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SPECIAL ACCOUNTING PROBLEMS OF DETERMINATION OF BUSINESS INCOME IN LEBANON

EDWARD J. GRESS

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TO KETTY AND ALBERT

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ABSTRACT

Two main problems face accountants in their process of determination of business income in Lebanon. The first is the problem of depreciation of tangible fixed assets and the second is the problem of key money. These problems arise mainly from the Income Tax Law, the Buildings Tax Law and the Rent Law of Lebanon.

The problem of depreciation of tangible fixed assets arises from the rigidity of the Income Tax Law with respect to matters such as the limitation of the minimum useful life of depreciable assets and the requirement of the straight-line method of depreciation. The inadequacy of depreciation rates for business firms that own their places of business was more than covered by the acceptable deduction from gross earnings of a generous figure representing the rental value of the premises wherein the business is conducted. In accordance with the Buildings Tax Law, the rental value of the place wherein the business is conducted does not only include the rental value of the building proper but also includes the rental value of equipment and machinery which are fixed permanently in the building and hence form part of it. The Buildings Tax Law of September 17, 1962, prohibits the deduction

of rental value from gross earnings in accordance with the Income Tax Law and thus leads to inadequate depreciation provisions and causes a greater tax burden on taxpayers.

The problem of key money emerges from the provisions of the rent laws of Lebanon. The requirement for the renewal of rent contracts at the same rate year after year or sometimes at an increased or reduced rate, the growth of business activity in the commercial centers and the expected increase in rent rates lead a landlord to exact from a tenant key money which is supposed to represent the present value of future increases in rent rates from which the landlord cannot benefit and for possible future decreases in rent rates not warranted by market conditions. Key money thus received by the landlord is a deferred rent income over the useful life of his building and is not an income for the period in which it is received as treated under the Buildings Tax Law. Key money paid by the tenant, on the other hand, is a prepaid rent that should be amortized over the useful life of the property leased and should not be kept on the books indefinitely at cost without amortization as required by the Income Tax Law. The fact that the value of key money usually increases with time should not be a deterrant to the amortization of key money but should be considered as an adjustment to the Key Money account and hence an adjustment to the periodical rent charge.

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CHAPTER I

INTRODUCTION

A. Purpose of the Study and General Considerations

The purpose of this study is to bring to light and discuss some accounting problems of determination of business income in Lebanon. The problems to be discussed in this study mainly emerge from the Income Tax Law of June 12, 1959, (Legislative Decree No. 144), the Buildings Tax Laws of June 12, 1959, (Legislative Decree No. 145), and September 17, 1962, and the various rent laws of Lebanon.

It should be pointed out at the outset that the first law imposing a tax on income was enacted on December 4, 1944. This law was amended several times and was finally substituted by Legislative Decree No. 144 dated June 12, 1959, which is presently in force. Before 1944 there was no income tax as such but there was a hybrid income tax called the *tamattu'* tax which was levied only on the commercial, professional and salaried classes. This tax was rarely levied directly on income but usually through convenient indices of income.[1]

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[1] For a discussion of the tamattu' tax and the indices on which it was based, refer to George Hakim, "Fiscal System," *Economic Organization of Syria*, ed. Said B. Himadeh (Beirut: American Press, 1936), pp. 363-366.

The main purpose of accounting in a business firm is a fair determination of business income for successive years.[1] This view was adopted in 1938 by the Committee on Accounting Procedure of the American Institute of Public Accountants.[2] Besides the determination of business income, accounting serves a variety of important purposes which need not detain us here.

Granting the fact that a fair determination of income is the main purpose of accounting in a business firm, an accountant, in the process of determining income, relies on a set of generally accepted principles and postulates that he uses consistently over the years. These principles have emerged as a result of their usefulness and general acceptance by accountants and not as a result of a decree from a regulative body.[3] In general, it is desirable that income as determined by generally accepted accounting principles and income for tax purposes be as nearly the same as possible.[4] This is recognized in the tax laws of both the United States and Great Britain.[5]

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[1] Study Group on Business Income, Changing Concepts of Business Income (New York: The Macmillan Company, 1952), p. 19.

[2] Ibid., p. 19.

[3] For a discussion of principles of accounting, refer to H.A. Finney and H.E. Miller, Principles of Accounting: Intermediate (5th ed.; Englewood Cliffs, New Jersey: Prentice Hall Inc., 1958), pp. 165-185.

[4] Study Group on Business Income, op. cit., p. 69.

[5] Ibid., p. 69.

If one accepts the view that accounting income and tax income should coincide as closely as possible, then one expects that taxable income should be that income figure determined by the taxpayer's methods of keeping his books. The first "carefully" drawn Income Tax Law in the United States in 1918 "and all later laws provide that taxable business income shall normally be determined by the methods originally employed by the taxpayer in keeping his books and accounts."[1]

In 1918 the United States Congress adopted the following view of Section 212 (b) of the Act of 1918:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) in <u>accordance with the method of accounting regularly employed in keeping the books of such taxpayer</u>; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made <u>upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income</u>."[2]

This is not to mean that accounting income and taxable income are always the same in the United States. Differences do exist.

In Lebanon, the Income Tax Law specifies the deductions that can be made from gross earnings to reach the taxable income figure and specifies the items that are not considered as deductible. The law even specifies the end of the accounting

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[1]Study Group on Business Income, <u>op. cit</u>., pp. 37-38.

[2]<u>Ibid</u>., p. 38.

period of business firms which should be December 31st of each year. However, a business firm can apply to the Ministry of Finance for permission to close its books on a date other than December 31st. Such permission would be granted provided there is good reason for the request.

The Ministry of Finance Decree No. 2716 dated April 5, 1949, which was partly amended by Ministry of Finance Decree No. 74 on January 23, 1956, fixes the rates of depreciation to be applied to certain fixed assets regardless of the degree of utilization of those assets. Thus with respect to depreciation the law requires the use of straight-line depreciation and specifies the useful life of the asset.

In the United States, the Federal Income Tax Authorities publish a list showing the estimated useful lives of various assets but these are published for the guidance of the taxpayer and are not binding. The taxpayer is free to decide on a reasonable useful life which will take into consideration obsolescence.[1] The United States Federal Income Tax Law also gives the taxpayer the freedom to choose a method of depreciation from a number of depreciation methods specified in the law.[2]

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[1]Joseph P. Crockett, The Federal Tax System of the United States (New York: Columbia University Press, 1955), pp. 20-21.

[2]Commerce Clearing House, Inc., 1959 US Master Tax Guide (Chicago: 1958), p. 315.

In France, the taxpayer is also given some freedom in determining the useful life of an asset. Accelerated depreciation is allowed in France on some assets as specified by the French Income Tax Law. The French Law also takes into consideration changes in the value of money by allowing the taxpayer to multiply the book value of an asset by an index number appropriate to the year the asset was bought and spreading the revised book value over the remaining useful life of the asset provided the revised book value does not exceed the current market value of the asset.[1]

With respect to the cost of goods sold, the Lebanese Income Tax Law simply mentions that the cost of the goods sold is an allowed deduction from gross earnings and does not specify the method to be used in computing cost. A taxpayer may use any of the methods of determining cost of goods sold by adopting any of the familiar approaches to inventory costing such as the weighted average method, the first-in first-out method and the last-in first-out method.

It is apparent from the above that the Income Tax Law in Lebanon is rigid with respect to items such as depreciation. In view of the rigidity in some aspects of the Income Tax Law, differences are apt to arise between the accounting income

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[1]Walter H. Diamond, Digest of French Taxes and Business Organization (New York: Matthew Bender & Co. Inc., 1958), pp. 52-56.

figure and the taxable income figure and hence arise some accounting problems of determination of business income.

In Lebanon, a taxpayer has the right to object to the tax assessment, but he would have to pay the tax before he protests. According to one certified public accountant,[1] the procedure for recovering an excess tax payment is lengthy and it is unlikely that a taxpayer will get any adjustment of the original assessment. As a result, most taxpayers tend to pay the tax without raising any objection even if there is reason for one. Objections to the law are sometimes voiced by trade associations such as the Association of Lebanese Industrialists and sometimes by auditing firms.

Unfortunately, one does not find in Lebanon many court decisions with respect to income tax matters, since, in most of the cases, disputes are settled before they reach the courts. Thus, some provisions of the Income Tax Law remain vague and are interpreted differently by different people and by the income tax inspectors themselves. In the United States, in contrast,

> "the extensive evolution of accounting methods, the great number of court decisions and administrative rulings, and the amendments and modifications of the internal revenue laws since March 1, 1913, have combined to produce so great an accumulation of rules applicable to specific taxpayers, specific transactions, and specific circumstances ... ".[2]

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[1]The name of the certified public accountant cannot be disclosed.

[2]Crockett, <u>op. cit</u>., p. 63.

A word is now in order about dealings with the Income Tax Authorities of Lebanon. Working with income tax inspectors very often requires working from "under the table". Many income tax inspectors are bribed, and very often the taxpayer and the inspector arrive at a taxable income figure depending on personal considerations and on the benefits rendered to the inspector. As such, some auditing firms refuse to handle the tax matters of their clients whereas those same firms sometimes handle only tax matters of their clients in other Arab countries. Professor Benjamin Higgins in his report on the Fiscal Policy of Lebanon makes the following comment:

> "Informed estimates of the present extent of tax evasion run in the neighborhood of 66 2/3 %. The present writer's impression, on the basis of available figures and conversations with businessmen, is that this figure is on the conservative side. It also seems clear from these conversations that the extent of corruption among tax officials is very great indeed. The skimpy evidence available to me suggests that for many tax officials bribes received from taxpayers are a more important factor in their annual incomes than their official salaries. Several businessmen have told me that the bribes they pay exceed the income tax they pay."[1]

Recently, a proposal was submitted to the Lebanese Parliament to cancel the income tax. This was supported by Mr. Pierre Gemayyel, former Minister of Finance and Public Works, on the grounds that the Income Tax Machinery cannot

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[1]Benjamin Higgins, Financing Lebanese Development: A Report on Fiscal Policy (Beirut: Unpublished, 1960), p. 52.

be reformed.[1] The proposal stated that income tax should be replaced by indirect taxes whose yield, in the opinion of Gemayyel, will substantially exceed the yield from income tax. The income tax yield was about L.L.32 million in 1962.[2] It is not the purpose of this study to discuss a philosophy of taxation for Lebanon.

