]Due, <u>op. cit</u>., p. 172.

being grossly discriminatory in favor of the owners of the firms in the industries involved, and as being unnecessarily expensive in accomplishing the desired purposes. Their basic defect arises from their application to all firms in the areas affected in order to aid the few marginal operations . In some fields serious questions can be raised about the desirability of encouraging a rapid rate of exploitation and thus depleting resources available for the future. [19]

There is no standard method for handling the depletion problems. It has logical difficulties, because both the value of the resources and the time period for exploitation are uncertain. Some countries determine the deduction as a percentage of gross income (Turkey, U.S.A.) or percentage of net profits (Canada) or according to the ratio of profitability as it is used in Cyprus.[20]

Depletion Provisions in the Cyprus Income Tax Law

Under the currently applicable Income Tax (Foreign Persons) Law, 1961, mining companies in Cyprus are given the option of claiming their depreciation allowances under section 12,

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[19] Ibid.

[20] William L. Thorp, Cyprus - Suggestions for a Development Program, (New York: United Nations Publications, 1961), p. 40.

or under the First Schedule of the law. [21]

Prior to the year of assessment 1962, mining operations in Cyprus were allowed the following deductions under section 12:

Initial Allowance. -- "Where, on or after the first day of January 1946, a person carrying on a trade of mining incurs expenditure, there shall be deducted in computing his chargeable income,

(a) An initial allowance equal to 20 per cent on plant and machinery,

(b) 10 per cent on buildings."[22]

Annual Allowance.-- An annual allowance is granted in each year of assessment subsequent to the year of assessment in which the initial allowance was allowed. The annual allowance to be granted is ascertained by dividing the total output of minerals in the year preceding the year of assessment by the sum of the potential output of the source estimated at the end of that period plus the output of the year, or 5 per cent of the potential output of the source whichever is greater.[23]

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[21] Income Tax (Foreign Persons) Law, 1961.

[22] Ibid.

[23] Ibid.

After 1962 any person carrying on a trade of mining who has elected to be granted a depletion allowance in respect of the year of assessment 1962 and any subsequent years, the following depletion allowances will be deducted with respect to a new mine in computing its chargeable income.

Because of the technical language used in relation to mining it is advisable to define and where it seems appropriate to quote the law in order to help the reader to understand better the rather technical and complicated nature of the depletion allowance. The following technical words are taken from the Income Tax Law of 1961:

"Source" means the total mineral deposits in or upon any land from which carrying on the trade of mining had the right to extract such mineral deposits. A source may include one or more mines in the same mineral field. The ore reserves discovered in an existing source shall not be deemed to be a new mine."[24]

"Net Proceeds" means gross income less royalties and delivery costs such as shipping and insurance."[25]

"Profits" means gains or profits derived by a person from carrying on a trade of mining in respect of a new mine

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[24] Ibid.

[25] Ibid.

during the year immediately preceding the year of assessment and included in his chargeable income for that year, but before deducting any depletion allowance under the first schedule".[26]

"New mine" means a mine discovered and worked for profit on or after January 1, 1961."[27]

"Ratio of Profitability" in respect of a new mine means the percentage ratio which profits bear to net proceeds."[28]

The depletion allowances granted on the basis of ratio of profitability are as follows:

(a) "Where the ratio of profitability does not exceed fifty per cent, the depletion allowance shall be at the rate of ten per cent of the net proceeds;

(b) Where the ratio of profitability exceeds fifty per cent but does not exceed sixty per cent, the depletion allowance shall be at the rate of six per cent of the net proceeds;

(c) Where the ratio of profitability exceeds sixty per cent but does not exceed seventy per cent, the depletion allowance shall be at the rate of five per cent of the net proceeds;

(d) Where the ratio of profitability exceeds seventy per cent, but does not exceed eighty per cent, the depletion allowance shall be at the rate of four per cent of the net proceeds;

(e) Where the ratio of profitability exceeds eighty per cent, no depletion allowance shall be deducted:

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[26] Ibid.

[27] Ibid.

[28] Ibid.

Depletion allowance shall in no case exceed twenty per cent of the profits. No depletion allowance shall be granted in respect of profits derived by any person carrying on a trade of mining from a mine in which production commenced prior to January 1, 1962." 29

The most complicated item encountered in dealing with the income tax cases of the mining companies is the word "expenditure" which means capital expenditure in connection with a source of mineral deposits incurred by any person carrying on a trade of mining:

(a) On searching for or on discovering and testing mineral deposits or winning access thereto or on development and on general administration and management prior to the commencement of production;

(b) On the provision of plant and machinery or any premium paid for the use of such plant and machinery;

(c) On the construction of any buildings, structures or works, from which has been deducted the net proceeds of sale of any minerals extracted prior to the commencement of production.

The law provides that the following shall not be included in the expression "expenditure" as defined above:

(i) Any expenditure on works constructed wholly or mainly for subjecting the raw product of the source to any process, except a process designed for preparing the raw product for use as such;

(ii) Any expenditure on searching for or on discovering or testing the mineral deposits for any source or winning access thereto in cases where the search, exploration or inquiry is given up without there having been carried out any trade which consists

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[29] Ibid.

of or includes the working of the source in question, such expenditure to be allowed as a deduction from the chargeable income in the year of assessment immediately following that in which the search, exploration or inquiry is given up:

(iii) Any expenditure on development, not being expenditure falling either under paragraph (b) or paragraph (c);

(iv) Any expenditure incurred on or after the 1st. January, 1960, by any person carrying on the trade of mining where the search, exploration or inquiry proves abortive, such expenditure being allowed as a deduction from the chargeable income of the year of assessment immediately following that in which the search, exploration or inquiry is given up.[30]

"The Law" means the Income Tax Law, 1961, or any law amending or substituted for the same.

Since under the current Income Tax (Foreign Persons) Law, 1961, mining companies are given the option of claiming their depreciation allowances under Section 12 of the law or under the First Schedule,[31] it is necessary and also advisable to examine both cases and to see their effects on business policy of the mining companies and also to find out if one of them is preferable to the other.

Mining is a very old industry in the island and still continues as an important contributor to the economy. Minerals

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[30] Ibid.

[31] First Schedule, is that Section of the Cyprus Income Tax Law which deals with allowances in respect of mining operations.

constitute 35 per cent of all exports and mining produces 20 per cent of the gross national product.[32] But, according to Thorp Report, the presently known reserves in Cyprus have a very limited length of time and new exploration is therefore extremely important.[33]

Mining operations in Cyprus are carried on by a small number of companies at a relatively small number of locations. In terms of actual operations, the various companies have had extremely varied records. One of them, the Cyprus Mines Corporation, an American Company, after a long period of exploration and development, has proved to be a very successful operation and is an excellent example of the application of modern mining methods. Other companies have been less fortunate, and are so deeply in debt that their future seems rather uncertain. The records of various companies indicate that there are four requirements for success in mining:

1 - Successful discovery
2 - Adequate Capital
3 - Competent management
4 - A good market.

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[32] Cyprus, Economic Report, Statistics and Research Department, (Nicosia: The Printing Office of the Republic of Cyprus, 1964), p. 37.

[33] Thorp Report, op. cit., p. 4.

Although the last two factors are largely beyond the reach of government policy, the first two can be substantially affected by government action through the medium of income tax and depreciation allowances.

The estimate of the known reserves indicates a probable future life for most of the mining companies of from two to ten years. This suggests that even in the short run, both profits and taxes paid will diminish substantially unless new deposits are discovered and developed.[34] It seems clear that it should be an urgent obligation of the government to encourage the existing mining companies to carry on extensive exploration work on their mining claims, grant new concessions to prospective mining companies, and at the same time allow them to charge the exploration expenses incurred by them during the year against the income of that year.

Prior to the year of assessment, 1962, exploration expenses were capitalised and them amortised over the entire life of the mine. If these exploration expenses were incurred in a venture which proved to be unproductive, the expenditure could be deducted from income only in the year in which the company abandoned its claim in the unsuccessful venture. Since the corporate income tax bears a flat rate of

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[34] _Ibid_.

42.5 per cent, the exact timing as to when a deduction can be taken would not affect the total tax payment over the period presently used for capitalisation. However, the companies expressed the idea that it could ease their financial burdens considerably in carrying on exploration if they could take their tax deductions in the same period in which money was spent by them. The government should revise the income tax law in such a way as to minimise the inconvenience to the prospective mining enterprises. The severity of the income tax must be measured not only by looking at the rates but also at the nature of the deductions which are allowed in connection with the determination of net profits.

The mining industry in Cyprus needs to be revitalised by the investment of additional capital in order to continue to be an important factor in the economy of the country. Without added investment the production of minerals will decline sharply during the next few years; this could cause a great reduction in the government revenue from income taxation. Because of the high proportion of tax paid by the mining companies, a reduction in G.N.P. and in employment would also incur.[35]

One of the respondent companies, which is the biggest and the most prosperous of all the mining companies in the

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[35]Thorp Report, op. cit., p. 40.

island, stressed the fact that it is to the advantage of mining companies to claim their allowances under the First Schedule. Allowances with respect to capital expenditure are granted there-under on the basis of the proportion which the tonnage mined in any year bears to the total ore reserves at the beginning of the year. Thus, all capital expenditure is depreciated over the life of the property. However, the method is based on the presumption that every asset purchased will last the life of the property which, of course, is not the case. It is desirable that a provision should be made in the law for the write-off of the written down balance of obsolete and non-existent assets.

It is also suggested by the mining companies that, as is the case in many other countries where the mining industry forms a significant component of the economy, taxation should not be imposed until such time as total capital expenditure has been recouped out of profits. The immediate effect of this, of course, would be a budget deficit which would not be helpful for the economy of the country.

<u>Exploration Expenses</u>.-- Exploration expenditure which results in the opening up of a new mine is included with the "other capital expenditure" which, by way of initial deductions, together with annual deductions based on an output, is allowed

over the working life of the mine. Where, however, the search in a particular locality proves unproductive and is given up, the abortive expenditure, which is of course a complete loss and is not represented by any asset whatever, is allowed as a deduction in one sum for the year following that in which the search was relinquished. This was a particular recommendation of the Millard Tucker Committee which gave legislative effect in the U.K. by the Finance Act 1952, and was embodied in the Cyprus Income Tax Law, as amended by Section 16 of Law No 31, 1952.

The abortive expenditure is, however, deducted in one sum only if the whole of the source contains no mines being actively worked. If however, the source is being worked elsewhere, the abortive expenditure is added to the other capital expenditures and spread over the life of the mines in that source, although unrelated to them. It makes no difference in total to the revenue whichever treatment is accorded, but if deducted in one sum, it does provide present relief to the mining concerns for the expenditure which they have already and irretrievably lost.

The Thacker Report recommends for the purpose of equity and expediency, the writing off of the abortive expenditure

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[36] Ibid.

wherever incurred, to be allowed in one sum when the search has been given up. This is a practical means of giving relief and encouragement to a productive industry at no ultimate cost to the Revenue.[37]

<u>The Development Costs.</u>-- Like the exploration costs, the development costs should be given better treatment. Now the development costs are capitalised and prorated over the life of the mine. Under this formula the companies are encouraged to postpone exploration and development. The discovery of new and additional reserves may prolong the period over which past expenditure can be amortised and thus reduce the annual deductions. If current deductions were permitted, the amount of capital which the company would have to invest would be somewhat smaller. The only danger in such a policy is that, if there suddenly were very large exploration and development expenses, government revenue might suffer a temporary reduction. If such an unusual situation seems likely, a limit could be placed on the percentage by which the net profits for tax purposes could be reduced in any one year by such deductions.

In view of the need of the mining industry for more

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[37] Tucker Committee, <u>Report on the Taxation of Trading Profits</u>, (London: His Majesty's Stationery Office, April, 1951).

capital and the fact that the taxation of mining profits in Cyprus was higher than in many other countries, the government introduced a depletion allowance law which was published on 5th. March, 1959, in Supplement No 5 of the Cyprus Gazette (No 4217).[38] The purpose of this change was to put Cyprus mining on a competitive basis with other countries. Additional investment of capital in mining had to be encouraged through some tax adjustments.

No action was taken upon the above proposals because of the approaching change of the government then. The proposed bill which came into force after the establishment of the Republic of Cyprus in 1960, provides a rather unusual formula for calculation of the depletion allowance; it is computed on a sliding scale from zero to ten per cent of the net proceeds. The net proceeds are the gross income less royalty and delivery costs such as shipping and insurance. The sliding scale is based on the ratio of profit to net proceeds whereby the higher the ratio of profitability, the lower the allowance. In no case can the depletion allowance exceed twenty per cent of the profits.