B. Some Features of the Income Tax System of Lebanon

The Lebanese income tax system is divided into three parts. The first part deals with the tax on the income of industrial, commercial and non-commercial occupations; the second part deals with the tax on salaries, wages, pensions, etc ... ; and the third part deals with the tax on income from movable capital.

1. The Tax on Income of Industrial, Commercial and Non-Commercial Occupations

The Income Tax Law distinguishes between income of industrial and commercial occupations and income of non-commercial occupations. The income of industrial and commercial occupations is subject to a progressive tax ranging between 5% and 42%, while the income of non-commercial occupations is subject to a progressive tax ranging between 4%

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[1]See Le Commerce du Levant, Nos. 919, 922 and 923 of July 6, 13 & 17 1963.

[2]Ibid., No. 922, p. 5.

and 37%.[1] A municipal tax of 10% of the income tax,[2] and a reconstruction tax of 3% of any income tax above L.L.1,000 are also levied.[3]

The income tax is assessed on "actual income" (that is, income determined by accounting records), on a "lump-sum" basis, or on the basis of "estimated profit".

Taxpayers who are required under the provisions of the Commercial Law to keep accounting records must declare to the Income Tax Authorities their "actual income" or their total gross revenue for the year if they are to be assessed on a "lump-sum" basis. In the latter case (that is, the "lump-sum" basis), the Income Tax Authorities will determine the taxable income by multiplying gross revenue by a rate applicable to each type of occupation.[4]

Some business enterprises such as partnerships, corporations, branches of foreign firms, factories, exporters,

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[1]Table 6 on page 40 shows the various income tax brackets and the rates to which they are subject.

[2]Legislative Decree No. 144, Article 33.

[3]Law of April 9, 1956, Article 12, and also Legislative Decree No. 15 dated January 30, 1959, Article 12.

[4]For a list of rates applied to the revenues of various occupations, refer to Ministry of Finance Decree No. 2149 dated December 14, 1957.

importers, retailers who employ more than four persons, and owners of drug stores are required to declare their "actual income".[1] Enterprises that are not required to declare their "actual income" may choose to declare their "actual income" but these enterprises may not revert in subsequent years to either the "lump-sum" or "estimated profit" method.

Assessees engaged in non-commercial occupations and that are not required to keep accounting records, must keep a journal wherein they record their daily revenue.[2] Assessees such as butchers, tailors and small grocers that cannot keep records of any sort, are assessed on the "estimated profit" basis.

The income tax is levied on the net income ascertained on the "actual income" or "lump-sum" basis after deducting for each natural person L.L.1,500, if a bachelor, L.L.2,400, if married and with no children, and L.L.3,000 if married and with children. A corporation does not enjoy any exemption. The tax on "estimated profit" is levied after deducting L.L.2,400 per assessee irrespective of his family status.

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[1]For a complete list of enterprises that are required to declare their "actual income" to the Income Tax Authorities, refer to Article 11 of Legislative Decree No. 144, dated June 12, 1959.

[2]Legislative Decree No. 144, Article 20.

2. The Tax on Salaries, Wages, Pensions, Etc ...

Salaries, wages and pensions are subject to a progressive tax ranging between 2% and 10%[1] after deducting L.L.1,500, L.L.2,400, or L.L.3,000 depending on the family status of the assessee. The income tax should be withheld at the source by the employer and remitted to the Income Tax Authorities once a year.

3. The Tax on Income from Movable Capital

Under income from movable capital, the Income Tax Law includes items such as income from investment in stocks, fees paid to stockholders for attending the general assemblies, appropriations made to the directors of a corporation, earnings distributed in the form of stock dividends, interest from bonds and loans and interest from bank deposits.[2] Capital gains such as gains on disposal of assets and appraisals of assets are considered income from movable capital.[3] Income from movable capital is subject to a flat income tax rate of 10%.[4]

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[1] For the various income tax brackets and the rates to which they are subject, refer to Article 58 of Legislative Decree No. 144.

[2] Legislative Decree No. 144, Article 69. Interest income resulting from the exercise of the occupation is subject to the tax on the income of commercial and non-commercial occupations.

[3] Legislative Decree No. 144, Article 45.

[4] *Ibid.*, Article 72.

It should be noted that the tax system of Lebanon imposes different taxes on the various sources of income. As an example, rent income is subject to the buildings tax and not to the income tax. So, if a business organization derives its income from rents and from trading operations, income from rents is subject to the buildings tax while income from trading operations is subject to the income tax. Article 8 of Legislative Decree No. 144 states that in case a revenue is subject to a tax other than the income tax, that revenue is an allowable deduction from gross earnings for income tax purposes.

C. The Scope and Limitations of the Study

This study is limited to a discussion of a few accounting problems of determination of business income in Lebanon. The most important problems discussed are the problem of depreciation of tangible fixed assets and the problem of treating key money on the books. Other problems are discussed as they are encountered.

The problem of depreciation of tangible fixed assets affects seriously industrial firms that own their factory buildings and equipment. If the discussion of this problem is more or less limited to industrial firms throughout this study, it is because these firms, more than others, experience problems of determination of business income with respect to depreciation. The problem is not as significant for a trading

firm which typically owns very little depreciable assets. Some service enterprises meet a problem of depreciation and among these enterprises are refrigerated warehouses that face a problem of depreciation with respect to the refrigerating system and installation.

The problem of key money to be discussed is common to firms in practically all sectors of the economy especially to those firms conducting their operations in the commercial centers.

The information needed for this study was mostly derived from the laws of Lebanon and from interviews with officials in the Ministry of Finance and with auditing firms. Interviews with business firms besides the Société des Ciments Libanais were not attempted since in a country like Lebanon, officials of firms would look suspiciously at the interviewer and would refuse to give information. The type of information needed for this study has a bearing on financial statements and on the filing of income tax returns which are kept in the utmost degree of secrecy. The Société des Ciments Libanais was interviewed because it feels the impact of the problem of depreciation most seriously. A case study of the Société des Ciments Libanais is conducted illustrating the problem met by that firm. The problems faced by other firms are probably similar in nature.

D. Definition of Terms

Business Income throughout this study refers to the income of profit-seeking firms determined in accordance with generally accepted accounting principles and postulates. Business Income, Accounting Income and Actual Income are used interchangeably throughout this study. Business Income is obtained by deducting from gross earnings the cost of goods sold and operating expenses determined by accepted accounting principles and adding or deducting other income or expense such as interest, rent and the like.

Taxable Income, Income per Tax Return, or Tax Income throughout this study refers to the income figure recognized for tax purposes. Taxable income is obtained by deducting from gross earnings the cost of goods sold and operating expenses recognized for tax purposes in accordance with the provisions of the Income Tax Law and adding or deducting other items of income or expense as recognized by the law.

Business Income and Taxable Income might be the same figure if the methods and procedures used by a taxpayer in keeping his books are acceptable to the Income Tax Authorities.

CHAPTER II

PROBLEMS OF DEPRECIATION OF TANGIBLE FIXED ASSETS

A. Depreciation Practices and Problems in Lebanon

In determining taxable income, the Income Tax Laws of December 4, 1944, and of June 12, 1959, allow for the deduction from gross earnings in addition to other deductible charges and expenses the following: (1) the rent of the premises wherein the business is conducted or its rental value if owned by the assessee; and (2) the customary depreciation provisions on fixed assets according to the usages of the trade, industry, occupation or business in question. The rates and terms of such depreciation are set out in a decree issued by the Minister of Finance.[1]

1. Rental Value as a Deduction from Gross Earnings

Business firms that rent their place of business have no problem in determining their taxable income with respect to the above items. These firms will deduct from

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[1]Legislative Decree No. 144, Article 7, and also Income Tax Law of December 4, 1944, Article 7.

their gross earnings the rent they pay as evidenced by receipts or by the rent contract and will also deduct the depreciation acceptable for tax purposes on their fixed assets. Business firms that own their place of business will deduct from their gross earnings the rental value of their place of business <u>in lieu</u> of depreciation on the building and will also deduct the depreciation acceptable for tax purposes.[1] But complications arise when one explores the concept of rental value and its implications.

The rental value of the place of business is determined by the Department of Built Property in the Ministry of Finance. The rental value so determined is then subject to the Buildings Tax Law (Legislative Decree No. 145 dated June 12, 1959) at a flat rate of 1/12 (that is, 8 1/3 %). A municipal tax not exceeding 3% of the rental value is added to the buildings tax,[2] and a reconstruction tax of 3% of the buildings tax in excess of L.L.1,000[3] is also levied. Hence the rental value of the place of business is subject to a total tax of about

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[1]Depreciation rates acceptable for tax purposes are discussed later in this chapter.

[2]Legislative Decree No. 145, Articles 8 and 9. The municipal tax rate is determined by the municipal council of every district, and in almost all districts it is equal to 3%. According to the Buildings Tax Law of September 17, 1962, which came into effect on January 1, 1963, the municipal tax is equal to 3% of the buildings tax.

[3]Law of April 9, 1956, Article 12, and also Legislative Decree No. 15 dated January 30, 1959, Article 12.

11.58%. Thus, although rental value is a deductible charge for the purpose of calculating the taxable income of a business firm, it is considered as a revenue from built property for the same firm subject to the Buildings Tax Law. The buildings tax will have to be paid regardless of the amount of income earned by a business firm in a particular year.

According to Article 21 of Legislative Decree No. 145, the rental value of the place of business should include, in addition to the rental value of the building proper, the rental value of equipment and machinery that are considered by law as "Immeuble par destination"[1] (to be identified in this study as "Immovables by design").[2] Article 3 of the Law of Real Property issued by means of Decree No. 3339 dated November 12, 1930, defines immovables by design in industrial firms as movable property fixed permanently in the building, spare parts and all equipment including trucks, wagons and horses provided the building is specially constructed to accomodate the equipment and installations. Immovables by design exclude all types of furniture.