It is logical that any step taken to reduce the cost of production of the mines in Cyprus will put the country in a

[38] Cyprus Gazette, Supplement No 5, March 5, 1951.

stronger position in relation to it competitors in the world markets. This process raises certain problems. In order to lower costs, it is often necessary to increase the output through increased efficiency of labor and with the help of mechanisation. It is unfortunate that the depletion allowance instead of encouraging efficiency, penalises it by not allowing any depletion to firms having a profitability rate of 80 per cent and over. This discrimination forces the efficient companies not to put extra effort in favor of more efficient methods of production which have so much advantage for the country's competitive position in mining. The companies prefer to extract smaller output below the optimum level, because their efficiency is penalised. They carry on with their old equipment because the depletion allowance indirectly subsidises the inefficient and directly and unfairly penalises the efficient.

A final method for bringing tax arrangements to bear upon the maintenance and development of the mining industry is to provide special arrangements to attract new mining companies to Cyprus. The government might allow mining enterprises the possibility of amortising, during the first three years of mining operations, as much of their mining investment as their profits would permit. This type of inducement has been effective in the Philippines, Northern Rhodesia and other countries.[39]

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[39] Thorp Report, <u>op. cit.</u>, p. 41.

Depreciation Allowances as Incentive for Investment

After the Second World War many governments proceeded briskly to experiment with fiscal methods in order to stimulate investment. A movement toward manipulating depreciation or tax reduction to induce variations in capital formation is evident and visible in the fiscal policies of many countries. In the U.S.A. the Eisenhower Administration modified depreciation charges in 1954, and in 1962 the Kennedy Administration recommended tax credits to stimulate investment in plant and equipment; now there is a new movement in the direction of further liberalising of depreciation.

Unfortunately in Cyprus there has not been any movement in this direction. From its inception to the present day there has been a constant rise in the rates charged to the companies, and the rate of 8 1/2 shillings established in 1956 is still the same without any change either way.[40] Thacker Report's mention of the Income Tax in Cyprus as being "very static" seems to be more than justified in the light of the above facts.[41] Since independence, when Cyprus entered an era of development and expansion, the economic tool of income taxation has not

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[40] One pound sterling is divided into 20 shillings. 8 1/2 shillings are equivalent to 425 mils or 42.5 per cent of a pound.

[41] Thacker Report, op. cit., p. 7.

been used at all. Probably this might have arisen out of the belief that in a country like Cyprus income tax cannot induce any desire to expand capital formation.

The following table shows the capital formation in the island during the last decade.

TABLE 6

GROSS DOMESTIC CAPITAL FORMATION (Current Market Price)

Date	Million Pounds
1953	8.7
1954	13.4
1955	16.8
1956	19.7
1957	19.8
1958	14.5
1959	13.6
1960	12.4
1961	13.0
1962	20.5
1963	25.7
1964	16.1

Source: Cyprus, Economic Report, 1964.

The above table shows an erratic development in the capital formation of the island. There is an increase during each of the three years 1954, 1955, 1956. During 1958 the change is negligible. During 1958 there is a sharp decline which continued until 1961. There is a sudden rise in 1962 and in 1963. The volume of capital formation was at its highest ever in 1963. In 1964 again, there was a very sharp drop, nearly to the 1955 level. The fluctuations in the volume of capital investment are not related with depreciation allowances which were kept constant most of the time during the above shown period. These fluctuations are clear results of the political and communal disturbances in the island.

Business Practice in Adjusting Depreciation for Price Changes

Because of the rapid increase in the general price level, capital equipment has become more costly. The sum of the depreciation allowances upon the old equipment cannot cover the cost of the new equipment necessary to replace it when it wears out. Accordingly, it has been argued that, for tax purposes firms should be allowed to depreciate upon the basis of replacement rather than the original cost, or to adjust original cost upward by an index of changes in the general price level. The issue is debated very extensively in the accounting profession and elsewhere. But, still most countries do not allow it, and Cyprus is one of them.

Actually Cyprus is justified in not allowing the replacement cost basis, because according to the general price index there has been a very slight rise during the last decade. Although Cyprus does not have an index to measure the price changes of the capital goods, at least the retail price index may give some indication in this connection. The following table shows the retail price changes in the island between 1957 and 1965.

TABLE 7

RETAIL PRICE INDEX

Date	Index
1957	100.0
1958	105.6
1959	107.7
1960	108.6
1961	107.9
1962	108.0
1963	110.2
1964	109.8
1965	110.1

Source: Economic Research Department, Central Bank of Cyprus. Statistical Bulletin, April. 1966.

Studies made by Carry E. Brown in the U.S.A. indicate that historic cost depreciation is more desirable than replacement-cost depreciation for income tax purposes. His analysis of the effects of the two methods on the stability of economic activity points out a slight favoring of historic-cost depreciation. From the longer-run viewpoint, historic-cost depreciation in a period of inflation is likely to result in a smaller amount of capital formation than would replacement cost depreciation.[42]

Because of the small size of business units and their capital assets in Cyprus, price inflation will create a negligible effect; it will not be effective enough to influence the policies of the businessmen in a certain direction in order to escape its effects or reduce them. Secondly, Cyprus has not experienced any noticeable inflation till now; that is why no one in the island has bothered himself about its effects on the depreciation methods nor in connection with the replacement of obsolete assets. As it will be noticed from table 2, the retail price index has gone up only ten per cent in nine years which is s proof of the price stability in the island. But because prices may rise faster in the future than in the past, and because tax rates may be higher, we cannot rule out its quantitative significance. The provision in the Cyprus Income Tax Law stating that depreciation allowances can never exceed the cost of an asset automatically procludes the use of replacement-cost method of depreciation.

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[42]Carry Brown, op. cit., p. 18.

CHAPTER IV

EFFECTS OF THE INCOME TAX ON SMALL AND GROWING BUSINESSES

Introduction

The economy of Cyprus, like many underdeveloped and predominantly agricultural countries is characterised by small units of business enterprises. This type of small business firms are so predominant in the island that the author has decided to devote one chapter to the study of the effects of the Income Tax Law on the policies of these small businesses.

The term "business" has many definitions. It has been defined differently for different purposes by various authorities and persons. One writer concluded from this diversity of definitions that it is impossible to compile a reasonably compact group of generalisations to cover the manifold senses in which the term is used in the literature of the social sciences.[1] The National Tax Association of the United States defines business to include "trade, profes-

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[1] Dexter M. Keezer, "Business, Encyclopaedia of the Social Sciences, Vol. 3, pp. 80 - 81.

sion, occupation or employment".[2]

In business taxation, therefore, we may say that "business" when used to mean activities, may be understood to include manufacturing, wholesaling, retailing and other mercantile and commercial activities. The latter includes agencies and commission and brokerage businesses, public utilities, banking, insurance, professions and other occupations.

The Cyprus Income Tax Law does not define business as such, but stipulates that anyone who is engaged in a trade, profession or vocation is considered to be performing a business and is charged with tax on the profits and gains accruing to him from these occupations.[3]

In this chapter, the author has assumed small business to mean all the unincorporated businesses, namely sole proprietorships and partnerships which employ less than five workers, and which are the predominant features of the great majority of business units in Cyprus. It is not very easy to compile figures showing the number of these units because,

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[2]Bulletin, The National Tax Association, Jan., 1921, p.113.

[3]The Income Tax (Foreign persons) Law, 1961. (Nicosia: The Government Printing Office of the Republic of Cyprus, 1962).

although the partnerships are required to register and file details about their partners, the sole proprietors are not required to do so. They are formed freely and in the same way they can be dissolved without informing any authority in this respect. Therefore, in this study the author will confine himself to those small businesses which have a file in the Income Tax Office. These businesses include all kinds of trades, professions, e.g. Accountants, lawyers, engineers, doctors and all other businesses except the cooperatives which are tax exempt by law.

According to the Annual Administration Report of the Department of Inland Revenue for the year 1962, 4359 assessments were made on a business group comprising 39 different industries. Wholesale and retail trade was leading the group with 1358 units, followed by agriculture with 516 units. Transport, real estate, personal services and community services comprised the third important group.[4]

Business Environment in Cyprus

Manufacturing.-- According to the industrial census conducted in 1960, out of 12,375 establishments in the island

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[4] Annual Administration Report, 1962, Department of Inland Revenue, (Nicosia: The Printing Office of the Republic of Cyprus, 1964), p. 18.

11.409 or the 92 per cent were business units employing less than five persons which is considered to be a small unit for the purpose of the census. The author has not been able to find more up to date data in this respect, but feels that there has not been any significant change since 1960 census. The following table gives the distribution of business units according to industries:

TABLE 8

DISTRIBUTION OF BUSINESS UNITS ACCORDING TO INDUSTRIES

Name of Industries	Employing less than 5 workers	Employing more than 5 workers	
	Small	Big	Total
Mining	313	51	364
Manufacturing and Trade	11,090	910	12,000
Electric, Gas, Water	6	6	12
	11,409	967	12,376

Source: Census of Industrial Production (Nicosia: Statistics and Research Department, Government Printing Office, 1963).

In fact manufacturing in Cyprus is essentially a very small-scale activity. It is largely confined to processing the raw materials produced in the island or supplying consumer goods which do not necessitate the employment of much capital in their production.

Most of the proprietors of these small businesses possess some technical skills necessary for their businesses, but usually have very little knowledge of the rudiments of business management, particularly with respect to keeping proper accounts, cost records, budgeting and the like.

Agriculture.-- In spite of the importance of agriculture for the economy of Cyprus as the producing and employing industry, it is carried on by traditional and backward methods, and in small uneconomic units. There are an estimated number of 65.000 agricultural holdings; possibly this number is increasing. Average holding is 60 donums per family.[5] The holdings are composed of small strips scattered at long distances from each other.[6] Most of these units are not suitable for mechanised agriculture because of their smallness and location.

According to the Thorp Report, capital formation in agriculture is low as compared with other sectors. In 1959,

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[5]One donum is equal to 1000 square meters.

[6]D. Christodoulou, "Contributions Towards a Development Plan for Cyprus Agriculture", Department of Agriculture, (Nicosia: May, 1960), p. 3.

there were 3038 licenced tractors in the island. These figures are exceedingly low considering the importance of agriculture for the country. It is estimated that capital formation represents only about a 0.3 per cent per annum addition to capital already invested (other than land).[7] This is a very slow rate of capital formation and indicates why productivity and efficiency are low in Cyprus. If agriculture is to have the benefit of increased productivity deriving from increased investment, it probably must provide capital largely from its earnings. Because agricultural incomes have been so low without a change, there has been little opportunity for capital accumulation from that source. Not many farmers or others connected with the agricultural sector have surpluses for plowing back into their enterprises. Agricultural investment is not generally attractive to non-farming groups, and the farmers themselves do not have the necessary savings for investment.[8]

Cooperatives.-- Cyprus is one of the countries where the cooperative form of business has been very successful. It is an exception not to find at least a cooperative grocery shop even at the smallest and the remotest villages in the island. Bigger villages have their cooperative saving banks. The

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[7] William L. Thorp, Cyprus, Suggestions for a Development Program (New York: United Nations Publications, 1961), p. 22.

[8] Ibid., p. 23.

cooperatives are tax exempt according to the Cyprus Income Tax Law. They constitute competition for the private enterprise in the island.

It is generally argued that preferential tax treatment has resulted in the rapid growth of the cooperatives, and that it represents a threat to a country's economy and to the stability of the private enterprise. Glarence L. Turner argues that by piling up tax free accumulated earnings in added capital and reserves, cooperatives are growing ten times faster in the United States than the tax paying small businesses which are beginning to feel the pinch of a competitive disadvantage.[9] His remarks show that the tax exemption of the cooperatives is considered to be a big advantage for the cooperatives and a disadvantage to the free enterprise.

In Cyprus too, the competition of the cooperatives with the small businesses has been very grave and resulted in their bankruptcy in big numbers. But, in spite of their tax exemption, which is a sheer discrimination against other forms of business enterprises, big cooperatives have been less successful as compared with the small ones, becauseof the inefficiency

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[9]Clarence L. Turner, "Damaging Competition from Farm Cooperatives, Taxation and Business Concentration, Tax Institute Symposium, June 15-16, 1950 (New York: Tax Institute, 1952), p. 84.

of their management. The managers of the cooperatives are elected by democratic procedure of voting, where efficiency and management ability have less weight than other considerations. Moreover, the lack of profit motive which is accepted to be the guiding principle in private enterprise, is missing in the cooperatives which has been one of the contributing factors to their failure.

A close study of the cooperative movement in the island reveals that, although the small cooperatives have been very successful, the big ones proved to be a failure. Among the failing big cooperatives in the island, the most notable ones are the Paphos Wine Cooperative Society and the Cooperative Diary Factory in Larnaca. While the Cooperative Diary Factory of Larnaca failed, the Bittas Diary Factory in Nicosia is prospering and expanding rapidly. Therefore, one can safely conclude from the above information that in Cyprus, while the small cooperatives have been very successful, the big ones have been less successful because of the inefficiency of the management running those big cooperatives. So, one can say that tax exemption by itself, though very helpful, has not been the sole factor contributing to the success of small cooperatives, because, if the tax exemption was the only and the most important factor there would have been no failures among the cooperatives.