Although Decree No. 3339 is still presently in force, the Department of Built Property in the Ministry of Finance does not consider all the elements listed in the decree in

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[1]Legislative Decree No. 145, Article 21.

[2]The Arabic term is عقارات بالتخصيص.

determining the immovables by design of a business firm and hence the rental value of the place of business.[1] According to the Director of the Department of Built Property in the Ministry of Finance,[2] immovables by design include only machinery and equipment that are installed permanently in the building and the removal of which would destroy that part of the building to which they are fixed such as an oven in a cement factory or a bakery, a central heating system and a central air conditioning system. He further admitted that it is really difficult to give a clear cut definition of immovables by design. In the case of a firm that sells concrete mix, immovables by design include delivery trucks that transport the cement mix to construction sites on the grounds that the trucks are equipped with a cement mixer and are considered complimentary to the structures used for the operations of the firm.

Four out of the five auditing firms interviewed for the purpose of this study were unaware of Decree No. 3339 and of the complexities in determining rental value. The one auditing firm aware of the decree does not handle the tax matters of its clients, while the other four firms simply take the figure of rental value determined by the Department

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[1]Interview with Mr. Mohammad Ali al-Ahdab, Director of the Department of Built Property in the Ministry of Finance, on July 13, 1963.

[2]Mr. Mohammad Ali al-Ahdab.

of Built Property for granted in preparing the tax returns of their clients.

The rental value of the place of business is determined for a period of 5 years unless there is reason to recompute the rental value due to additions in plant and equipment and the like.[1] The rental value of the place of business should bear no relationship to the cost of the property. Where difficulties arise in estimating rental value, such value is considered to be equal to at least 5% of the cost of the property.[2]

Once the rental value of the place of business is determined by the Department of Built Property in the Ministry of Finance, then the figure so determined is an allowable deduction from gross earnings in determining the taxable income figure. An auditing firm has reported that in the case of a flour mill, the income tax inspector has refused to accept the rental value as a deduction from gross earnings.

2. Depreciation Allowances for Tax Purposes

As mentioned earlier, business firms are allowed to deduct from their gross earnings the depreciation on fixed

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[1] Legislative Decree No. 145, Article 23.

[2] Buildings Tax Law of September 17, 1962, Article 36.

assets according to the usages of the various kinds of trade, industry, occupation or business as determined by a decree from the Minister of Finance. Ministry of Finance Decree No. 2716 dated April 5, 1949, provided the first schedule of depreciation rates recognized for tax purposes. These rates are still in force but some of them were amended and others added per Decree No. 74 dated January 23, 1956, issued by the Ministry of Finance. It should be noted that the Minister of Finance did not publish a new schedule of depreciation rates according to the provisions of Article 7 of Legislative Decree No. 144 dated June 12, 1959.

Table 1 on page 21 shows the schedule of depreciation rates currently recognized for tax purposes. The schedule does not provide for depreciation on buildings since rental value of the place of business is deducted from gross earnings _in lieu_ thereof. Depreciation rates on assets not shown in the schedule are reckoned by comparison with rates on assets of a similar nature.[1] It should be noted that the depreciation rates allowed are uniform for all types of industries contrary to the provisions of the Income Tax Law which states that the depreciation rates should be in accordance with the usages of the various kinds of trade, industry, occupation or business.

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[1]Ministry of Finance Decree No. 2716, Article 3.

TABLE 1

DEPRECIATION RATES RECOGNIZED FOR TAX PURPOSES

Item	Percent
Factories, Workshops and Means of Transport	
Dams, water supply installations, reservoirs, tunnels, aqueducts	2
Pressure pipes	2
Thermal combinations (Diesel)	6
Vapour thermal combinations	6
Boilers	6
Water turbines	4
Electric transformers	4
Electric equipment, high and low tension tools and electric boards and meters	5
Overhead electric lines on metal poles	2
Overhead electric lines on insulated wooden poles	4
Tool machines	8
Electrical machines (Dynamos, generators and motors)	7
Fixed water equipment (Taps and valves)	2
Underground electric cables	3
Pumps run by electric motors	5
Supporting bridges	2
Motor cars and bicycles	12
Aeroplanes	25
Means of iron traction and electric tramcars	5
Vessels and boats	5
Motors and electric machines	10
Sewing machines	7½
Spinning and weaving machines	7½
Machines used in chemical plants	7½
Machines and other materials	5
Barrels, bottles and cases	Re-evaluation
Printing Presses	
Letters and accessories (stereotype)	20
Printing machines and spare parts	7½

(Continued on page 22)

TABLE 1 (Cont'd)

	Percent
Hotels, Restaurants and Cafés	
Furniture and silverware	10
Linen ware (sheets and kerchiefs)	20
Cinema Halls, Theatres and Places of Entertainment	
Projection apparatus	15
Furniture	10
Offices and Shops	
Furniture	7½
Typewriters	10

Source: Ministry of Finance Decree No. 2716 dated April 5, 1949, Article 1, as amended by Ministry of Finance Decree No. 74 dated January 23, 1956.

It is clear from the schedule of depreciation rates shown in Table 1 that the Income Tax Authorities require the use of the straight-line method of depreciation and limit the minimum useful lives of the assets being depreciated. A business firm may decide on a useful life longer than the one suggested for a particular asset, but may not write-off the cost of an asset over a period shorter than the one fixed as minimum. Hence the depreciation rates allowed do not take into consideration the degree of utilization of the fixed assets. A firm that operates its machinery for 24 hours a day

is allowed the same depreciation deduction as a firm that operates similar machinery for 8 hours a day. This creates a problem of matching revenues and costs. The inadequacy of the depreciation charges overstates the income of business firms, implies a greater tax burden than is actually due, and overstates the book value of assets on financial statements.

According to the Director of the Income Tax Department,[1] the depreciation rates allowed for tax purposes are for an 8-hour work period and that higher rates are allowed if the business firm works more than one shift per day. Such higher rates would be determined by a committee appointed by a decree issued by the Minister of Finance. The income tax inspectors interviewed asserted that the depreciation rates allowed by law are for one year regardless of the hours of work since it is not possible to determine the hours worked every day in business firms. This was also the view of officials of auditing firms interviewed. The Société des Ciments Libanais which works for 24 hours a day is not allowed higher rates.[2]

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[1]Interview with Mr. George Badr, Director of the Income Tax Department in the Ministry of Finance, on July 12, 1963.

[2]Interview with Mr. Rudolph Klat, Administrative Manager of the Société des Ciments Libanais, on August 23, 1963.

The limitation of the minimum useful life of assets is not the only problem of determination of business income. The requirement of adopting the straight-line method of depreciation creates a further problem. A business firm may wish to use any of the other familiar methods of depreciation such as the sum-of-years' digits method. On the assumption that the maintenance expense of an asset increases as the asset becomes older, the depreciation methods which produce a decreasing depreciation charge tend to even out the total charge in connection with an asset over the years of useful life. Unfortunately, this refinement is not allowed in Lebanon.

Article 2 of the Ministry of Finance Decree No. 2716 dated April 5, 1949, allows the use of other methods of depreciation provided the results thereof are not different from the results obtained from straight-line depreciation. The writer is unable to think of a method of depreciation that gives the same results as the straight-line method of depreciation and that is not called the straight-line method of depreciation.

In case a fixed asset wears out before the expiration of the minimum useful life assigned to it and the asset is written-off the books, the undepreciated cost of the asset may be considered as a loss deductible for income tax purposes

if the taxpayer can convince the income tax inspector that the asset cannot be used any further. Alternatively, the asset can be sold as scrap and the loss (that is, the difference between the proceeds and the book value of the asset at the date of sale) is a deductible charge for income tax purposes. The problem of discrepancy between residual value and book value can arise irrespective of income tax considerations. However, when the Income Tax Law is rigid as to depreciation rates and useful lives of assets, there is a greater likelihood for such a discrepancy to appear so that the principle of proper matching of revenues and costs is thereby impaired.

In an attempt to prepare more meaningful and useful financial statements, a business firm may record the depreciation on its fixed assets in accordance with generally accepted accounting principles and prepare its income tax returns in accordance with the provisions of the Income Tax Law. As a result of such a procedure, the income per books might differ from the income per tax return with the result that the income tax paid (or the income tax liability) might bear no relationship to the income before tax determined by accepted accounting principles.

The problem that faces the accountant in this respect is whether something should be done to reconcile the distortion that is created between the income tax expense that should match the income before tax and the income tax paid (or the

income tax liability) according to the provisions of the Income Tax Law. This kind of distortion can be corrected by income tax allocation procedures. The purpose of income tax allocation is to show as expense the amount of tax that would be payable if the accounting method used in the books had been accepted for tax purposes rather than the amount of tax actually payable. Income tax allocation is advocated by accountants who base their arguments on the principle of proper matching of revenues and expenses.

The application of income tax allocation is a vexatious problem especially in Lebanon where the income tax rates are progressive and where the Income Tax Law fixes the minimum useful life of assets and does not allow for the deduction of some items of expense, such as depreciation on buildings, from gross earnings.[1]

3. Rental Value and Depreciation on the Same Asset

It was stated previously that a business firm is permitted to deduct from its gross earnings the rental value of equipment considered by law as immovables by design as determined by the Department of Built Property in the Ministry of Finance. The Income Tax Law also allows the deduction of depreciation on fixed assets in general, other than land and

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[1]For a discussion of income tax allocation procedures and of the problems involved in the application of income tax allocation, refer to Finney and Miller, <u>op. cit</u>., pp. 602-622.

buildings, and does not make any exclusion of such assets considered as immovables by design and whose rental value would have been deducted in determining taxable income. Hence it is apparent that the Income Tax Law allows a business firm a double deduction for the same asset if the asset forms part of the immovables by design: one in the form of rental value and the other in the form of depreciation. In view of this double deduction, business firms do not complain of the inadequacy of the depreciation allowances sanctioned by law. The rental value of equipment more than covers the deficiency in the allowed depreciation charges.

According to the Director of the Income Tax Department in the Ministry of Finance,[1] double deduction is not permitted. In his opinion, if rental value includes the rental value of fixed assets other than the building, no depreciation can be deducted on those assets. This was also the view of some income tax inspectors. Other income tax inspectors said that they cannot tell whether double deduction is practiced since the rental value figure is determined by the Department of Built Property and hence there is no way of knowing what rental value means.

Members of the auditing firms interviewed stated that no double deduction is permitted. However, it seems that, double deduction is in fact practiced. This is evidenced

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[1]Mr. George Badr.

by a letter from the Association of Lebanese Industrialists[1] to the Ministry of Finance and by an interview with the Société des Ciments Libanais. Auditing firms consider the rental value of the place of business as a deduction from gross earnings in preparing the tax returns of their clients without any investigation from their part as to its determination and content.

The Director of the Department of Built Property[2] expressed the view that the Income Tax Law does not specifically preclude double deduction. He however admitted that double deduction is practiced and that this was one of the main reasons for enacting the Buildings Tax Law of September 17, 1962, which does not allow the deduction of rental value from gross earnings.

The conslusion that can be drawn is that the Income Tax Law is interpreted differently by different people with regard to double deduction. The absence of court decisions in this respect leaves this issue unsettled.

In view of the unsettled issue of double deduction, an accountant meets a problem in determining the income tax liability and hence net income. The determination of the

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[1]The letter of the Association of Lebanese Industrialists is discussed in part B of this chapter.

[2]Mr. Mohammad Ali al-Ahdab.

income tax liability depends on the income tax inspector's interpretation of the Income Tax Law. What is acceptable to one income tax inspector might not be acceptable to another income tax inspector the following year.[1] The problem is made more pronounced when the income tax inspector exercises his right in reviewing the income tax returns of a business firm for the preceding five years, and hence assessing additional taxes or considering excess tax payments as an offset to the current year's tax liability. Such additional tax payments or offsets should be considered as corrections of prior years' earnings and not an adjustment of the income tax expense of the current year.

4. Problem of Price Level Changes

One of the major problems of determination of business income that faces the accountant in a period of rising prices is whether he should take into consideration the change in the price level of fixed assets in recording the depreciation charge. Such a procedure is advocated by some accountants on the grounds that it achieves a closer matching of current revenues with current costs.

As machinery are mainly imported into Lebanon from the United States and Western Europe, the price level changes

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[1]The income tax inspector of a business firm does not have to be the same every year.

in the United States and in selected countries of Western Europe, namely, Germany, the United Kingdom, France and Italy will be discussed to determine whether the accountant in Lebanon meets a problem of price level changes. Table 2 on page 31 shows the export price indexes of the United States, Germany, the United Kingdom, France and Italy for the period 1953 to 1962.

The following data derived from Table 2 show the percentage increase (decrease) in export prices in the United States, Germany, the United Kingdom, France and Italy for the period 1953 to 1962:

Country	Percentage Increase (Decrease)
United States	9.57
Germany	6.12
United Kingdom	10.68
France	(6.80)
Italy	(15.45)

The export price index includes exports of all commodities and does not reveal changes in the prices of machinery with which we are concerned. Changes in the prices of machinery can be obtained by analyzing the price index of machinery for each of the above-mentioned countries. Unfortunately, price indexes of machinery are not readily available for Germany, the United Kingdom, France and Italy. Hence the discussion will be limited to the United States.

TABLE 2

EXPORT PRICE INDEXES OF SELECTED COUNTRIES

FOR THE PERIOD 1953 TO 1962

(1958 = 100)

YEAR	U.S.	GERMANY	U.K.	FRANCE	ITALY
1953	94	98	92	103	110
1955	94	96	93	98	104
1956	97	98	96	102	101
1957	100	101	101	103	105
1959	100	98	99	93	92
1960	101	99	101	97	96
1961	103	104	102	96	92
1962	103	104	103	96	92

Source: International Monetary Fund, International Financial Statistics (Washington: Volume XVI, No. 8, August 1963), p. 30.

TABLE 3

WHOLESALE PRICE INDEXES OF MACHINERY
IN THE UNITED STATES
FOR THE PERIOD
1954 TO 1962
(1957-1959 = 100)

YEAR	INDEX
1954	83.2
1955	85.8
1956	92.1
1957	97.7
1958	100.1
1959	102.2
1960	102.4
1961	102.3
1962	102.3

Source: Federal Reserve System, *Federal Reserve Bulletin* (Washington: Volume XLIX, No. 7, July 1963), p. 1000.

Table 3 on page 32 shows the wholesale price index of machinery in the United States for the period 1954 to 1962. The table shows that for the period 1954 to 1962, the index increased by 22.96%. For the period 1954 to 1957, the increase was 17.43%, while for the period 1958 to 1962, the increase was only 2.20%. Hence it is apparent that the wholesale prices of machinery were more or less stable for the period 1958 to 1962.

The increase in the price level of machinery in the United States has to be compared with the change in the dollar exchange rates in Lebanon to determine whether the increase in the price level has been accentuated by an increase in the exchange rate or has been offset by a decrease in the exchange rate. Table 4 on page 34 shows the average dollar exchange rates in Lebanon for the period 1954 to 1962.[1]

Table 4 shows that for the period 1954 to 1962, the dollar exchange rate in Lebanon has decreased by 5.56% which means that the exchange rate for that period has moved in favour of importers in Lebanon. The decrease was 2.47% for the period 1954 to 1957 and 3.16% for the period 1958 to 1962. This latter figure has to be compared with the 2.20% increase in the wholesale prices of machinery in the United States for the period 1958 to 1962.

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[1]The average dollar exchange rates for 1952 and 1953 were L.L.3.57 and L.L.3.19 respectively. These are excluded from Table 4 because they are abnormal.

TABLE 4

AVERAGE DOLLAR EXCHANGE RATES IN LEBANON
FOR THE PERIOD 1954 TO 1962

YEAR	RATE
1954	L.L.3.24
1955	3.25
1956	3.20
1957	3.16
1958	3.16
1959	3.16
1960	3.15
1961	3.02
1962	3.06

Source: International Financial Statistics, August 1963, pp. 176-177.

Thus, it seems that for the period 1958 to 1962, the decrease in the dollar exchange rate has more than offset the increase in the prices of machinery in the United States. A look at Table 2 on page 31 shows that for the period 1959 to 1962, the export price indexes of Germany, the United Kingdom, France and Italy increased as follows:

Country	Percentage Increase
Germany	6.12
United Kingdom	4.04
France	3.24
Italy	1.09

The conclusion that can be derived is that in Lebanon the problem of price level changes with respect to the accounting for the depreciation of machinery and equipment has been a mild one. Hence, there is no pressing need for the adjustment of depreciation charges in relation to price level changes.

The Commercial Law of Lebanon requires all corporations to appropriate 10% of their annual earnings as a legal reserve until that reserve amounts to one-third of the authorized capital.[1] This legal reserve might be more than adequate to provide for the replacement of fixed assets in a period of rising prices.

A business firm in Lebanon may appraise its fixed assets once every ten years.[2] The unrealized increment in the value of fixed assets is subject to the tax on income from movable capital at the rate of 10% unless the business

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[1]Legislative Decree No. 304, dated December 24, 1942, Article 165.

[2]Legislative Decree No. 144, Article 45.

firm can prove to the income tax inspector that the gain was reinvested in the enterprise within three years.[1] The reinvestment of an unrealized increment in the value of assets in the business is absurd. The law probably means that such a gain should not be available for dividends to qualify for exemption from the tax. Once an asset is appraised, subsequent depreciation will be based on the appraised value.[2]

The writing up of fixed assets to their appraised values is a departure from generally accepted accounting principles. In 1940, the Committee on Accounting Procedure of the American Institute of Accountants issued Accounting Research Bulletin No. 5 which contains the following statement: "Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient."[3]

The issue whether fixed assets should be written up to their appraised value is a controversial issue and is not peculiar to Lebanon. Business firms that fall in income tax brackets subject to an income tax rate above 10% benefit from appraisals although the appraisal increment may be taxed at 10% for they will be enjoying a greater deduction for depreciation.

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[1]Legislative Decree No. 144, Article 45.

[2]For a discussion of the accounting treatment of appraisals, refer to Finney and Miller, _op. cit._, pp. 389-396.

[3]_Ibid._, p. 127.

B. Problems Arising from the Buildings Tax Law of September 17, 1962

On September 17, 1962, a new Buildings Tax Law was enacted repealing Legislative Decree No. 145 dated June 12, 1959. The new law came into effect as of January 1, 1963.

1. Some Provisions of the Buildings Tax Law of September 17, 1962

According to the Buildings Tax Law of September 17, 1962, income[1] from built property is made subject to a proportional tax of 8% and to a progressive tax ranging from 3% to 15% as shown in Table 5 on page 38. In addition to the buildings tax, a municipal tax equal to 3% of taxable income and to 10% of the progressive tax is levied. The progressive tax is reduced by 25% to all corporations and does not apply to public bodies and to non-profit organizations.[2] Previously, according to Legislative Decree No. 145, the buildings tax was 8 1/3 % of taxable income. The new Buildings Tax Law states that rental value is estimated for a period of 3 years instead of 5.

Article 7 of the new Buildings Tax Law exempts business firms that own their place of business and that are assessed on their "actual income" according to the provisions of the Income Tax Law from the buildings tax.

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[1]For the determination of taxable income refer to Articles 24 through 29 of the Buildings Tax Law of September 17,1962

[2]Buildings Tax Law of September 17, 1962, Article 56.

TABLE 5

PROGRESSIVE TAX RATES ON INCOME FROM BUILDINGS

EFFECTIVE JANUARY 1, 1963

Income Bracket	Percent
Over L.L. 20,000 and up to L.L. 50,000	3
Over L.L. 50,000 and up to L.L.100,000	5
Over L.L.100,000 and up to L.L.200,000	8
Over L.L.200,000 and up to L.L.400,000	11
Over L.L.400,000	15

Source: Buildings Tax Law of September 17, 1962, Article 56.

Article 7 further states that business firms assessed on their "actual income" for the purpose of the income tax are not permitted to deduct from their gross earnings the rental value of the place of business they occupy. This contradicts Article 7 of the Income Tax Law which allows a business firm to deduct from its gross earnings the rental value of its place of business in determining taxable income.