At present there is a resentment among the proprietors of the small businesses against the unjustified tax advantage extended to the cooperatives. In some areas they are forcing taxpaying firms out of business. The tax paying enterprises are penalised by being made to subsidise, through the taxes they pay, the tax exempt existence of the cooperatives that are operating in direct competition with them.[10]

Turner argues that unless the loopholes in the tax systems are closed and the tax laws are revised to conform to the actualities of our time, rather than the outworn theories of the 19th Century, the cooperative way of doing business will continue in the ascendancy and private business enterprises will correspondingly decline.[11] Present trends are indicative to the direction that, sooner or later cooperatives should be taxed. This will reduce the unfair discrimination against other private businesses, and also will not encourage and subsidise a form of business which is generally less efficient than the non-cooperative form of business.

Tax Exempt Institutions in Cyprus

The income tax capacity of the Cyprus Government is

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[10] *Ibid.*

[11] *Ibid.*, p. 111

greatly reduced by the exemption of the Turkish Evcaf, Greek Archbishopric and the cooperatives from income taxation. It would not be an exaggeration to state that income tax revenues in Cyprus have not realised their potential as much from income-exemption, as from avenues of escape built in the law or in the faulty and inefficient administration of the Income Tax Law.

Richard Bird and Oliver Oldman claim that income tax is a poor instrument of taxation for agricultural producers and shopkeepers who account for a large share of total income in many low income countries.[12] Cyprus, being a predominantly agricultural country and having small units of business firms, fits in the above explained category of countries. The percentage of population who pays income tax shown in the following table strengthens the arguments of the above authorities.

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[12] Richard Bird and Oliver Oldman, Readings on Taxation in Developing Countries (Baltimore: The John Hopkins Press, 1964), p. 43.

TABLE 9

PERCENTAGE OF THE POPULATION PAYING INCOME TAX

Country	Per cent of the population paying income tax
U.S.A.	25.0
Jamaica	2.1
Trinidad	1.8
British Guiana	1.4
Ceylon	0.6
Pakistan	0.26
Cyprus	3.3

Source : Richard Bird and Oliver Oldman, Readings on Taxation in Developing Countries (Baltimore : The John Hopkins Press, 1966), p.77.

The Turkish Evcaf and the Greek Archbishopric are two religious institutions owning land and other immovable properties all over the island. It is difficult to obtain correct information as to the value or the area of their landholdings. The unofficial estimates indicate that their land holdings exceed several millions of sterling, and they are considered to be the richest single units in the island. These institutions are not managed very efficiently. Their land is rented out by auction usually at very low prices, because of lack of attendance at these auctions as a result of people's ignorance of their dates.

These two institution are exempted from income tax. Their exemption dates back to the period of Turkish rule in the island. In fact they have a great ability to pay taxes, which could be utilised for the development and general welfare of the people of Cyprus.

The elimination of the above institutions from the tax base, coupled with the inefficient tax administration in the island, has reduced the tax collection capacity of the government. It is also generally accepted that tax exemption has not made any positive effects on these institutions; on the contrary subjecting them to tax may encourage them to be more efficient. Therefore, if the government can utilise the revenue to be collected, it would be more advisable to tax these institutions and use this revenue for the benefit of the whole island. This action of the government can be more than justified when one takes into consideration the dubious ways in which the revenues of these institutions are currently spent in the island. This move may encounter strong opposition from the vested interests, but a country led by a religious leader can easily overcome such opposition.

Effects of the Income Tax on the Formation of New Enterprises

Importance of the Problem

The continued formation and growth of small and independent enterprises is generally recognised to be essential to the continued preservation of political stability and personal freedom.[13]

According to Bird and Oldman a widespread formation of new firms and a rapid growth of the existing firms are essential for the achievement of a high level of employment and national income under a private enterprise system. Expansion in the economy must be undertaken in order to absorb the labor and capital released by declining industries and businesses.[14] If this expansion does not take place in a private enterprise economy like Cyprus economy, the only available alternative will be the extension of the activities of the government. If the government does not fill the vacuum produced by the private enterprise, vast unemployment is inevitable. The existence of mass unemployment is not compatible with the ideals of any private enterprise system, therefore, the government has to use all the available means of encouragement for the establish-

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[13] _Ibid._, p. 15.

[14] _Ibid._, p. 16.

ment of new firms to vitalise the economy of the country.

It is therefore, of great importance to determine the effects of income taxation on the formation and growth of small independent business enterprises. Thus, the author is devoting this chapter to ascertain the effects of income tax on the formation and growth of new enterprises in Cyprus.

With few exceptions, Cyprus economy is characterised by a large number of small units of business. The majority of these small firms have a capital not exceeding £ 5000. They usually start with much less and generally this amount is provided by their savings or through borrowing from friends, relatives and sometimes from banks. Most of these businessmen have no knowledge about business principles, and in most cases they do not have any education above high school level.

When one takes into consideration the above state of business and businessmen in the island one should not be surprised by the fact that Cyprus Income Tax Law has so little or even no influence on the formation of new enterprises. The fact that the Income Tax Law was in English until August 1960, was another reason why people were unaware of its provisions relating to their business. Although after independence the law was published both in Greek and Turkish, it is usually expressed in a very technical and complicated terminology which is beyond the ability of any layman to understand.

Even if the founders of small independent enterprises are aware of the provisions of the Income Tax Law they seldom give detailed consideration to taxes in deciding whether or not to undertake their ventures. This conclusion holds good almost without exception for the large number of small businessmen interviewed by the author in Turkey, and from Cyprus.

The conclusion arrived at by K. Butters in the United States about the behaviour of the promoters of new enterprises tend to support the conclusion arrived by the author.[15] According to K. Butters promoters of new businesses usually have an idea in which they are intensely interested and a fixed determination to develop that idea. They want to be their own bosses and will start their own businesses even though their opportunity for profit, objectively considered are not good. Given these attitudes, it is no wonder that they seldom give careful thought to income tax.[16]

Although the income tax has no effect on the formation of new small businesses by unsophisticated businessmen, yet for

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[15] J. Keith Butters, Effects of Federal Taxes on Growing Enterprises (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1945), p. 14.

[16] Ibid.

the formation of relatively bigger enterprises by somewhat sophisticated promoters it has some indirect effects. For this kind of businessmen taxes may have two kinds of effects:

1 - They may dull the incentive needed to induce promoters and enterpreneurs to undertake to form or develop new businesses;

2 - They may curtail the supply of capital required to finance the formation of a new enterprise or the expansion of an existing enterprise. Both adequate incentives and an adequate supply of capital are essential to a successful business formation and development .

As for the very small businesses the income tax may not have any effect as far as their formation is concerned, but, once they are formed and developed to a certain stage, however, the high individual income tax rates begin to affect the development of these businesses beyond a certain level.

The most important and frequent effect of personal income taxes, though indirect, on the formation and early progress of new enterprises is that income taxes restrict the amount of personal funds available to the prospective organization of new enterprises.

Questionnaires filled by the Cypriot businessmen revealed that income tax did not have any effect on the formation of the businesses of the 70 per cent of the respondents. The remaining 30 per cent who answered that income tax affected the formation of their businesses were respondents who were the managers of big businesses which are not included in the classification of small business as defined for the purpose of this chapter.

From the above information one can conclude the following:

1 - Income tax considerations seldom dominate the decisions of the small enterpreneurs in the formation of their businesses in Cyprus. When one takes into consideration the conclusion reached by K. Butlers in the United States that income tax considerations seldom dominate decisions to organize independent enterprises, one can safely conclude that this tends to be a universal tendency applicable both in developing and developed countries of the world.[17]

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[17] <u>Ibid</u>.

2 - Generally income tax is given little conscious consideration by the individuals actually responsible for the establishment of new and small enterprises in Cyprus. This is so because, first they are mostly ignorant about the Income Tax Law and, secondly, they know that it is easy to evade it.

Effects of the Income Tax on the Methods of Financing

Although income tax does not appear to have a significant effect on the desire of individuals to start enterprises , they may have a pronounced effect on their ability to do so. In their early stages new businesses frequently have to depend primarily on the personal resources of the individuals directly interested in the enterprise. High personal income taxes, by curtailing the funds available to these individuals, may effectively prevent the organisation of some important new businesses and delay the progress of others.[18] Since one of the major elements of risk for a small firm is the danger of being caught short of capital and thus of having to abandon a project on the verge of succes, high taxes drastically reduce the prospects of a success to a small firm.

Until a business reaches a point where it gives real indications of being profitable, outside capital is likely to have

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[18] Ibid., p. 16.

little interest in it. Moreover, the promoter of a new venture is usually uninterested in sharing his undertaking with outside capital in its very early stages.

Financing Through Retained Earnings.-- The basic financial need of small business is the ability to expand from retained earnings. It seems imperative that income tax structure permit small firms to grow from retained earnings until they become large enough to have reasonable access to capital markets.

For a variety of reasons, the expansion of small businesses may be dependent on the availability of funds from retained earnings. The more important reasons are:

1 - Businesses with outstanding prospects for growth are likely to attach very much importance to control and ownership considerations. In the same way they will hesitate to share bright prospects with outsiders. Where both of these motivations are strong, a slow rate of growth financed through retained earnings may be preferred to a more rapid expansion with aid of outside capital.

2 - Many small firms encounter great difficulty in raising outside capital.

Family owned businesses unwilling to surrender control ordinarily has to rely on retained earnings as a source of funds for expansion since outside investors are usually reluctant to furnish capital in exchange for only a small interest in such a business.[19]

3 - The technicalities in borrowing constitute a serious impediment to small businesses.

After considering the above difficulties usually met by small businesses in obtaining outside capital for their expansion programs, retained earnings clearly must be regarded as the only available source of capital with which to finance their new projects.

The question "where do you get the capital needed for expanding your business?" received the following answers from the respondent Cypriot businessmen: 40 per cent of them indicated that they obtain the needed capital for expansion from their retained earnings. When one takes into consideration the inadequacy of the earnings of small businesses, it seems very logical that they should resort to borrowing if they can manage to do so.

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[19]*Ibid*., p. 57.

The high rate of income tax in Cyprus reduces the chances of small businesses to retain enough earnings to plowback for their development. In an underdeveloped country like Cyprus very high rates of tax reaching to 85 per cent after L 10,000 of taxable income seems to be prohibitive for small businesses. This situation blocks the only way of finance available for small business under favorable conditions. In certain cases they may be able to borrow but this puts them into a very delicate position because of the disadvantageous conditions under which they have to borrow.

Financing from outside sources.-- Firms which do not have enough retained earnings to plow back into their business for expansion, have the alternative source of finance which is borrowing from outsiders, if they can manage to do so. The principal source of these outside credits are the commercial banks and other financial intermediaries. Sometimes government or semi-government institutions help the small business financially. In many instances small businesses unable to satisfy the requirements of the commercial banks, have to resort to loan sharks and obtain the necessary credit at a very high rate of interest. This situation puts the small businesses into a very difficult position and usually increases the bankruptcies among them.

In Cyprus too, the expansion of many small businesses is restricted by the shortage of credit extended to business firms. The importance of being able to borrow from the banks easily, and under favorable terms can be easily seen from the example of three firms which are known to the author. These firms experienced unprecedented growth and prosperity because of the ease with which they could borrow from a certain bank as a result of their close connection and family relationship with the manager of this bank.[20]

Sixty per cent of the respondent Cypriot businessmen replied that they obtain their capital requirements from the banks in the form of loans. Another reason, other than the inadequacy of retained earnings which led them to borrow is the provision of the Cypriot Income Tax Law which allows interest payments as deductible expenses in ascertaining their chargeable income.

The author has encountered many taxpayers, who preferred borrowing at 9 per cent per annum while they had their own funds deposited with banks abroad at 4 per cent. This was an attempt to mislead the Income Tax Office, because they could easily

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[20]The names of the Businessmen and the Manager of the bank cannot be disclosed.

conceal their bank deposits, while declaring their debt and interest payments so that they could be allowed relief for the interest payments. Another purpose was to try to prove that their business was losing money and they were heavily indebted to the banks.

Trade Credit.-- The third method of financing, especially short-term is done by trade credit allowed to them by others and usually by bigger firms which supply them with goods. Small firms on the average depend much more on trade credit than do large firms, probably because of their lower average credit ratings. Moreover, small firms have placed increasing reliance on trade credit in recent years.

The effect of the income tax law on the borrowing of small businesses in the form of trade credit is negligible. The only persuasion is that small businesses prefer to show debts in their books and accounts as an indication for the defence of their eternal claim that their business is not making any profit.

Effects of the Income Tax on Management Incentives

According to Keith Butters, the management of small businesses have to choose between the following two alternatives in deciding whether or not to attempt a new projects:

1 - An expansion which offers high potential profits, prestige and future growth, but presents grave risks, or

2 - Keep small and be contended with moderate success.[21]

If a business is organised as a sole proprietorship, the personal income tax greatly reduces the incentive of its managers to undertake major expansions: The highly progressive nature of the personal income tax in Cyprus strikes with full force at the profits resulting from a partnership expansion, but if the expansion is unsuccessful and results in business failure, the partners' personal assets as well as their business assets, and perhaps also their jobs will be in jeopardy.[22]

The highly progressive nature of the personal income tax rates in Cyprus makes it exceedingly difficult for a partnership to earn a large return, after the deduction of the partners income taxes unless the partnership is divided among a large number of partners.