Hence, according to the provisions of the new Buildings Tax Law, the rental value of the place of business is made subject to the income and not to the buildings tax.

2. Impact of the Buildings Tax Law of September 17, 1962, on Business Firms

Subjecting the rental value of the place of business to the income tax instead of the buildings tax has varying financial effects on various business firms. Business firms that rent their place of business are not affected by the new law. The rent they pay is still an approved deduction from their gross earnings for income tax purposes. Business firms that own their place of business are affected in different manners: some firms stand to gain and others stand to lose depending on the income tax bracket into which they fall.

Business firms that own their place of business were supposed to pay the buildings tax according to Legislative Decree No. 145 regardless of the income they earned. According to the new Buildings Tax Law, firms that are incurring losses do not have to pay any income tax whereas previously these firms were supposed to pay the buildings tax. These firms stand to gain from the provisions of the new Buildings Tax Law. Also, business firms that are in income tax brackets subject to a rate lower than the old buildings tax rate stand to gain from the new law; these firms will now pay a lower rate on their rental value than what they would have to pay under Legislative Decree No. 145. Business firms that are

in income tax brackets higher than the old buildings tax rate stand to lose, for these firms would now have to subject their rental value to a rate higher than the old buildings tax rate. Table 6 below shows the various income tax brackets and their corresponding rates.

TABLE 6

INCOME TAX RATES ON COMMERCIAL AND NON-COMMERCIAL OCCUPATIONS

Income Bracket	Commercial Occupations	Non-Commercial Occupations
Below LL. 5,000	5%	4%
Over LL. 5,000 and up to LL. 15,000	7	5
Over LL. 15,000 and up to LL. 25,000	9	7
Over LL. 25,000 and up to LL. 35,000	13	10
Over LL. 35,000 and up to LL. 50,000	17	13
Over LL. 50,000 and up to LL. 75,000	22	17
Over LL. 75,000 and up to LL.100,000	27	22
Over LL.100,000 and up to LL.250,000	32	27
Over LL.250,000 and up to LL.750,000	37	32
Over LL.750,000	42	37

Source: Legislative Decree No. 144, dated June 12, 1959, Article 32.

Before the Buildings Tax Law of September 17, 1962, was enacted, business firms that had their equipment fully depreciated but still in use were allowed to deduct the rental value of their equipment from gross earnings. According to the new Buildings Tax Law, these firms do not enjoy this privilige any more.

The following two illustrations show the impact of the new Buildings Tax Law on incorporated business firms of various income tax brackets. The illustrations exclude the municipal tax and the reconstruction tax which would have to be paid in addition to the buildings tax and income tax.

Illustration 1

Assume an industrial firm with an income figure of L.L.15,000 before deducting rental value and with a rental value figure of L.L.5,000. The income tax and the buildings tax which the firm would have to pay under the old Buildings Tax Law (Legislative Decree No. 145) and under the new Buildings Tax Law of September 17, 1962, are as follows:

Amount of Tax under the Old Buildings Tax Law:

Net Income before deducting rental value			L.L.15,000
Rental Value			5,000
Taxable Income			L.L.10,000
Income Tax:	L.L.5,000 @ 5%	L.L.250	
	5,000 @ 7%	350	
Total Income Tax			L.L. 600
Buildings Tax:	L.L.5,000 @ 8 1/3 %		416 approx.
Total Tax			L.L. 1,016

Amount of Tax under the New Buildings Tax Law:

Net Income (equal to the taxable income since rental value is not an allowed deduction)			L.L.15,000
Income Tax:	L.L.5,000 @ 5%	L.L.250	
	10,000 @ 7%	700	
Total Income Tax			L.L. 950
Buildings Tax			0
Total Tax			L.L. 950

The first illustration shows that for a firm that falls in an income tax bracket subject to a rate lower than the rate paid on the rental value (that is, a firm with

earnings below L.L.15,000), the total tax burden under the new Buildings Tax Law is less than the total tax burden under the old Buildings Tax Law. In the illustration, the rental value is subject to 7% instead of 8 1/3 %.

Illustration 2

Assume an industrial firm with an income figure of L.L.50,000 before deducting rental value and with a rental value figure of L.L.15,000. The income tax and the buildings tax which the firm would have to pay under the old Buildings Tax Law (Legislative Decree No. 145) and under the new Buildings Tax Law of September 17, 1962, are as follows:

Amount of Tax under the Old Buildings Tax Law:

Net Income before deducting rental value			L.L.50,000
Rental Value			15,000
Taxable Income			L.L.35,000
Income Tax:	L.L. 5,000 @ 5%	L.L. 250	
	10,000 @ 7%	700	
	10,000 @ 9%	900	
	10,000 @ 13%	1,300	
Total Income Tax			L.L. 3,150
Buildings Tax:	L.L.15,000 @ 8 1/3 %		1,250
Total Tax			L.L. 4,400

Amount of Tax under the New Buildings Tax Law:

Net Income (equal to the taxable income since rental value is not an allowed deduction)			L.L.50,000
Income Tax:	L.L. 5,000 @ 5%	L.L. 250	
	10,000 @ 7%	700	
	10,000 @ 9%	900	
	10,000 @ 13%	1,300	
	15,000 @ 17%	2,550	
Total Income Tax			L.L. 5,700
Buildings Tax			0
Total Tax			L.L. 5,700

The second illustration shows that for a firm that falls in an income tax bracket subject to a rate higher than the rate paid on the rental value (that is, a firm with earnings exceeding L.L.15,000), the total tax burden under the new Buildings Tax Law is greater than the total tax burden under the old Buildings Tax Law. In the illustration, the rental value is subject to 17% instead of 8 1/3 %.

3. The Reaction of Business Firms

Industrial firms that are in the high income tax brackets and that own considerable immovables by design were

the first to object to the Buildings Tax Law of September 17, 1962. While the draft of the law was still being discussed in the House of Parliament, these firms drew the attention of the Association of Lebanese Industrialists to the impact of the change on their firms. These firms also complained of inadequate depreciation allowances and said that the deduction of rental value from gross earnings covered the inadequacy of the depreciation charges. They asked the Association of Lebanese Industrialists to raise the matter to officials in the Ministry of Finance.[1]

On September 18, 1962,[2] the Association of Lebanese Industrialists wrote a letter to the Ministry of Finance presenting the case of the industrialists. The letter of the Association of Lebanese Industrialists stated that Legislative Decree No. 144 allows firms that own their place of business including immovables by design to deduct from their gross earnings the rental value of their place of business and depreciation on their assets thus permitting double deduction. The letter further stated that the proposed law contradicts the provisions of Article 8 of Legislative

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[1]Files of the Association of Lebanese Industrialists.

[2]The date of the letter by coincidence fell a day after September 17, 1962, the date of the enactment of the new Buildings Tax Law. The letter was written before the law was enacted.

Decree No. 144 which states that in case a revenue (such as rental value) is subject to a tax other than the income tax, that revenue is an allowable deduction from gross earnings for income tax purposes. The letter further requested that steps be taken to raise the depreciation rates and make them more flexible in order to encourage investment.

Unfortunately, the Ministry of Finance did not answer the letter of the Association of Lebanese Industrialists. It seems that the Ministry of Finance does not intend to introduce changes in the Income Tax Law. The only change that is expected is the allowance of a depreciation deduction on buildings. According to the Director of the Income Tax Department,[1] allowance for depreciation on buildings will have to be studied and added to the list of depreciation rates recognized for tax purposes.

The Executive Secretary of the Association of Lebanese Industrialists[2] said that the Association will not follow up the matter since the proposed Buildings Tax Law was enacted and there is no point in arguing against a law. He further added that he expects some changes in the Income Tax Law especially with regard to depreciation allowances.

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[1]Mr. George Badr.

[2]Interview with Mr. Marwan Nasr, Executive Secretary of the Association of Lebanese Industrialists, on August 30, 1963.

C. A Case Study of the Société des Ciments Libanais

The case of the Société des Ciments Libanais illustrates the problem resulting from the enactment of the Buildings Tax Law of September 17, 1962, faced by industrial firms that own considerable immovables by design and that are in the high income tax brackets.

The SCL is one of the biggest industrial concerns in Lebanon. For the period 1931 to 1954 it was the only producer of cement in Lebanon. In 1955 another cement factory was established, and in 1962, the SCL produced 619,427 tons of cement out of a total of 870,678 tons,[1] that is 71.15% of the output of the industry.

The SCL falls in the highest income tax bracket. The net income figures earned for the years ending September 30, 1961, and September 30, 1962, were L.L.4,607,544.73 and L.L.4,756,708.23 respectively.[2] According to the Administrative Manager of the SCL,[3] the SCL is the biggest taxpayer in Lebanon. The income tax provisions on the Balance Sheets of the SCL

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[1]Peter Graf, The Cement Industry in Lebanon (Beirut: Unpublished Thesis Presented to the Faculty of the Beirut Management College, 1963), p. 19.

[2]Financial Statements of the SCL for the years ending September 30, 1961, and September 30, 1962.

[3]Interview with Mr. Rudolph Klat, Administrative Manager of the SCL, on August 23, 1963.

as of September 30, 1961, and September 30, 1962, amount to L.L.3,094,033.32 and L.L.2,947,404.00 respectively.[1] The total income tax revenue for the years 1961 and 1962 amounted to L.L.27,480,956 and L.L.31,682,268 respectively.[2] Hence, it is apparent that the SCL pays around 10% of the income tax of Lebanon. The break-down of the income tax revenue by sources as discussed in part B of Chapter I is not available. The Administrative Manager of the SCL said that the SCL pays about one-sixth of the income tax from commercial, industrial and non-commercial occupations.

The buildings and immovables by design owned by the SCL have an estimated rental value of L.L.1,500,000,[3] and its depreciation deductions for the years ending September 30, 1961, and September 30, 1962, amounted to a total of approximately L.L.5,200,000. The exact depreciation figures are not available for each year but may be estimated by analyzing the financial statements of the company.

The SCL operates its machinery and equipment for 24 hours a day, and as a result, the actual useful life of some of its assets is less than the minimum useful life assigned

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[1] Financial Statements of the SCL for the years ending September 30, 1961, and September 30, 1962.