Given the above conditions, under most circumstances the partnership or sole proprietorship forms of businesses do not appear very attractive, because any failure will send them out

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[21] J.K. Butters, op. cit., p. 27.

[22] Ibid., p. 39.

of business, out of job and out of their personal properties. On the other hand if they are successful businesses with good prospects of growth and in need of capital, corporate form of business seems to be more attractive and advantageous under the present high rates of personal income tax.[23]

Tax Evasion by Small Businesses

General Survey

It has already been mentioned in the previous chapters that most of the small businesses do not keep proper books of accounts. When this is the case, the Income Tax Office cannot get reliable data about the profits of a firm. The only alternative open to the Income Tax Office is the capital investigation method which is very widely used. Under this method the capital of a business is ascertained by the crude and simple method of deducting its liabilities from its assets. The increment in its capital between the two dates is divided by the number of years between these dates, and after allowing for certain adjustments the ascertained amount is assumed to be its annual income on which it is required to pay income tax.

A simple example will help to clarify this method: Let us assume that tax payer "X" had capital amounting to Ƀ 5000

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[23] Ibid., p. 40.

on December 31, 1962. The next capital investigation is made on say, June 30, 1965 and his capital is found to be Ƀ 7500. Therefore, his capital has increased by Ƀ 2500 in two and a half years, which means that he had an increase of capital of Ƀ 1000 each year. The maintenance expenses of the family of "X" depending on its size is added to the annual income. An average of Ƀ 400 is considered to be normal for a family of five . Therefore, the taxable income of "X" is ascertained to be Ƀ 1400 each year for the years of assessment 1963 and 1964. After deducting the allowances for his children and wife the remaining balance will be the chargeable income subject to the graduated rate of tax depending on the income bracket in which it will fall.

It can be easily concluded that this is not a very scientific method of assessment of tax liability. But, under the prevailing circumstances it seems to be the best and the only practical method to be used. Naturally, it is expected that there will be a lot of tax avoidance by the businessmen. The income tax officials are aware of the fact that the businessmen are able to escape with considerable understatement of income and overstatement of business expenses. A test audit by Internal Revenue has shown that 70 per cent of the misstatements of tax liability arise from underreporting of receipts. Deductions of essentially personal expenditures as business expenses is a major source of evasion. Other persons often succeed in failing to report miscellaneous casual income from irregular sources.

Treatment of essentially personal expenses as business deductions for deliberate tax avoidance or evasion is done by the small businessmen. Without doubt this is one of the most important sources of escape from tax and inequity in the income tax structure. This is a problem of particular importance because this escape route is available only to persons gaining income from sources other than wages and salaries. Farmers, professional people and small businessmen are in the best position to escape taxes by these means. A doctor or a farmer deducts all of his car operating expenses instead of only those attributable to his business activity. Expenses of vacation travel are deducted as cost of travel necessary for business, as are those of entertainment. By contrast, the average worker, dependent upon wages or salary, has no possibility open to him of comparable deductions.

According to the United Nations' Report on the world social situations in 1963,

> "Fiscal practices have favored two categories of influential income recipients, the one is the landlords: Income derived from the land has been subject to low rates or has been exempted totally in Iraq, Jordan, Syria and Turkey. The other privilaged category has consisted of self-employed persons in commercial and service occupations,

in so far as administrative procedures have not been adequate to prevent tax evasion; in one country , non-reporting of income has been estimated at 75 per cent in private business and 90 per cent in liberal professions." [24]

In Cyprus the farmers are not exempt from taxation, but because of their scattered nature all over the country and the difficulty in tracing them they can easily avoid income tax payment. The self-employed persons in commercial and service occupations are in the same privilaged position as it is mentioned in the above U.N. Report. The inadequacy of the administrative staff in the income tax office gives them a better chance for evasion. Although the power of the assessors in Cyprus is unlimited, they do not perform their duties efficiently, and indirectly help evasion. It seems that it is a general phenomenon that fixed income people suffer from income tax while the businessmen, professional and other self-employed persons who are usually in a better position to pay tax evade and avoid it. The degree of discrimination varies from country/to country and usually has a positive correlation with the inefficiency of the income tax administration in a particular country.

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[24] 1963 Report on the World Social Situations, Department of Economics and Social Affairs, United Nations, New York, 1963.

Small Business Methods for Tax Avoidance

Formation of Partnerships.-- One of the most commonly used method of income tax avoidance in Cyprus is the formation of partnerships instead of a single proprietorship. Usually these partnerships are composed of the children and the wife of the owner of the business. The children who are shown as partners do not put in any effort or take part in the management of the business. They only share the profit which actually goes to the pocket of their father. In this way large profits of the partnership are split into several smaller shares and divided among the children. Naturally, smaller individual incomes resulting from the above operation falls to lower income brackets and become subject to lower tax rates, than otherwise they would have been had it not been split in the above explained manner.

The income tax authorities in Cyprus have come to realise that the division of property or income among the members of a family through the channel of a partnership is a means of tax avoidance. The Income Tax Law actually has a provision which stipulates that, "Where the commissioner is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious.... he may disregard any such transaction... and the person concerned shall be assessible accordingly."[25]

The two important criteria used by the income tax authorities in deciding whether a certain partnership is genuine or not are:

1 - Whether the children who are shown as partners in the partnership do actually take part in the management of the partnership;

2 - Whether they are over the age of eighteen.

Manipulation of the year-end Inventory.-- The most common item which is manipulated by the small businesses for tax evasion is the year-end inventory. This is the key item which they use to lower the income of the year of assesment under consideration. The author, in his capacity as an income tax assessor, encountered many cases whereby the businessmen argued and swore that their inventory was worth £ 2000, while it was actually many times larger than that. Unfortunately, this is the case in Cyprus, and the inventory figure declared to the income tax assessor when he conducts a capital investigation once in every three or five years is highly underestimated.

Although, in nearly every case the assessing officer

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[25]Income Tax (Foreign Persons) Law, 1961.

is aware of the evident evasion, he would not dream of going to the shop of the taxpayer to check his inventory. This is a very inefficient practice going on in the Cyprus Income Tax Office, and one can easily conclude that this is more than inefficiency, and can be considered as some sort of help given to the taxpayer for tax evasion and avoidance.

Capital gains.-- According to the Cyprus Income Tax Law capital gains are not taxable. But in the administration of the law this exclusion of capital gains from tax has been held to windfall gains from single and unrelated transactions, but not otherwise. The exclusion of capital gains is considered to be the most important deficiency in the Cypriot Income Tax Law which has created a lot of agitation in the press for its correction.

The effect of this exclusion has given incentive and channelled the savings of many small businesses and people into the trade of land or building plots. The purchase of these plots is not done for the purpose of erecting houses, but is a sort of speculation in land. This seems to be the most profitable outlet for the savings of people in all walks of life. The investors in land could gain from capital appreciation or from the trade of land as long as they do it in such a scale that they are not considered to be a trader in land who earns his living in this trade.

The incentive given to this activity through the favoring of the income tax law has created inflation in the value of land, especially for the building plots. This has created chain effects in the form of higher rents and higher cost of house buildings.

In other countries where capital gains are subjected to tax, but at a lower rate than the personal income or corporation tax, the effect of the lower capital tax rates has been to form corporations especially closely held corporations by a few people in the high income bracket. These people accumulated the earnings of these corporations which was reflected in higher prices of their stock. Then, they could realise capital gains by selling these stocks and pay lower rates of tax, then they would otherwise have done if they had their income in the normal form.

In Cyprus this is not so, because capital gains are not taxable in the hands of those who are not engaged in business of such a nature. In other words, a doctor or a small businessman may buy and sell two building lots in one year and realise a profit of say £ 500, which will not be taxed, whereas an estate agency which buys and sells land or houses as a part of its profession will be subject to tax on its earnings from doing so. Therefore, the criterion is whether the capital gain is a part of one's normal business earnings or is it a casual earning realised once in a while. Therefore, unless the law is corrected to include all kinds of capital gains no matter how they are realised, a lot of tax avoidance will go on and the savings of many people will be channeled in this unproductive speculation which is only a transfer of property without any addition of real value.

Formation of fictitious Companies.-- The Cyprus Income Tax Law does not encourage the formation of companies. The tax on company profits is a flat rate of 42.5 per cent, and is witheld from the dividends paid. Although this rate is much lower than the rate paid by many taxpayers beyond a certain level of income, due to the fact that the dividend recipients are required to include their gross dividends in their taxable income and pay a personal tax on it, the advantages of the companies over the sole proprietorships and partnerships are lost. But some clever businessmen have found ways of avoiding tax through creating new fictitious companies which continuously showed a loss. The purpose was to set-off the loss against the high profits derived by these businessmen from their more prosperous companies. This encouragement to the businessmen is given by the provision of the Cyprus Income Tax Law which considers losses as allowable deductions until they are fully set-off against the profits.

Effects of the Income Tax on the Accounting Policies of Small Businesses

It has already been mentioned that most of the small businessmen have no knowledge of business principles and in most cases they do not have any education above high school level. On the other hand, there is no specific provision in the Income Tax Law requiring the businessmen to keep proper books of accounts and submit audited accounts to the income tax office. Therefore, it is not surprising to find out that only a very negligible number of businessmen keep some kind of books, usually consisting of a cash book and an accounts receivable book.

The most important effect of the Income Tax Law on the business accounting policy results from the provision of the law requiring the accounts submitted to the Income Tax Office to be certified by a practising accountant, if a businessmen decides to submit accounts he has to keep proper books which could be acceptable and could form a basis for preparing a reliable financial statement. But, those actually keeping proper books are very few indeed.

Actually the practise of the income tax assessors not to allow any depreciation unless proper books are kept and audited accounts have been submitted has had more effect on the small businessmen in forcing them to keep proper books of accounts than any other provision of the Income Tax Law.

The chaotic state of accounts kept by the businessmen promted the Income Tax Office to include a provision in the law requiring every businessman to keep proper books signed and stamped by the commissioner. Although this provision was included in 1961, still it has not been implemented and has not affected the accounting policies of the businessmen.[26]

Conclusion

The characterisation of the Cyprus economy by small units of business and the classification of the island as an underdeveloped country leads to certain conclusions in respect of the effects of income tax on business policies. The conclusions are different from those prevailing in advanced countries which are characterised by big business units and sophisticated businessmen.

1 - The small businessmen in Cyprus are not aware of the various provisions of the Income Tax Law

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[26] Income Tax (Foreign persons) Law, 1961. p. 30.

which can be advantageous or harmful to their businesses.

2- Even if the businessmen are aware of these provisions the inefficiency of the tax administration, and the laxity in the implementation of certain provisions of the law makes it an ineffective economic tool in the hands of the government.

3- Income Tax Law is complicated and vague in meaning so that small businessmen cannot understand it and have to consult a number of tax advisors before each business decision if they ever feel to do so.

All these statements about the problems and needs of small business enterprises in Cyprus results from a careful, but narrow investigation. However, they have to be tested in a general survey based on a more detailed questionnaires sent to a larger sample than is done in this study.

In an underdeveloped country like Cyprus, so sadly lacking in capital for the proper utilisation of its natural resources, and where most of the investment is done by the private sector, income tax rates in excess of 50 per cent seems to have a discouraging effect on investment, and therefore, cannot be justified. This rate is at present reached on the chargeable income bracket so low as £ 2500 to £ 3000. In harmony with the Thacker Report the author thinks that income tax rate of 85 percent on every pound above an income of £ 10,000 in an island like Cyprus is confiscatory.[27]

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[27] Charles W. Thacker, Income Tax in Cyprus (Nicosia: Cyprus Federation of Trade and Industry, 1954), p. 79.

CHAPTER V

EFFECT OF THE INCOME TAX ON THE POLICIES OF LARGE BUSINESS FIRMS

Introduction

It has already been mentioned in chapter I, that the Cyprus economy is characterised by small business units. Although large units of business are very few in the island, because of their important contribution to the GNP, and above all to the government revenue, they cannot be neglected. Another important reason necessitating the study of large business units is the prevailing tendency in the island for establishing big firms which are essential for the development of the economy of the island.

According to the Annual Administration Report published by the Department of Inland Revenue in 1962, there were 328 companies which made an income tax return to the Income Tax Office. In the year of assessment 1963, out of these companies 166 were tax exempt because they did not make any profit, and the remaining 162 were assessed to pay 5 million and six hundred and three thousand Cypriot pounds. The amount of tax payable on this assessed company income was two millions three hundred and seventeen thousand pounds. This amount constituted the 78 per cent of the total income tax revenue of the government. The contributions of small businesses and the individual employees were 8 and 14 per cent respectively.[1]

Statistics show that 1.8 per cent of the taxpaying units paid the 78 per cent of the total tax revenue of the government in the form of company income tax, while 23 per cent of the taxpayers which are the small business firms contributed only 8 per cent of the government's income tax revenue.[2]

In Cyprus, most of the companies are closely controlled family enterprises, converted into the company form of business for certain advantages, such as limited liability and permanence pertaining to this form of business.

The public companies which are widespread in England, United States and in other developed countries are very rare in Cyprus. Their numbers do not exceed ten in all.

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[1] Annual Administration Report, 1962 (Nicosia: Ministry of Finance, 1963), p. 17.

[2] Ibid.

General Survey of the Cyprus Company Taxation

Since this chapter will be devoted for companies, it is essential and appropriate to say something about the Cyprus company tax, analyse its effects on business policies of the companies, and compare it with the company laws applicable in certain other countries.

Cyprus Income Tax Law being a simplified version of the British Income Tax Law, followed and is still following the British method of company taxation. According to the prevailing Cyprus Income Tax Law as far as dividend payments are concerned, the portion of the income tax applying to companies is treated simply as a witholding levy, comparable to the witholding collections of personal income tax on wages and salaries. When the stockholder declares his income, he includes the gross dividends received in it. The income tax office after calculating the taxpayer's income tax liability, sets-off the tax witheld from his dividends by the company, against the tax payable. On the other hand, if his tax liability is less than the tax witheld, the excess is refunded to the taxpayer. This method is an integration of the personal tax with the company tax.

It can easily be deduced from the above information that in Cyprus there is no company tax similar to the American

Corporation Tax. In Cyprus only the dividend recipients, that is the individual stockholders are taxed, whereas in the States the companies pay corporation tax in addition to the tax paid by the individuals on the dividends they receive. In a sense the American system of corporation tax amounts to double taxation of the same income both in the hands of the company and in the hands of the dividend recipient stockholders.

In spite of the fact that it results in double taxation there are certain arguments in favor of the treatment of companies as separate and distinct entities for income tax purposes. Those who believe in this treatment put forward the following arguments:

1 - Companies by their own very character, are distinct from their owners, and have an identity of their own.

2 - The earnings of a company do not directly accrue to the stockholders and they may be retained by the company contrary to the wishes of particular individual stockholders.

3 - The government can collect more revenue through the means of company tax; otherwise it might resort to more harmful methods of tax collections with worse effects than the company tax.[3]

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[3]John F. Due, Government Finance (Homewood, Illinois: Richard D. Irwin, Inc., 1959), p. 221.

In addition to the above the eligibility of the company tax as an economic tool in the hands of the government to be manipulated in order to create the desired effects on the economy is an important point in favor of the corporation tax. The fact that the majority of the countries of the world employ company taxation implies that these countries are well aware of the above advantages of this form of tax.

The Cyprus Income Tax Law takes exactly the opposite view, and does not consider the company to have a separate identity of its own distinct from its owners. But, it is expected that in pursuance with the trend of considering the company to be a separate identity Cyprus may shift to this form of more widely accepted method of taxation.

Relative Attractiveness of Different Forms of Business from Tax Standpoint

The relative attractiveness taxwise of companies, partnerships or individual proprietorships depends on the size and regularity of income of the company, the size of the other incomes of the owners, and the extent to which the business income is to be retained in the company.

Since the company tax is exacted only from companies, it may encourage firms to change their legal form in order to escape the income taxation applicable to this form of business.

Thus the subjection of companies to company tax may lead firms away from forming companies to establishing single proprietorship or partnership in preference to companies.

Thinking of the importance of companies in the economy of a country , it will be advisable to pass tax laws encouraging the formation of companies. The huge capital required to establish big factories or other enterprises can only be achieved by the subscription of capital by manyinvestors. This necessity is still much greater in developing countries. Therefore, it can be easily concluded that even if a company tax is established it should preserve low rates and try to make companies more attractive forms of business than the partnerships and sole proprietorship.[4]

The inexistence of a separate company tax is inducive to the formation of companies in preference to other forms of business. The scarcity of companies in the island is the result of other reasons not connected with income taxation.

Effects of the Income Tax on Companies' Financial Policies

It has been already mentioned that the majority of the companies in Cyprus are closely controlled. So, the

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[4]Kenan Bulutoglu, Vergi Politikasi (Tax policy) (Istanbul: Sermet Matbaasi, 1962), p. 200.

author has decided to study the effects of company tax on the policies of the closely held companies separately.

The owners of the closely controlled companies regard their company interests in a highly personal sense. The company assets are personal assets one step removed. The analysis of the effects of the income tax on the financial policies of the closely controlled companies thus depends to a very considerable extent on various aspects of individual taxation and the degree of progression in the income taxation.[5]

According to the prevailing income tax law in a country, different firms will resort to different methods of finance which will be more advantageous for their businesses from taxation point of view. According to prof. Philip E. Taylor, not only may the company tax affect the volume of investment but it also may alter the method of financing.[6] The tax gives some incentive toward greater reliance upon borrowing and less reliance upon sale of stock. Since interest is deductible the tax does not increase the difficulty or cost of financing from this source.

In other ways, as well, the tax may influence the general corporate structure. A combination of high rates

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[5] Dan Throop Smith, Effects of Taxation on Corporate Financial Policy, (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1952), p. 11.

[6] Philip E. Taylor, The Economics of Public Finance (New York: The MacMillan Company, 1961), p. 401.

plus the favorable treatment of capital gains may be a factor which increases mergers.

Debt Financing:

Probably the most widely recognised effect of income tax on company financial policy is the encouragement it gives to debt financing. This encouragement is due to the fact that interest payments are deductible expenses for taxation purposes. Debt is not regarded as permanent and does not represent a shift to a new pattern of capital structure. The debt financing is usually regarded as a temporary expedient to secure funds for a specific and urgent requirement.[7] For many companies the indebtedness, regardless of its cost, will not be a continuing item in their capital structures.

The differential tax treatment of interest and the common stock dividends encourages more widespread use of debt financing in preference to common stock financing.

A survey conducted in 1956 by the Association of Cyprus Industries among 22 firms employing more than 10 workers indicated that, 16 of them had been unable to finance a desirable extension project through self-finance. Only one out of 16 firms found easy finance from the banking

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[7] Smith, op. cit., p. 38.

system, 7 obtained funds with great difficulty and were charged a very high rate of interest, and eight of them had to abondon their plans.[8]

The information received through the questionnaires sent by the author and responded by the Cypriot businessmen indicate that 66 per cent of them obtained the necessary finance needed for their projects and expansion by borrowing from the commercial banks, 30 per cent used their retained earnings and only 4 per cent of them issued new stock in order to raise the needed funds.

Many business tax advisors recommend that a new, and closely held company should be started off in life as poor as possible. This means that a company should start with a minimum of common stock and a maximum of senior securities, preferably debt obligations. Such a capital structure tends to be advantageous from the standpoint of both the personal and the company income taxation, because the interest payment is a deductible expense for tax purposes, while the dividend payment is taxed both in the hands of the company and in the hands of the dividend recipients.[9]

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[8] William L. Thorp, Cyprus, Suggestions for a Development Program (New York: United Nations Publications, 1961), p. 77.

[9] Smith, op. cit., p. 255.

In an underdeveloped country like Cyprus, so sadly lacking in capital for the proper utilisation of its resources, the excessive company tax absorbs a large proportion of profits, and inevitably restricts the accumulation of adequate liquid recources. This situation forces the companies to have continued resort to borrowed money. This dependence on borrowed money hits the businessmen very hardly, because the interest rates are very high as a result of the scarcity, and of the great demand for loanable funds. This has been a long and unfortunate feature of the Cyprus economy.[10]

Common Stock Financing

The stockholders of a closely controlled company are more conscious of the importance of control than the stockholders of a public company are. In Cyprus, the author's interviews with a few stockholders of a closely controlled company revealed that they would prefer not to expand or embark on a certain project no matter how profitable it could be, if it involves a dilution of control. They would also prefer to borrow even at very high interest rates instead of issuing new stock, or they would expand as much as they could do so by plowing back into their business their retained earnings.

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10 Charles W. Thacker, The Income Tax of Cyprus (Nicosia: Cyprus Federation of Trade and Industry, 1956), p. 61.

In addition to the dilution of control, the dilution of earnings too, generally scare the stockholders of a closely controlled company. For this reason they are expected to object this form of financing. A dilution of earnings occurs as a result of new stock financing when the total net income after taxes does not increase as a result of the new funds in proportion to the number of shares of stock outstanding.

Financing from Retained Earnings

Retained earnings are an especially important source of funds for business expansion; since many expansions will be undertaken only if they can be financed from retained earnings. This is so, because of the unwillingness of the management to weaken its control position and its freedom of action by acquiring new equity capital; it may also be unwilling to incur the risk and restrictions involved in borrowing funds, or it may simply be unable to acquire outside capital.

High company and individual taxes do absorb large amounts otherwise potentially available for investment. But the large differentials between the high personal income taxes and the much lower rates of capital gains act as a positive incentive for many investors to search for speculative investments which may yield large capital gains.

In general, therefore, high company taxes appear to curtail the availability of capital to companies with outstanding growth possibilities much more than do high personal taxes; at least so long as the favorable treatment now accorded to capital gains is continued.[11]

The effect of company taxes on funds available for expansion changes after a company grows and reaches a profitable level. Over a period of years high company tax will drastically curtail the growth of a small company from retained earnings.[12]

The high rates of the personal income tax have been recognised quite generally as constituting a strong inducement to stockholders, especially in the closely controlled companies, to retain rather than distribute their earnings. The advantages of retention are so great that companies have sometimes been formed for the sole purpose of accumulating funds. The advantages of the retention of earnings are very closely related to the marginal tax rates of the individual stockholder.

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[11] Keith J. Butters, Effects of Federal Taxes on Growing Enterprises (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1945), p. 50.

[12] Ibid.

A stockholder subject to a higher personal income tax rate than the company tax will prefer retention to distribution, because he will be able at a later date to realise these retained earnings indirectly by selling part of his stock, and will be subject to relatively low capital gains tax.

The tax exemption of the capital gains arising from occasional transactions in Cyprus, tends to give relatively greater encouragement for retention of earnings as compared with other countries where the capital gains are subject to income tax. Therefore, it is easily observed that income taxation plays a direct and often a dominant role on retention.[13]

Because of the following reasons the above mentioned effects of income tax do not apply in Cyprus:

(i) All the profits of a company whether retained or distributed are taxed at a flat rate of 42.5 per cent. Whereas, if the profit is distributed as dividends the tax to be paid by the dividend recipients will depend on the income bracket in which they fall. In case of a public company where there are many small stockholders who usually fall in the lower income brackets, it will be to their advantage to have all the profits

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[13] Smith, _op. cit._, p. 185.

distributed instead of being retained. On the other hand, in case of closely controlled companies owned by a few people who usually fall into high income brackets, they would prefer to retain their profits and let the company pay 42.5 per cent income tax instead of receiving dividends and paying much higher rates of tax.

(ii) In Cyprus capital gains are not subject to income tax unless they are earned not as a casual and occasional income, but are the normal gains accruing to a person as a result of his usual profession or activity. The sale of a stock in a company or the sale of a building plot, no matter how profitable, will not be considered as income subject to tax by the recipient. So, this situation induces the owners of the closely held companies to retain earnings instead of distribution.

The non-inclusion of capital gains in the taxable income may influence the direction of foreign as well as domestic capital. For example various British establishments in India have expressed willingness to set up new industries in India if they could be granted concessions on the taxation and transfer of the capital gains earned by them.[14]

Effects of the Company Income Tax Upon Investment and Growth

Effects upon expansion from retained earnings.-- The effects of the income tax upon the funds available from retained earnings for use in investment and expansion are very real to the extent that the tax is not shifted, since a substantial portion of the earnings is taken from the firm. Prof. J. K. Butters maintains that company tax affects business expansion from retained earnings in the following ways:

(i) A high company income tax as compared with a low one, places severe restrictions on the rate of expansion that the growing enterprises can finance from their retained earnings.

(ii) A high company income tax rate, will also reduce the internally financed expansion possibility for a growing enterprise.

(iii) The companies paying out a large percentage of their net income as dividends may be able to

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[14] Richard Bird and Oliver Oldman, Readings on Taxation in Developing Countries (Baltimore: The John Hopkins Press, 1964), p. 204.

maintain a given rate of expansion in spite of a tax increase by drastically reducing the net income paid as dividends.[15]

Although it is generally accepted that high income taxes curtail investment and expansion, there are certain historical examples which prove that the contrary view can hold good too. This fact can be observed from the precedents created by Japan in the 1870's, the Scandinavian Countries and Austria recently, and Israel more recently prove that high taxation may and often does help development.[16] For these countries the rate of tax receipt to GNP was more than or close to 30 per cent of GNP in the period. This shows that a high rate of public capital expansion financed by a high level of public saving is a definite asset in a resolute policy for development.[17]

But, in Cyprus or in certain other countries where the free enterprise economy is prevalent and the private sector is more important and active than the public sector in the economic activities of the country, this measure, that is resorting to high taxation and shifting the available resources from the private sector to the public sector's disposal,

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[15] Butters, op. cit., p. 70

[16] Thorp Report, op. cit., p. 85.