[2] Le Commerce du Levant, No. 922, dated July 13, 1963, p. 5.

[3] Interview with Mr. Rudolph Klat on August 23, 1963.

to them by law. The company follows the practice of deducting the legal depreciation on its machinery and equipment till the depreciation deductions cover the original cost. This means that part of the yearly depreciation deductions is for assets that are not in use. This procedure results in erroneous depreciation charges and hence in overstatements and understatements of net income. The Administrative Manager of the SCL does not worry about this situation for he said that since the company makes a net income figure of about L.L.4 million above the L.L.750,000 starting figure for the 42%[1] income tax bracket, its earnings can decline by L.L.4 million before it drops below the highest income tax bracket. So a depreciation allowance of 15% or 10% on the same asset will not change the income tax bracket of the company and hence the total tax burden will be the same over the years unless the Income Tax Law is changed. The writer suggested to the Administrative Manager of the SCL that the SCL depreciate its assets in accordance with accepted accounting principles and resort to income tax allocation in order to match the income tax expense with the net income before tax, but it seems that as long as the ultimate tax burden is the same, the SCL does not worry about this problem. In the case of some other business firms, the depreciation rate will determine, in part at least, the income tax bracket into which those firms will fall.

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[1]Refer to Table 6 on page 40.

However, the Buildings Tax Law of September 17, 1962, which does not allow the deduction of rental value from gross earnings creates a serious problem to the SCL. This involves an additional yearly tax burden of about L.L.538,180 as computed below:

Tax Paid on Rental Value According to Legislative Decree No. 145:

Buildings Tax:	L.L.1,500,000	@ 8 1/3%	L.L.125,000
Municipal Tax:	1,500,000	@ 3%	45,000
Reconstruction Tax:	(125,000-1,000)	@ 3%	3,720
Total Tax			L.L.173,720

Tax Paid on Rental Value When it Is Not Deductible for Income Tax Purposes:

Income Tax:	L.L.1,500,000	@ 42%	L.L.630,000
Municipal Tax:	630,000	@ 10%	63,000
Reconstruction Tax:	630,000[1]	@ 3%	18,900
Total Tax			L.L.711,900

Additional Tax Payment:

L.L.711,900 - L.L.173,720 = L.L.538,180.

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[1] L.L.1,000 would have been already exempted.

The way the SCL will handle the problem arising from the Buildings Tax Law of September 17, 1962, is not yet known. The company does not intend to take any action until the issué of eliminating the income tax is solved. In case the income tax is not abolished, the SCL may organize a subsidiary company that will buy its premises including the equipment and that will rent the premises to the SCL. The SCL is preparing a project to be submitted to the Ministry of Finance concerning some modifications of the Income Tax Law which should apply to cement factories. Among the items in the project will be the question of depreciation rates for the cement industry.[1]

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[1]Interview with Mr. Rudolph Klat, Administrative Manager of the SCL, on August 23, 1963.

CHAPTER III

PROBLEM OF KEY MONEY

A. Definition of Key Money

The term "key money"[1] literally refers to that sum of money that has to be paid by a tenant to a landlord, other than the payment for rent, to obtain the key to the property leased. The rent laws of Lebanon, parts of which will be discussed at length in this chapter, made of key money an economic phenomenon that arises in connection with most rent contracts for business in the commercial centers of Lebanon and gave key money a metaphorical meaning beyond the amount of money paid to obtain the key to the property.

Key money can be defined from more than one angle depending on the transaction involving key money and on the party affected by that transaction. There are usually two parties to a transaction involving key money: the owner of the building (the landlord) and the tenant.

In a transaction involving the lease of a property, key money can be defined from the point of view of the landlord

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[1]The Arabic term is مفتاحية او خلوّ.

as that sum of money received, usually in a lump-sum, at the beginning of the period of the lease in addition to the annual rentals to hedge against future increases in rents from which he cannot benefit due to the rent laws and against possible future legal provisions for the reduction in rent rates which are not warranted by market conditions. To the tenant, key money can be defined as that sum of money paid, usually in a lump-sum, at the beginning of the period of the lease in addition to the annual rentals to compensate the landlord for future increases in rents from which the landlord cannot benefit due to the rent laws and against possible future legal decreases in rents which are not warranted by market conditions.

In a transaction involving the evacuation of the property by the tenant either due to its repossession by the landlord in accordance with the Rent Law[1] or due to its lease to a new tenant with the approval of the original tenant, key money (sometimes called evacuation money) can be defined from the point of view of the tenant as that sum of money he would have to receive as a compensation for evacuating the property.

B. Factors Giving Rise to the Emergence of Key Money in Lebanon

Most of the factors that have contributed to the

[1]The provisions of the Rent Law that allow a landlord to repossess his property will be discussed later in this chapter.

emergence of key money in Lebanon are embodied in the rent laws which do not always conform with the economic realities of the market for rents. Some provisions of the various rent regulations, starting with the Rent Law of February 29, 1944, and ending with the Rent Law of July 31, 1962, affecting key money will be discussed in this section together with some comments on those provisions.

1. Legal Provisions for Renewal of Rent Contracts

All the rent laws of Lebanon state that the rent contracts in effect at the date of the enactment of the law are renewed for an additional year regardless of any agreement to the contrary. The only exception to the above statement is the rent of agricultural land and the constructions thereon, and the rent of 'luxurious' living houses.[1] The Rent Law of July 31, 1962, which is the most recent rent law, renews the rent contracts in effect at the time the law was enacted up to December 31, 1966, provided the renewal is done yearly.

In view of the legal obligation to renew the rent contract at the same rate, except as discussed in the section that follows, the landlord receives key money to hedge against future increases in rents from which he cannot benefit. It

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[1]The rent of 'luxurious' living houses will be discussed in the following sub-section of this chapter.

should be noted that key money is usually received from tenants of commercial leases and not from tenants of non-commercial leases (living houses) although all rent contracts are subject to the same renewal provision. This is due to the fact that commercial leases are usually in the commercial centers where rent rates are subject to a greater increase than in other centers and is partly due to the fact that the period of the lease for commercial purposes is usually longer than the period of the lease for non-commercial purposes.

Table 7 on page 56 shows the cost of living indexes of rents and water from 1943 to 1961 in the city of Beirut. The table reveals that the cost of living index for rents was increasing throughout the period 1943-1961. Since the table represents cost of living indexes, it is difficult to determine the increase in rent rates since the index of any one year is composed of old rents which remain unchanged and of new rents at the current rates. This means that the rate of increase in rent rates was greater than the rate of increase in the cost of living indexes. The table shows that the cost of living index for rent in 1961 was 93 1/3 % greater than the cost of living index for rent in 1943 and 132% greater than the cost of living index for rent in 1939. The increase in the rent rates was definitely in excess of 93 1/3 % and 132% for the same periods. It should be noted that the growth of business activity in the commercial centers resulted in

TABLE 7

COST OF LIVING INDEXES OF RENT AND WATER

FOR THE PERIOD 1943 - 1961

IN THE CITY OF BEIRUT

(July - August 1939 = 100)

Year	Index
1943	120
1944	132
1945	130
1946	130
1947	130
1948	140
1949	141
1950	141
1951	148
1952	148
1953	148
1954	161
1955	161
1956	184
1957	207
1958[1]	231
1959	232
1960	232
1961	232

Source: Direction Centrale de la Statistique, Bulletin Statistique Trimestriel (Beirut: Volume XI, 1960-1961), p. 37.

[1] Average for 7 months.

rent rates in those centers higher than the average rent rates in the city of Beirut. In view of the substantial increase in rent rates, one can only expect landlords to hedge against the increase in rents by exacting key money. Hence, key money is supposed to represent the present value of future increases in rents from which the landlord cannot benefit.

2. Legal Provisions for Changes in Rents

In the previous section it was mentioned that rent contracts are renewed at the same rate. This is not always true. Sone rent laws state that rent contracts signed prior to a certain date are subject to a certain increase or decrease. To illustrate, the Rent Law of February 29, 1944,[1] states that rent contracts signed prior to December 31, 1939, are subject to the following increases:

Classification	Rate of Increase
Category I: (Includes living houses only)	
Rents from L.L. 1 to L.L.250 per year	30%
Rents from L.L.251 to L.L.500 per year	40%
Rents from L.L.501 to L.L.750 per year	50%
Rents from L.L.751 and above	60%

[1]Rent Law of February 29, 1944, Article 5.

Classification	Rate of Increase
Category II: (Includes hospitals, doctors' clinics, offices of lawyers and engineers, and the premises of philanthropic, athletic and scientific institutions)	
Rents from L.L. 1 to L.L.250 per year	40%
Rents from L.L.251 to L.L.500 per year	50%
Rents from L.L.501 to L.L.750 per year	60%
Rents from L.L.751 and above	70%
Category III: (Includes the premises of trading and industrial concerns and all rents not mentioned in the previous categories)	
Rents from L.L. 1 to L.L.250 per year	60%
Rents from L.L.251 to L.L.500 per year	80%
Rents from L.L.501 and above	100%

As another illustration and according to the Rent Law of July 31, 1962, rents contracted after June 30, 1943, and prior to January 1, 1962, are subject to a 15% decrease provided they were not subjected to a decrease in previous years.[1] The provisions of the various rent laws related to changes in rent rates cannot be all discussed in this study.

Rents of 'luxurious' living houses are not subject to the rent laws. A building is considered luxurious if it

[1]Rent Law of July 31, 1962, Article 11.

provides an elevator, a central heating system or a central air conditioning system and a janitor who lives in the building.[1] Thus, the rents of luxurious living houses may be changed with the expiration of the period of each lease. However, the rents of offices and shops in luxurious buildings are subject to the rent laws.

The legal provisions for changes in rent rates attempt to render old rents more in line with the current rates, but they may never succeed in this endeavour. Landlords cannot tell whether future rent laws will increase or decrease the rents of the properties they lease and they cannot tell whether the legal provisions for the increase in rents will be equal to the actual increase in rent rates, and whether they will occur at the time the actual increase takes place. So as a hedge against an uncertainty, landlords ask for key money. In the commercial centers where rent rates are expected to increase at a rate higher than in other centers, the key money required could be substantial. Statistics showing the amount of key money received in relation to the cost of the buildings are not available.

The tenant of a property in the commercial centers hesitates to terminate the rent contract because, with the passage of time, the current rent rate of the property he occupies increases while he enjoys the payment of a fixed rent

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[1]Rent Law of June 21, 1956, Article 17.

and sometimes of a reduction in the rent provided for by the rent laws and which might not be warranted by market conditions. So he will tend to hold to the property and would not terminate the rent contract unless he receives a 'handsome' sum of key money as a compensation for his moving elsewhere where he would have to pay a higher rent. In instances where a tenant makes a profit on the key money, that is in instances where he receives more than what he has originally paid for the key money, the landlord is entitled to one-third of that profit in accordance with the 'custom',[1]

3. Legal Provisions for the Evacuation of Buildings

As was mentioned previously, a landlord cannot terminate a rent contract of his own free will upon the expiration of the period of the lease except in the case of luxurious living houses. However, various rent laws provide for various provisions whereby a landlord can terminate the rent contract and repossess his property. The provisions of the various laws cannot possibly be all discussed here; so the discussion will be restricted to the provisions stated in the Rent Law of July 31, 1962. The provisions of the other rent laws are more or less similar.

According to Article 3 of the Rent Law of July 31, 1962,

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[1]Interview with Mr. Afif Salloum, Manager, Real Estate Department of Intra Bank, on December 6, 1963.

the rent contract can be terminated by the landlord under any of the following conditions:

(a) If the tenant fails to pay the rent within a month after the receipt of a notice to this effect from a notary public or through a registered letter with 'advice of receipt'.[1]

(b) If the tenant destroys the property in such a manner that the destruction is not the result of normal usage, or if the property is used for a purpose other than the one stated in the rent contract without the approval of the landlord.

(c) If the tenant leases the whole property to another tenant without the written approval of the landlord. In this case, the new tenant is forced out.

(d) If the tenant terminates the contract in favour of a new tenant in accordance with the provisions of the rent contract, the new tenant replaces the old tenant vis-a-vis the landlord.

(e) If the tenant leaves the property for a continuous period of six months without informing the landlord of his new address to be used in informing him of the rent due.

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[1]Avis de Reception ، اشعار بالوصول

(f) If the tenant leaves the property for a continuous period of one year.

(g) If the tenant constructs a building in which he has at least a three-fourth interest, or if a building in which he has at least a three-fourth interest becomes vacant, and is fit for his accomodation.

In addition to the above conditions which allow a landlord to terminate the rent contract, a landlord is permitted to repossess his property for other reasons.

A landlord may repossess a building he owns for his personal dwelling or for the dwelling of his children provided he is not living in a property he owns or if the property he owns and lives in becomes unfit for his accomodation. In this situation, the tenant is allowed some period of time to evacuate the property and is entitled to a compensation to be determined by the courts provided the amount of the compensation does not exceed the total of the rents paid to the landlord during the period of the lease.[1] The owner of the building who repossesses his property is under the obligation to occupy it within a period of four months from the date of repossession and has to remain living in it for a minimum period of three years. If the landlord fails to move to the

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[1]Rent Law of July 31, 1962, Article 4.

repossessed property within four months, he has to pay to the tenant who evacuated the property an additional compensation that should not be less than the rent of five years. Also, if the landlord leaves the property he has repossessed before the lapse of three years, he will have to pay a compensation determined by the courts to the original tenant unless the landlord leaves the property for valid reasons.[1]

The law also allows the landlord to repossess his building in order to demolish it and erect a new one instead. The landlord can also repossess the construction on the roof of his building in order to build additional floors provided the construction occupies less than half the area of the roof.[2] The law also allows the landlord to repossess his leased land for the purpose of constructing a building on it even if the tenant of the land has constructed some modest construction on it, provided the period of the lease has expired.[3]

The landlord who wishes to repossess his property in accordance with the law has to pay to the tenant a compensation to be determined by the courts provided the amount thereof is not less than five times and not greater than ten times the

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[1]Rent Law of July 31, 1962, Article 4.

[2]*Ibid.*, Article 6.

[3]*Ibid.*, Article 6.

difference between the rent paid by the tenant at the date of the repossession in accordance with the rent contract and the fair rent of the property determined by the courts at the date of the repossession. The tenants of commercial and industrial premises are entitled to an additional compensation determined by the courts to compensate them for losses sustained from the evacuation of the property, consideration being given to key money, location and other factors, provided the amount of the original compensation is taken into account. In addition, the landlord has to pay compensation for any construction on the land he repossesses.[1]

The landlord has to start on the construction within six months from the date of the evacuation of the property and has to complete the construction within three years from the date the construction starts. If the landlord violates this provision of the law, he has to pay to the old tenants a compensation equal to five times the yearly rent paid by the tenants without presenting any evidence from their part as to the loss they have sustained.[2]

The above discussion shows that once the rent contract is signed, the landlord cannot repossess his property or change the rent except as provided by the law. Hence, the

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[1] Rent Law of July 31, 1962, Article 7.

[2] _Ibid._, Article 8.

tenant is protected by the law and the value of this protection is reflected in the amount of key money he will have to receive in order to evacuate the property. The landlord on the other hand protects himself by receiving key money at the time the rent contract is signed to hedge against future increases in rents from which he cannot benefit, against future decreases in rents imposed by law and not warranted by market conditions, and against future evacuation costs he might have to pay to the tenants.

C. Treatment of Key Money under the Existing Laws

The Income Tax Law and the Buildings Tax Law of Lebanon view the question of key money differently with respect to tenant and landlord. Key money paid by the tenant is treated under the Income Tax Law while the same key money received by the landlord is treated under the Buildings Tax Law. Due to this distinction, key money paid by the tenant and key money received by the landlord will be discussed separately in the following sub-sections.

1. Key Money Paid by the Tenant

The Income Tax Law of Lebanon does not allow as a deduction from gross earnings any amortization or write off of key money.[1] Hence, according to the Income Tax Law, key

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[1]Legislative Decree No. 144, Article 7.

money paid by the tenant is considered to be one of the permanent intangible fixed assets of the organization. The Income Tax Authorities consider such value to be recoverable without loss any time the tenant wishes to evacuate the property since other prospective tenants will be willing to pay to the old tenant a fair value for key money.[1]

However, where the value of key money is declining due to some factors that render the area in which the property is located unattractive and hence lower the current rent rate of that property, the tenant is not allowed to write down or to write off the key money for income tax purposes. On the other hand, if a tenant evacuates the property and the amount of key money he receives is less than the amount he has originally paid, that realized loss is deductible for income tax purposes. Alternatively, if the tenant evacuates the property without receiving any key money, the entire key money will be considered as a loss and will be deducted from earnings for income tax purposes.[2]

When a tenant realizes a gain on key money, that is when he receives more than he has originally paid, that gain is subject to an income tax rate of 10% since it is considered

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[1]Interview with Mr. George Badr, Director of the Income Tax Department in the Ministry of Finance, on July 12, 1963.

[2]_Ibid_.

by law to be a gain from movable capital.[1] It should be repeated here that not all the gain is subject to tax since in accordance with 'custom', one-third of the gain reverts to the landlord, hence, only two-thirds of the gain are subject to income tax.

2. Key Money Received by the Landlord

Key money received by the landlord is considered as income for the period in which it is received and is subject to the Buildings Tax Law.[2]

Before the enactment of the Buildings Tax Law of September 17, 1962, and although the previous Buildings Tax Law (Legislative Decree No. 145) considered key money received as income, some landlords managed to argue with the income tax inspectors that the key money they receive is not income but is a recovery of part of the cost of the property. Such arguments usually led to their exemption from the tax. This situation arises when a landlord pays compensation to the tenants in order to repossess his property, then demolishes the property and erects a new one instead. The compensation paid can be deducted from the key money received in connection with the new building and hence only the 'net' key money

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[1]Refer to Part III of the Income Tax Law discussed on page 11.

[2]Legislative Decree No. 145, Article 5, and also Buildings Tax Law of September 17, 1962, Article 26.

received will be subject to the buildings tax. There have been instances where landlords have presented forged receipts of key money and made the income tax inspector accept these as a deduction from the key money they received.[1]

The Buildings Tax Law of September 17, 1962, has stressed in a very obvious manner that key money paid by the landlord to repossess his property is not an acceptable deduction from earnings.[2] With the enactment of the Buildings Tax Law of September 17, 1962, landlords can no more argue with income tax inspectors for exemption from the tax.[3]

It is clear from the above that key money paid by the landlord to the tenants in order to repossess his property is not an acceptable deduction from gross earnings while the key money received by the landlord is considered in total as income. It is also clear that key money paid by the tenant is not an acceptable deduction from gross earnings for income tax purposes while the same key money received by the landlord is considered as income as far as the Buildings Tax Law is concerned. Such procedures reveal inconsistencies in the treatment of key money by the tax laws of Lebanon.

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[1]Interview with Mr. Jamil Atiyyeh, Owner and Manager of Atiyyeh Auditing and Accounting House, on August 5, 1963.

[2]Buildings Tax Law of September 17, 1962, Article 29.

[3]Interview with Mr. Karim Khoury, Partner, Saba and Company, Accountants and Auditors, on April 22, 1963.

D. Suggested Accounting Treatment of Key Money

The suggested accounting treatment of key money will be discussed from two points of view in two sub-sections. The accounting treatment of key money from the point of view of the tenant of the property will be discussed in the first sub-section, while the accounting treatment of key money from the point of view of the landlord will be discussed in the second sub-section.

1. Key Money from the Point of View of the Tenant

Key money paid by the tenant represents a compensation to the landlord for future increases in rents which the tenant does not have to pay and for possible future reductions in rents not warranted by market conditions but enforced by the rent laws. Such an amount represents a prepaid rent over the period of the lease and should be charged to a Key Money account that will be amortized by periodical additions to rent expense preferably in the same proportion as the increase in rent rates. Since key money represents a prepaid expense over a long period of time, the Key Money account would be classified as an intangible fixed asset in line with the Leasehold Improvements account which may be considered as a prepaid rent and is classified as an intangible fixed asset. Two practical difficulties to the amortization of key money present themselves: in the first place, the period of the

lease cannot be ascertained with absolute accuracy since rent contracts are subject to renewal; and in the second place, the future increase in rent rates cannot be objectively determined. Hence, practical considerations call for the amortization of key money over an arbitrarily determined period of time on a straight line basis.