[17] Ibid.

is not easily accepted and will meet with very strong resistance from the general public and the vested interests. Under these conditions high income taxation will have definite negative effects on investment and expansion of the economy.

A high level of income tax also raises a great number of difficult problems, e.g. political, institutional, technical and economic, the solution of which requires a very determined spirit of national solidarity and even sacrifice.

Effect upon Investment Incentives.-- Income tax can affect investment incentives in a number of ways. They reduce the disposable income of some income recipients; decrease their consumption expenditure and indirectly, may reduce the level of investment. Also, it may directly reduce investment expenditure through its effect on the profitability of investment or on the funds available for investment.

According to a study of the effects of income tax upon investment carried out at Harvard showed that the tax structure has a definite effect upon the incentives of persons, especially in the higher income groups, in the undertaking of various investment programs. In the income group over $ 500,000 from 80 to 90 per cent of persons stated that the income tax influenced their investment policies.[18]

On the whole the net effect of the high income tax is to lessen the ability and the desire of the rich people to purchase common stock, but by no means to dry up the supply of equity capital. A very substantial amount of money capital is still supplied to the business firms by the higher income groups on an equity basis.[19]

The company income tax may also reduce the incentives of the business managers to undertake major expansions. The tax usually reduces the net return which will be available to the firm as a result of expansion, and as a consequence some marginal projects will not be undertaken. New firms are particularly hampered by the company tax because they are more dependent on current and retained earnings for expansion than the well established firms.[20]

Further, the management may be more interested with the future success of the business than the individual interests of the stockholders. In this event they will consider

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[18] Due, op. cit., p. 207.

[19] Ibid.

[20] Due, op. cit., p. 233.

only the effects of the company tax in making their investment decisions. On the other hand, they may give close attention to the effects of their decision on the personal positions of individual stockholders. This is more usual in Cyprus where the personal income tax instead of company tax prevails, and the closely controlled companies have important bearing on the decisions of the management, who are usually the stockholders themselves greatly interested in the success of their own business.[21]

Cyprus Income Tax Law in Relation to Capital Gains

Capital gain means a financial gain resulting from the sale of a capital asset at a higher price than was paid for it. The gain usually arises out of an appreciation of capital value, and creates in the hands of the receiver a clear capacity to pay taxes.

Capital gain is the irregular or unusual sort of gain which occurs outside the normal course of one's business. e.g. an accountant or a doctor who draw their regular income from the practice of their profession may pick up gains occasionally through the purchase and sale of securities. In practice the principal capital assets subject to this special

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21 Butters, op. cit., p. 32.

tax treatment are investment securities and real estate.

In the United States capital gains are subject to a lower rate of tax than other incomes. In England capital gains were not taxable until 1965. Cyprus income tax law being a close copy of the British income tax system does not tax capital gains too. Although the British have changed their law recently in this respect, Cyprus income tax law has not followed suit, and still exempts capital gains from income taxation.

Because of the differential tax treatment of the capital gains in the United States, there is a tendency encouraged by the favourable treatment of capital gains to retain more and more earnings and realise them later in the form of capital gains which are subject to 25 per cent tax instead of a very high personal income tax. This tendency is greater in closely controlled companies, because they can do so as a result of their full control over the management of their business.

In Cyprus the situation is totally different. First, at present capital gains are not taxed as such, but, if capital gains are not occasional and constitute the normal income of a business, e.g. an estate agent gaining large sums of money as a result of appreciation in the values of land will be taxed on his capital gain from this source. This gain will be considered as being a part of his aggregate income from all sources and will be subject to the same rate of tax as the other incomes. Therefore, one can easily see that capital gains tax does not have the same effect on the policies of companies in Cyprus as in other countries.

The Cypriot businessmen are not encouraged to retain earnings in preference to distribution for the purpose of obtaining capital gains and avoid taxation partially by paying lower rates than the normal rates applicable to ordinary income. When one compares the 25 per cent capital gains tax with the very high personal income tax rates prevailing in the United States one can easily appreciate the great desire of retaining huge profits instead of distribution. This tendency is markedly greater among the closely controlled companies than the public companies.

Effects of the Income Tax on the Expansion of Small Companies

Availability of Capital.-- It is generally accepted that high taxes restrict the growth of small companies, perhaps more than any other way, by the limitation which they place on the amount of capital available to such companies. Management can and often does ignore the adverse incentives resulting from high taxes, but it cannot safely ignore the limitations on new expansions by the lack of adequate funds to finance them.[22]

For various reasons, the restrictive effect of company taxation on the availability of capital to small and growing companies is particularly powerful:

(i) High company taxes directly reduce the amount of net income and hence the amount of retained earnings which can be used for expansion.

(ii) High company taxes reduce the potential profitability of new projects and render them more risky, and as a result the borrowing position of the small companies deteriorate. In many cases unfavorable terms of borrowing will force the company to obtain less capital from outside sources.[23]

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[22] Ibid., p. 49.

[23] Ibid.

The higher tax would increase the risk of a small and growing company, to the extent that tax cuts into the company's limited capital supply, the necessary improvements and expansions will be more difficult to introduce. The ability of a company to borrow depends to a great extent on the strength of its net worth and working capital position. Increased tax payments would obviously weaken both of these positions and reduce the borrowing power of the company which is more serious for a small and growing company than a large and well established one.[24]

Willingness and Ability of Management to Acquire outside Capital. -- Small companies may be unable to obtain funds from the capital markets or be unwilling to do so. But, actually the management of small companies with outstanding growth possibilities are particularly likely to be unwilling to seek outside capital, because the owners of such companies place a very high value on the maintenance of personal control over their businesses. Under these circumstances the effect of the company tax rate will be very great, because the higher the rate the smaller will be the retained earnings which could be used for expansion. This conclusion will hold good even if abundant savings are

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[24] Ibid., p. 54.

available in the economy from other sources.[25]

Flow of Long-term Funds to Small Businesses.-- With the exception of retained earnings, the savings of individuals are the most important source of funds for business expansion. Recently, individual savers have increasingly entrusted their funds to safe forms of investments, such as government bonds, life insurance companies and other similar institutions. Funds so invested are very rarely made available to small companies in need of venture capital. Therefore, the conclusion is that the more the high company taxes reduce the retained earnings available to small companies, the more difficult it will be for them to make risky investments, and their growth will be curtailed.

Experience of Small Companies Seeking Outside Capital:--

Additional equity capital is the primary capital requirement of growing enterprises. Without adequate capital the issue of bonds is unwise and usually impossible. If growing companies have adequate equity capital which can act as a cushion of safety, they can usually manage to obtain the outside funds which they may require without much difficulty and on favorable terms. If they do not have adequate equity capital

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25 Ibid., p. 56.

they are almost certainly restricted in the amount of funds they can borrow, and in the terms on which such funds can be borrowed.[26]

The smaller the percentage of the net income paid out as dividends the more restrictive will be the effect of a high tax. On the other hand, if a large percentage of net income is paid out as dividends an increase in tax rates may be met by reducing the dividend payments instead of restricting the rate of business expansion.

Some firms attach so much importance to rapid growth that they would completely eliminate their dividend payments in the face of increased company tax. This can be done more easily in a closely controlled company, but it will be very difficult to persuade the large number of stockholders of a public company.

In Cyprus the cost of capital is extremely high. There are apparently a number of firms which have plans for expansion or modernising but find difficulty in obtaining funds. Therefore, the income tax law can play a big role in enabling these firms to accumulate large retained earnings by exempting or taxing their undistributed profits at a reduced rate.

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[26] Ibid., p. 91.

According to the data obtained through the questionnaires filled by the Cypriot businessmen the tendency of retaining profits is greater in small companies than in big ones, because these small companies are essentially the property of one or a few owners. So, the owners consider the retained earnings as their own personal savings. Actually, in many circumstances the purpose of converting a business into a company is to make savings from tax liability by making the savings and investment in the form of reserve. In other words in these small companies there is no difference of interest and attitude between the management and the owners as it usually prevails in big companies. For this reason the few members of a small company usually prefer to invest all their savings in their own business.

The owners of small closely controlled companies do not like to issue new stock, because they do not want to lose their controlling interest in their business. They do not want to share their business with others. The investors on the other hand do not like to invest in small companies without receiving some advantage of control in the management. For these reasons it is very difficult if not impossible for small companies to obtain financial aid from outsiders. Therefore, small companies can only expand and grow through self-financing by way of retained earnings.[27]

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[27] Bulutoglu, op. cit., p. 214.

In a newly developing country like Cyprus, if the quick accumulation of capital is one of the aims of the government's economic policy, it must keep the company tax rather low, so that the companies can accumulate enough profits to help their expansion programs. A saying by Henry Ford, one of the most successful businessman in the world indicates the importance of accumulating business profits for growth. He said that "the profits belong to the business to safeguard the business in its task of giving service and to permit natural growth."[28]

The inexistence of a capital market in Cyprus leaves only one source of obtaining funds, that is the commercial banks. But since the commercial banks in the island are small and it is against their policy to lend to business firms for long-terms, especially to new and small companies, the retained earnings seem to be the first and usually the last resort in financing the development projects of nearly all the small companies.

Taxation of Undistributed Profits

It has been already mentioned that if the undistributed profits are not taxed at all, or are taxed at a lower rate than

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[28]Henry Ford, Today and Tomorrow (London: William Henemann Ltd., 1926), p. 37.

is applicable to dividend payments, it will be encouraging to the retention of large profits instead of distribution as dividends. This tendency will be greater among closely controlled family companies. It will also encourage those individuals whose income bracket is taxed at a higher rate than the company tax rate.

In Cyprus, both the distributed and the undistributed profits are taxed at the same flat rate of 42.5 per cent. When the profits are distributed in reality the dividend recipients pay the tax, but if profits are not distributed it is the company itself that pays the tax. This tax will be recovered by the dividend recipients when they receive this undistributed profits later as dividends.

Section 33 of the Cyprus Income Tax Law leaves a loophole by providing that the income derived by a non-resident from any source within the Republic shall be assessed and shall pay tax at the appropriate rates as provided in the law for companies. If the non-resident person delivers a return of his total income derived from the Republic, he can be charged at the rates provided for individuals.[29]

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[29] The Income Tax (Foreign Persons) Law, 1961 (Nicosia: Government Printer of the Republic of Cyprus, 1962), p. 22.

This loophole can be used and is actually taken advantage of by non-residents. If the non-resident person has a large income and falls within an income bracket which is taxed at a higher rate than the company tax of 42.5 per cent applicable to dividends, he will prefer to be taxed under the company tax rate. On the other hand, if his total income is low and falls within an income bracket taxable at a lower rate than 42.5 per cent he will prefer to deliver a personal return which will qualify him to be taxed at the rates provided for individuals.

While working in the Income Tax Office in Cyprus, the Author observed that hundreds of dividend certificates were sent abroad to the non-resident owners of certain companies established in the island, but none of these dividend recipients ever claimed back as a refund any portion of the tax witheld from their dividends. This is indicative to the fact that they must have fallen into the income bracket which should pay more than the amount deducted from their dividends.

A single tax like that of the Cyprus Income Tax, which is a lighter tax than that would be if the taxation of dividends was added to the taxation of company profits, tends to make the corporate form of business more attractive for the growing domestic enterprises. The only disadvantage is that it results in a loss of government revenue. [30]

In Cyprus the expected increase in the number of companies in response to the tax incentive has not been achieved because, in the island the seperation of control and ownership characterising the big public companies, and the inexistence of a capital market to facilitate the trading of the stocks of a company has counterbalanced the positive effects of the tax incentives.

The taxation of the undistributed company profits was intended to close a loophole of long standing, and was to be imposed at rates which would make it a matter of indifference, so far as taxation is concerned, whether earnings were paid out as dividends or put into company reserves.[31]

An incidental effect of closing this escape route would probably be to encourage dividend distribution. Consequently, not only would tax revenue probably increase, but encouragement of distribution would also raise the level of consumption by dividend recipients. It is further argued that any taxation of undistributed profits is a burden on saving. Since the business companies are big savers this argument tends

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[30] Bird and Olman, op. cit., p. 205.

[31] Due, op. cit., p. 417.

to be valid, but sometimes it is not easy to distinguish a proper saving from a purposely done accumulation for the sake of capital gains and tax avoidance.

Preventing Unreasonable Accumulation:

The prevalence of the closely controlled companies, and the exemption of capital gains has given tremendous incentive for excessive accumulation of profits by the Cypriot companies. The realisation of this tendency among the companies prompted the Income Tax Office to include a provision in the law to prevent the accumulation of profits beyond a certain fixed percentage.

Section 51 of the Cyprus Income Tax Law states:

> "If a company controlled by not more than five persons does not distribute to its shareholders as dividend the profits of the year which could be distributed without detriment to the company's business or to the expansion or development of that business, the commissioner may treat a portion up to 75 per cent of such undistributed profits as distributed to the shareholders and the persons concerned shall be assessed accordingly"[32]

As it will be observed from the above provision of the Income Tax Law, the channel of avoidance is closed to the owner and unreasonable accumulation is prevented. According

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[32] Income Tax Law, Section 55. p. 31.

to Charles Thacker, this provision seems to be very harsh on the businessmen and at the same time gives a big discretion to the commissioner in the matter.[33] The income tax officials are not experts in this field, that is in deciding what percentage of a company's profits can be distributed without being deterimental to a company's future success and expansion. So, the businessmen may find themselves in very difficult situations.

The situation is still aggrevated by the fact that when the businessmen are dissatisfied with the decisions of the income tax officials, they cannot resort to an institution like the "board of referees" in England which is composed of business and professional men, who can bring expert knowledge to bear on this subject.[34]

This provision of the law hampers the companies' planning for the future by not letting them know how much they may justifiably retain of their profits, or how much they may plow back into their business, or to what extent legitimate reserves may be challenged under this section of the law.

It is often said that it is more important that the law should be more certain than that it should be perfect.

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[33] Thacker, _op. cit._, p. 48.

[34] _Ibid._

Therefore, to create certainty by giving guiding principles instead of being very ambiguous and uncertain, will be very helpful for the businessmen in planning their business affairs. This uncertainty may be overcome by stating definite percentages of the company's income which can be regarded as a minimum adequate distribution. This method has been applied in many countries and benefited both the taxpaying businessmen and the revenue alike.

Encouraging Effects of the Income Tax on New Industries

As it was mentioned in earlier chapters, agriculture and mining are the main sources of livelihood in Cyprus. The desirability of broadening the basis of the island's economy by attracting new forms of industry which will help to increase exports and create a more balanced economy is very urgent. The brochures prepared each year for distribution at the British Industries Fair, in which visitors to the Cyprus Stand at the fair are invited to consider the business possibilities of Cyprus state regularly "It is the government's settled policy to offer encouragement to new enterprises", adding, "Taxation is moderate and there are few restrictions on business activities."[35]

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[35] Thacker, *op. cit.*, p. 40.

The government is trying to attract pioneer industries to the island by giving them tax advantages. The inclusion of Section 8, to the Income Tax Law is in harmony with the genuine attempts of the government in this field. This section of the law states "the Council of Ministers may exempt from income tax the profits or part thereof of any industry or other new enterprise which is vital or essential to the economic, industrial or touristic development of the Republic.[36]

The years following the inclusion of this provision in the law have not been very normal in the island, and there is not enough evidence whether actually such facilities have been granted to any pioneering industry in the island.

The most common type of tax relief granted by other countries in an attempt to attract industries are:

(i) A "tax holiday" or "tax relief" period extending from two to five years from the commencement of the business or production, during which period any profits made are exempted from income taxation.

(ii) The exemption from tax any dividend declared out of the profits earned during the relief

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[36] <u>Income Tax Law</u>, Section 8., p. 8.

> period. The relief period is sometimes conditioned by the amount of capital expended.[37]

It is not of course expected that companies opening up industries in new territories will make large profits. They may even contemplate losses during the first few years, in the anticipation that they will be recouped when the business is established. The tax relief held out may thus be comparatively small, but in the long-run would be amply repaid by the revenue subsequently derived from such concerns. Therefore, it seems desirable that pioneering industry relief be considered as an aid to the development of the economy of the island.

Other Effects of the Company Tax on Business Policies

Burden on the Stockholders.-- To the extent that a company is unable to shift the tax forward, the direct and immediate burden rests upon the funds which the company has available after other expenses are covered. According to John Due, there are three steps which a company may take under the circumstances:

(i) May reduce certain types of expenditures, such as maintenance and research. The burden of the

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[37] Thacker, op. cit., p. 40.

tax in this case rests directly upon the persons affected as a result of a reduction in these activities.

(ii) Dividends may be reduced than they would otherwise be. If funds are not needed urgently, the dividends may be left unchanged and the tax is borne entirely out of profits which would otherwise have been added to surplus. On the other hand, if most of the earnings are paid as dividends, the company has little choice but must cut the dividends. The general policy will depend upon the urgency with which the company requires additional funds and the attitude of the stockholders.

(iii) The tax may be borne out of undistributed profits. However, the reduced surplus will tend to lower the selling price of the stock, and thus reduce the capital gains which the stockholders would ultimately have enjoyed. It will be observed that in all the alternative solutions to the problem the final burden falls upon the stockholders who are the residual owners of the company.[38]

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[38] Due, _op. cit_. p. 229.

Stimulation of Industry.-- During the last thirty years income taxation has gained great importance as an economic tool to be used by the government in the stabilisation of the economy of a country. Income tax can be used both to bear an effect on the overall economy, or on a particular sector or industry in the economy. Certain industries can be encouraged by being allowed tax relief in terms of depreciation or by being subjected to lower tax rates, whereas other industries' expansion could be curtailed by taxing them at a higher rate.

In many countries income tax laws provide incentives for self-financing. These incentives are selective and concern a given sector which is of special interest in terms of economic activity. Examples are the New Zealand law which assesses mining companies on only half of the dividends distributed, and the French law exempting from income tax the reinvested profits of companies engaged in oil research.[39]

In Cyprus too, the new depletion allowance granted to the mining companies is an attempt to encourage this industry because of its importance to the island.

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[39] Bird and Oldman, op. cit., p. 211.

CONCLUSION

There are few companies in Cyprus and most of them are closely controlled family businesses. They have chosen this form of business organisation because of certain advantages pertaining to companies.

The companies in Cyprus are not considered as having separate and distinct identity of their own apart from the members composing them. For this reason the company tax as it is known in the United States, or other advanced countries of Europe, is not applied in Cyprus. What is known as a company tax in Cyprus is nothing else but a personal tax witheld by the companies, like the tax witheld from wages and salaries before they are paid out.

The deductibility of the interest expense in ascertaining the taxable income of companies has affected their financial policies and made borrowing more advantageous than financing through the issue of common stock.

Although borrowing is more advantageous taxwise, because of the difficulty of borrowing and of the exorbitant interest rates charged, most of the companies, especially the small ones, have no alternative but to resort to their retained earnings.

Capital gains are not taxed if they are earned occassionally and not in the normal course of business of a person. If it constitutes the normal earnings of a person it is aggregated with his other income and is subjected to the personal tax rates. In many other countries the subjection of capital gains to a lower rates of tax than the ordinary income of a person encourages the retention of earnings in the companies in preference to distribution with the purpose of realising them later in the form of capital gains and may lower tax on them.

The profits of a company whether distributed as dividends or not is taxed at a flat rate of 42.5 per cent. The fact that personal income tax rates are higher than the company tax paid on undistributed profits encourage retention of profits. But, the realisation of this fact by the Income Tax Office prompted them to include a provision in the law requiring the companies to distribute that portion of their profits which would not harm the future success of the business of the company.

High income tax rates usually reduce the incentive for investment. In a developing country like Cyprus encouragement for both domestic and foreign investments in the island seems to be desirable. The 85 per cent personal tax rates on a taxable income of Ŀ 10,000 and above seems to be rather high and it is advisable to lower this rate so as to increase domestic investment and encourage the inflow of foreign capital.

CHAPTER VI

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This study has analysed the effects of the Cyprus Income Tax Law on the business policies in the island. The main stress has been on the effects of the Income Tax Law on the depreciation policies, on the policies of small businessmen, and finally, on the effects of the company tax on the policies of companies.

The weight of the study centered around the personal income tax instead of the company tax, because of the peculiar position of the company tax which is nothing more than a personal income tax witheld by the companies while paying out dividends.

Summary

The Economy of Cyprus and the Income Tax

Cyprus is the third largest island in the Mediterranean with a population of approximately six hundred thousand. The average per capita income was L205 in 1964, which was higher than that in several neighbouring countries.

Cyprus is a primary producing and underdeveloped country deriving a substantial proportion of its gross domestic product from agriculture and mining. Capital is scarce, which makes it dependent on foreign capital for development. The government is making great efforts both at home and abroad to encourage investment and accelerate the development of the country.

The Cyprus Income Tax Law was introduced by the British in 1941, when the island was a British colony. In 1965 the contribution of the income tax to the government revenue was L 4 million, which constituted approximately twenty per cent of the total tax collected.

General Features of the Cyprus Income Tax Law

Until 1961, Cyprus had a unitary Income Tax Law applicable to all the cypriots and the foreigners resident in Cyprus. As a result of certain misunderstanding between the Turkish and the Greek communities, each community introduced its own Income Tax Law in accordance with the constitution of the island. But, as a result of the abolition of the Greek Communal Chamber in 1964, at present there are only two separate Income Tax Laws, one applicable to the Turks, and the other applicable to the Greeks and the foreigners together. The income tax collected from the Turks goes to the Turkish Communal Chamber, while the tax collected from the Greeks and the foreigners goes to the Cyprus Government.

Although the Income Tax Law was originally revenue oriented, at present there are indications that the government is trying to manipulate it as an economic tool.

In Cyprus, the basis of assesment is the aggregate income from all sources. Business income is assessed on the preceding year's basis, while the income of the employees is taxed on the current year's basis, and the tax is witheld under the-pay-as-you-earn system. The personal income tax is progressive while the company tax is a flat rate of 42.5 per cent irrespective of the amount of income.

The assesment procedure practised is not scientific and a lot of guesswork enters the process which leads to bargaining between the taxpayers and the assessing officers.

Companies are subject to company tax at a flat rate of 42.5 per cent irrespective of the amount of the profits. But, the tax deducted from the dividends distributed by the companies is claimed back by the dividend recipients, which they receive in the form of a refund or as a set-off against their current tax liabilities. Therefore, one can say that in Cyprus, there is no company tax as it is known in the United States or in other countries. What is known as a company tax is merely a personal income tax imposed through the medium of a company.

The collection section of the Department of Inland Revenue is responsible for the collection of the tax assessed. Once the assessment is accepted by the taxpayer, usually little difficulty is encountered in collecting the tax payable.

The Income Tax Law is administered by the Inland Revenue Department of the Ministry of Finance. The assessing department has always been short of staff, as a result of which there are always many outstanding assessments. This situation costs a lot to the Treasury, and also creates hardship for the taxpayer in the form of accumulated tax liability.

The inefficiency of the administration is evidenced by the extent of the tax evasion which is great indeed. Many provisions of the Income Tax Law are kept in the Statute book without actual enforcement.

The Effects of the Income Tax on Depreciation Policies

Cyprus Income Tax Law states that in ascertaining the taxable income of a taxpayer a deduction of a reasonable amount for the exhaustion and wear and tear of property arising out of use in the business should be allowed. Among the various methods of depreciation only the straight-line method is permitted. This method spreads the total depreciation in equal amounts over the life of an asset. The law also specifies very rigid depreciation rates which leaves no room for the businessmen to maneuver.

A questionnaire study conducted by the author among the Cyprus businessmen has revealed that sixty five per cent of the businessmen are unaware of the existence of depreciation allowances in the Income Tax Law. Though thirty five per cent of the respondents are aware of the depreciation allowances, still a smaller percent of them took advantage of it.

In addition to normal depreciation allowances, The Cyprus Income Tax Law allows an initial deduction of twenty per cent on plant and machinery, and ten per cent on buildings when they are first acquired and used. This initial allowance is a kind of accelerated depreciation given in the year of purchase of the asset when it is most needed. It tends to have a positive effect on investment which is very much needed in a developing country like Cyprus.

The mining companies are permitted to deduct a certain percentage of their gross profit in the form of a depletion allowance. The percentage of the depletion allowance falls as the profitability of the company increases and vice versa.

The development costs of the mining companies are not permitted to be charged against their current revenues, but are capitalised and prorated over the life of the mine. This treatment encourages the companies to postpone their exploration and development attempts.

The state of exhaustion of the mining resources in the island, and the pressure exerted by the mining companies has prompted the government to allow the exploration expenses incurred by the companies as a deduction from the income of the year in which they incurred.

The rapid increases in the price levels in many countries which necessitated the use of replacement-cost method of depreciation has not been much felt in Cyprus, because the prices have risen very mildly and insignificantly during the last decade. This is why cypriot businessmen have not bothered themselves with the depreciation methods suitable under inflationary conditions.

The Effects of the Income Tax on the Small and Growing Businesses

The economy of Cyprus is characterised by small units of business enterprises. According to an industrial census conducted in 1960, ninety two per cent of all the establishments in the island were small business units employing less than five persons which was considered to be a small unit for the purposes of the census. Although six years have elapsed since then, the same economic structure seems to be prevailing.

There are certain institutions in the island which are tax exempt. These institutions which reduce the tax base and the tax collection of the government are the co-operatives, the Turkish Evcaf and the Greek Arcbishopric.

Because of the ignorance of the management of small business units, the Income Tax Law seems to be ineffective in influencing their policies.

Although The Income Tax does not appear to have a significant effect on the desire of individuals to start new enterprises, it may have a pronounced effect on their ability to do so. Once established, in their early stages of development small businesses generally depend on the personal resources of the enterpreneurs directly interested in them. High income taxes seem to curtail the funds available to those individuals and consequently may prevent the organisation of some important new businesses, and may delay the progress of the others.

Most of the small businesses encounter difficulty in raising outside capital. They are reluctant to surrender some of their control over their businesses. Therefore, retained earnings are vital for their growth.

The prevailing high rates of personal income tax which reach eighty five per cent after L10,000 of taxable income seems to be prohibitive for the small businesses. This situation blocks the only way of easy finance available to small businesses. In certain cases they may be able to borrow, but, the exorbitant interest rates charged puts them in a very delicate position and increases the bankruptcies among them.

Income tax evasion is very common among the small businesses. The crude and simple methods used by the Income Tax Office in ascertaining the taxable income, the lack of business records to be used as a basis of assesment, and the laxity in the implimentation of the Income Tax Law, increase the chances of small businessmen to avoid and evade the income tax. The formation of partnerships among the members of a family is generally resorted to as a means for splitting the total income and pay less tax.

The most common item which is manipulated by the small businesses for tax evasion is the inventory of the business. The inventory is underestimated year after year, because the Income Tax Office accepts the declared inventory figure without attempting to verify its correctness. But, it seems that this situation cannot go on indefinitely. It is expected that the increasing need of the government for more tax revenue, sooner or later will put an end to this form of inefficiency in the Income Tax Office.

The capital gains are not taxable if they are earned from casual transactions outside the normal business of the taxpayer. This exemption encourages and channels the savings and the efforts of many small businessmen into speculation in building plots. These activities have created inflation in the values of land and building plots.

The Effects of the Income Tax on the Policies of Companies

There are few companies in Cyprus, and most of them are closely controlled family businesses. They have chosen this form of business organisation because of certain advantages pertaining to companies.

For income tax purposes, companies are not considered to have a separate and distinct identity of their own apart from the members composing them. For this reason corporation tax as it is applies in the United States, Europe and other countries does not apply in Cyprus.

The deductibility of interest expenses in ascertaining the taxable income of the companies has made borrowing a more advantageous method of financing in preference to the issue of common stock.

Although borrowing is more advantageous taxwise, the difficulty of borrowing and the exorbitant interest rates charged oblige many companies to resort to their retained earnings as a means of financing their investment projects.

The tax exemption of capital gains encourages retention of earnings, especially among the closely controlled companies, for the purpose of realising them, at a later date, in the form of capital gains and avoid the payment of income tax.

The undistributed profits of a company are taxed at a flat rate of 42.5 per cent. This rate is exactly half of the personal income tax rate of 85 per cent paid on the taxable income above L 10,000. Therefore, it is not surprising to find out that the members of a closely held company prefer to retain their earnings in preference to distributing them as dividends. The realisation of this fact by the Income Tax Office has prompted them to include a provision in the Income Tax Law requiring the companies to distribute that portion of their profits which would not harm the future success of the company.

The high income tax rate in the island tends to have certain negative effects on investment. First, it reduces the funds available to finance expansion, and second, it reduces the incentives of management to undertake expansion, because the rate of return of the projects are reduced. New companies are particularly hampered because of their heavy dependence on retained earnings for expansion and growth.

Evaluation and Conclusions

1 - The rigidity with which businessmen are required to use only the straight-line method of depreciation and follow the stipulated duration of asset lives tends to discourage them from purchasing new assets.

2 - The obligation to use only the straight-line method of depreciation encourages the businessmen to dispose of their assets, especially during their profitable years in order to reduce their taxable income by way of a "balancing deduction" resulting from the ruthless retiring or disposal of assets. This is a waste of capital in a country where capital is scarce and must be used sparingly.

3 - The twenty per cent initial allowance on plant and machinery tends to induce mechanisation. It has

resulted in increased mechanisation in many firms. In certain cases it increased the purchase of luxurious mechanical devices which are not very appropriate at the present stage of development of the island.

4 - The capitalisation and prorating of the development costs in the mining industry over the life of the mine tend to encourage companies to postpone exploration and development. The allowance of development expenses as current deductions, on the other hand, tends to encourage exploration and development.

5 - The currently used depletion allowance which depends on the profitability of the mining companies, and falls as the profitability rises and vice versa, discourages the already efficient and profitable companies from putting in their maximum effort by penalising efficiency and profitability.

6 - The allowance of the abortive expenditure as a deduction in the year immediately following that in which the search was relinquished gives relief and encouragement to the mining industry for further exploration at no ultimate cost to the Treasury.

7 - Although the income tax tends to be ineffective on the

desire of small businessmen to start new businesses, it seems to have a significant effect on their ability to do so.

8 - The high personal income tax rates tend to have a prohibitive effect on the accumulation of capital by small businesses.

9 - The inefficient administration of the Income Tax Law encourages tax evasion and avoidance.

10- The exemption of the capital gains encourages speculation in land by many small businessmen which tends to create inflation in land values. It also encourages the retention of earnings by the companies for the purpose of tax avoidance.

11- The high income tax rates tend to have a discouraging effect on the policies of the companies through reducing the available funds and by killing the incentives of management.

As a general conclusion we can say that in an underdeveloped country like Cyprus, which is characterised by small units of business, and where agriculture is a predominant feature of the economy, the Income Tax Law tends to have an insignificant effect on the business policy. While it has a significant effect on the policies of a few big companies, its effect on the policies of the predominant small firms is negligible. Therefore, in Cyprus, the Income Tax Law is an economic tool in the hands of the government which can influence only a small section of the economy, unlike in the developed countries where it can have an overall effect on the economy.

Recommendations

This work has been devoted to the study of the effects of the Income Tax Law on the business policy in Cyprus, without any recommendations for changes in the Income Tax Law. Though it is not desirable to depart from this policy, it may be permissible to make the following suggestions for the improvement of the present Income Tax Law in the island.

Depreciation

The rapid obsolescence which characterises the depreciable assets of our time requires that more realistic service lives be permitted for computing the annual depreciation charges instead of the rigid and out-of-date service lives permitted by the Cyprus Income Tax Law. Greater flexibility warranted by the changing circumstances is necessary and desirable. Shorter service lives affect the cash outflow which by reducing the likelihood of dividend distribution tends to provide incentive and capability for modernising the plant and machinery, thereby, reducing the costs and improving the competitive position of the island in relation to foreign competitors.

Furthermore, because of their positive effects on investment, accelerated methods of depreciation should be permitted instead of the straight-line method of depreciation currently imposed on the Cypriot businessmen.

Encouragement to Local and Foreign Investment

Because of the scarcity of capital in Cyprus, incentives should be given on a discriminatory basis in favor of certain vital industries and areas in order to prevent the misallocation of resources. The desired allocation of capital can be accomplished by giving initial allowances and tax holidays to certain vital industries, instead of indiscriminatory extension of these incentives to all industries.

The excessive demand for capital investment can be met by attracting foreign investors into the island by granting them tax holidays for some years. This method has produced positive results in many developing countries, and it is expected that Cyprus may benefit from it too.

Improvement of the Income Tax Law and its Administration

The static character of the present Income Tax Law should be changed so that it could meet the changing demands of the economy. The static quality of the Cyprus Income Tax seems to be an inevitable consequence of permanently imposed taxation where there is no provision for periodic review. There has not been any change in the company tax rate since 1956. The preservation of the Income Tax Law implimented during the colonial administration even after the independence with only a few minor changes proves the static nature of the Cyprus Income Tax Law.

The changing economic conditions and the aspirations of the government necessitates a more flexible Income Tax Law which can be of utmost help in creating the desired effects on the economy.

The high rates of the personal income tax should be reduced and the existing loopholes in the law should be eliminated in order to remove the inequitable and uneconomic tax privilages which benefit some sectors of the economy.

Capital gains too should be brought under taxation so as to prevent the businessmen from indulging in tax avoidance by making use of this loophole in the law.

A separate company tax should be established at this stage of the development of the island, so that the government can avail itself of this powerful economic tool in order to influence the policies of companies as the necessity arises.

Improvement of the administration of the Income Tax Law by increasing the assessing staff with better qualified and duty conscious personnel seems to be imperative. In this way tax evasion and avoidance which is very widely practised in the island might be reduced, and the burden of taxation would be carried by all citizens according to their ability to do so.

APPENDIX I

DEPRECIATION RATES ALLOWED IN CYPRUS

Asset	Rate of Depreciation (%)
Buildings	3
Industrial Buildings, leasehold Buildings	4
Water Tanks	6
Mooring buoys and sub-marine pipe lines	6
Pumps and Pumping installatious	12
Meters	8
Electric Installations	
Motors and Dynamos	9
Other Plant	6
Cables and Wires and Outside Lines	5
Diesel Engines	12
Fire Equipment	
Engines and Pumps	8
Furniture and Fittings	6
Typewriters and Calculating Machines	10
Electric Fans, Stoves etc.	10
Advertising Equipment	8

Asset	Rate of Depreciation(%)
Compressors and Air Filling Apparatus	12
Trucks and Cars	
Private Cars	15
Vans	20
Jeeps	20
Tank Trucks	20
Horse-drawn Carts and Trailers	5
Loose Tools	33 1/3
Air Conditioning Units	12

APPENDIX II

A Specimen Letter sent to each respondent
with the questionnaire

The Director
Amiantos Asbestos Co.
Amiantos.

Mr. D. Ashkin, a graduate student at the American University of Beirut, is working for his Master's degree in Business Administration. As a requirement for his graduation he is working on a thesis entitled "The Income Tax Law in Cyprus and Its Effects on Business Policy". Being his advisor on this thesis I am sure that your valuable experience, knowledge, and views on the subject, will contribute very much to the success of this worthy study. I, therefore request that you kindly extend to him the necessary help you can provide in order that he may complete his thesis successfully.

Mr. Ashkin would like to assure you that anything mentioned in this questionnaire will be kept strictly confidential. It should be understood also that this study is being undertaken not to find out the views of individual businessmen, but, to obtain some information about the general view of the business community in relation to the Income Tax Law. I believe that this study merits your serious attention and cooperation.

Please accept our sincerest thanks in advance for your help and cooperation in this valuable project.

Emile Ghattas, Ph.D.
Assistant Professor of Business Administration

APPENDIX III

QUESTIONNAIRE

Please check the right answer.

Questions

1. What is the nature of your business?
   - a) Banking
   - b) Mining
   - c) Trade
   - d) General
2. Is your business-
   - a) A proprietroship
   - b) Partnership
   - c) Public company
3. Is your business-
   - a) Locally owned and registered.
   - b) A branch of a foreign firm
   - c) A subsidiary of a foreign firm.
4. Are the buildings you occupy-
   - a) Owned by you
   - b) Rented from others
5. Does your firm pay tax-
   - a) According to standard rate
   - b) According to personal tax schedule

6. Do you keep proper books of accounts?

   Yes No

7. Do you submit audited accounts to the Income Tax Office?

   Yes No

8. What is the amount of your Capital?

More than	10.000
" "	20.000
" "	50.000
" "	100.000
" "	300.000
" "	500.000
" "	1.000.000

9. Where do you get the money needed for expansion?

   a) From Retained earnings

   b) From shareholders

   c) Borrow from the banks

10. Did Income Tax considerations have any effect on the formation of your business?

    Yes No

11. What method of depreciation do you use?

    a) Straight line method

    b) Diminishing balance method

    c) Sum of the years digits method

12. Does initial allowance and depreciation encourage you to use more machines instead of Labor?

    Yes No

13. Does initial allawance on building induce you to buy your own building instead of renting?

    Yes No

14. Do you prefer accelerated depreciation to more conventional methods?

    Yes No

15. If your business is a public company-

    a) Do you prefer to distribute all the earnings

    b) Do you prefer retaining them

16. Does the Income Tax Law encourage you to-

    a) Retain earnings

    b) Pay out in dividends

17. Do you think the standard rate applied to companies is-

    a) Very high

    b) High

    c) Reasonable

    d) Low

18. Would you like the abolition of income tax?

    Yes No

19. Do you think the tax administration is fair and just in Cyprus now?

    Yes No

20. Does the tax collection methods affect your business?

    Yes No

21. Do you think the present tax law encourages foreign investment in Cyprus?

    Yes No

22. If your firm is a mining co, indicate which of the following do you think are advisable?

    a) Higher depletion allowance and depreciation.

    b) Lower standard rate

    c) Exemption of undistributed profits from taxation

    d) Tax exemptions for five years for new discovery of new mineral deposits

Please answer in writing and attach to the questionnaire:-

1. What suggestions can you make for a change in the income tax law ?

2. What do you think the effects will be if the standard rate is lowered?

3. What effects does the income tax law have on your business policy?

4. Do you think that the Income Tax Law has been improved since independence.

5. Any other general comments, views and recommendations in this respect.

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