The procedure outlined above rests on the assumption that both the book value and the market value of key money decline with time because of the implicit assumption of the limited period during which the protection is granted by law to the tenant in view of the limited period of the lease (limited useful life of the property). The assumption that the market value of key money declines with time is contrary to fact since in reality the market value of key money has been increasing due to the growth of business activity in the commercial centers and/or the general rise in price level, and hence the continued increase in rent rates.

The increase in the value of key money should not be a deterrant to the amortization of key money but should be considered as an adjustment to rent expense as will be discussed in this section.

In calculating the amount of key money to be exacted from the tenant, the landlord takes into consideration the indefinite period of the lease due to the legal requirement

of the renewal of rent contracts. Hence, the landlord will insist on an amount that in his opinion will give him a compensation equal to the present value of the increases in rents to be forgone and of possible reductions in rents over the useful life of his property. Therefore, the tenant should amortize the key money he pays over the useful life of the property he is occupying regardless of the period of time he intends to occupy the property. This procedure is correct because, theoretically, any time the tenant wishes to terminate the rent contract, the amount of key money he will receive, which will be determined by the market, will be equal to the book value of key money provided there was no revision in the useful life of the property, provided the rent rates behaved and are expected to behave in the manner previously projected, and assuming that key money is amortized by the compound interest procedure.

However, rent rates may not behave in the manner projected either due to the unexpected growth or decline of business activity in the commercial centers or due to an unexpected change in the price level or due to both factors. Hence, the market value of key money might not coincide with its book value.

An increase in the market value of key money is then a result of an increase in rent rates which was not previously anticipated. The tenant who enjoys the payment of a limited

rent rate should take into consideration the increase in rent rates while determining the periodical charge to rent expense. The increase in the market value of key money represents a windfall gain and should be debited to the Key Money account and credited to an unrealized owners' equity account. The new book value of key money sould then be spread over the remaining useful life of the property by periodical additions to rent expense. The unrealized stockholders' equity account would then be amortized by increases to retained earnings in the same amount as its counterpart increased value of key money is amortized by increases to rent expense.

It may be argued that the above procedure will lead to the same retained earnings figure on the balance sheet and hence no purpose is achieved. It is true that as far as the retained earnings figure on the balance sheet is concerned, the same amount of retained earnings would be obtained if the increased value of key money is taken into consideration or not, but for income statement purposes, the procedure outlined above would render the rent expense more in line with other operating expenses based on current prices and would lead to a more realistic income figure. Bearing in mind that the determination of income is the main purpose of accounting in a business firm,[1] the procedure stated is warranted.

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[1]Cf. <u>supra</u>., p. 2.

Hence, whenever the increase in the market value of key money can be more or less objectively determined, that increase should be taken into consideration.

The same is true when the market value of key money declines beyond the book value as a result of an unexpected decrease in rent rates. The decline in the market value of key money represents a loss and the Key Money account should be relieved of that loss so as to render the rent expense more in line with the current reduced rates.

If a place of business previously occupied without the payment of key money comes to have a key money of unquestioned market value, such value should be recorded on the books in the manner discussed previously.

The objection that may be raised at this point is related to the propriety of the departure from cost in the accounting for key money. It is not the purpose of this study to criticize the principles on which accounting is based, but it should be mentioned that in view of changes in the price level, information based on cost would not be very informative. Another objection that may be raised is that the useful life of the property is a long period of time that cannot be ascertained with absolute accuracy. It is true that the useful life of the property cannot be determined accurately but that fact should not invalidate

the procedure outlined above. Practical considerations might call for the amortization of key money over an arbitrarily determined period of time approximating the useful life of the property.

The question that is raised at this point is related to the procedure that should be followed in case all of a sudden the Rent Law of Lebanon is revised so that the landlord can dispose of his property in any manner he sees fit. If such a thing should happen, the landlord would then be in a position to ask for the current rent rate for his property and hence the value of key money would disappear. Such value should then be written off as a loss.

If a business organization leaves the property it is renting and receives an amount of key money greater than the value of key money per books, the difference between key money received and its book value should be credited to a gain account such as Gain from Sale of Key Money. It should be repeated here that the tenant is entitled to only two-thirds of the difference between key money received and key money originally paid since one-third reverts to the landlord in accordance with the 'custom'.[1]

A business organization might evacuate the property it is renting upon the receipt of compensation from the

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[1] Cf. supra., p. 60.

landlord when the landlord wishes to repossess the property he is leasing to demolish it and erect a new one or for other purposes specified by the Rent Law. The amount of compensation received in this situation does not only include a value for key money but might include in addition compensation for goodwill and for losses incurred as a result of the evacuation. Out of the total compensation received, the compensation for key money should be separately determined and the difference between such value and the book value of key money should be recognized as a gain or loss from the sale of key money. Expenses incurred as a result of the evacuation such as transportation and the like should not be charged against the gain from the sale of key money but may be charged to the account or accounts credited with the compensation representing the losses to be incurred as a result of the evacuation. If the landlord fails to abide by the articles of the Rent Law governing repossession, such as failing to start on the construction of the new property within six months from the date of the evacuation, he is under the obligation to pay an additional compensation to the old tenant. Such additional compensation may be considered by the tenant as an addition to the key money received and will then be treated as a gain from the sale of key money.

2. Key Money from the Point of View of the Landlord

It should be recalled that for tax purposes, key money received by the landlord is considered as income for the period in which it is received and is subject to the buildings tax. The purpose of this section is to consider the nature of key money received by the landlord and to suggest the accounting treatment of key money from the landlord's point of view.

It was mentioned previously that a landlord receives key money from the tenant of the building he is leasing at the time the rent contract is signed in order to hedge against future increases in rents from which he cannot benefit due to the rent laws and against future possible legal decreases in rents not warranted by market conditions. Additional key money for the same building may be received by the landlord only at the time the tenant of the building sells the key money to another tenant at a profit, and in this situation 'custom' dictates that the landlord is entitled to only one-third of the profit and may change the rent. Hence, the receipt of additional key money and the change of the rent are contingent upon the sale of key money by the tenant and upon the value of key money and the rent rates at the time the key money is sold.

It is clear then that key money received by the landlord should be considered as income, not income for the period

in which it is received but income for the whole period during which the building is leased whether to the original tenant or to other subsequent tenants. Key money is in fact an addition to rents received during the period the building is leased and should be considered as rent income. It should be noted that the period during which the building is leased corresponds to the useful life of the property.

Granting the fact that key money is rent income over the useful life of the property, then key money should be set up in a deferred income account that should be amortized periodically to increase rent income preferably in the same proportion as the increase in rent rates. However, the practical difficulties involved in estimating the increase in rent rates warrant the amortization of key money on a straight line basis. The deferred income account suggested for this purpose is "Deferred Rent Income from Receipt of Key Money".

It may be argued at this point that since key money will be spread over the useful life of the property to increase rent income, it is equivalent to a deduction from the cost of the property and it should be so treated thus reducing the property cost and hence the depreciation charge. It is true that as far as the determination of income is concerned, the same net income figure will be obtained whether key money

is treated as a deferred revenue or as a deduction from the cost of the building, but other factors besides the determination of net income should be taken into consideration. One factor is the question of rate of return on the investment in the property, for the rate of return will differ with the approach being adopted.[1] Another factor to be considered is that if key money is treated as a deduction from cost, the value of the property on the balance sheet fails to indicate the cost of such a property.

Additional key money that may be received when the tenant sells the key money to other tenants should be treated like the key money originally received and should be amortized over the remaining useful life of the property.

The useful life of the property is a long period of time that cannot be determined with absolute accuracy. Hence, practical considerations suggest the write off of key money over an arbitrarily determined period of time approximating the useful life of the property.

When a landlord repossesses his building for the purpose of demolishing it and constructing a new one, the key money he pays to the tenants together with other evacuation costs should be capitalized by charges to the Land account since these costs are incurred to render the land ready for construction. Such costs are usually material in amount and

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[1]The rate of return will of course be the same if the compound interest method of discounting cash flows is applied.

they add enormously to the cost of the land but at the same time they render the book value of the land more in line with its market value. The landlord is willing to incur these costs since he knows that when the construction of the building is over he will be collecting from the new tenants an amount for key money equivalent to or usually greater than the amount he has paid to repossess the property. The key money received by the landlord should be treated as a deferred revenue and dealt with in the manner discussed previously.

It may be argued, however, that key money received in this connection should be considered as a recovery from the cost of the land to the extent of key money (evacuation costs) paid and charged to the Land account and that only the excess of key money received over the key money paid should be treated as a deferred revenue. This procedure may be supported on the grounds that it is in line with the treatment of the sale of salvaged material from the destruction of an old building as a recovery of cost but it fails to consider the nature of key money paid to repossess the property. Key money is paid to render the property ready for construction and hence it is a proper addition to the cost of the land, and if it is considered as a recovery from the cost of the land, the recorded value of the land account will then be reduced below its market value since evacuation costs paid should increase the market value of the land.

E. Impact of the Buildings Tax Law on the Owners of Buildings

After discussing the nature of key money received by the landlord and suggesting the accounting treatment of key money, let us now turn to the impact of the Buildings Tax Law on the owners of buildings (landlords).

In accordance with the Buildings Tax Laws of June 12, 1959, (Legislative Decree No. 145), and of September 17, 1962, key money received is considered as income from built property for the period in which it is received and is subject to the buildings tax. This amounts to a huge tax burden in one year and relieves future years from a tax that otherwise would be necessary. If the spreading of the revenue from key money over the useful life of the building is allowed by law, the total tax burden over the years of useful life would be the same according to Legislative Decree No. 145 since the buildings tax is a flat rate of 1/12 (8 1/3 %) of income. But according to the Buildings Tax Law of September 17, 1962, the total tax burden would not be the same since the tax burden is composed of a flat tax of 8% of total revenue and of a progressive tax ranging from 3% to 15% as shown in Table 5 on page 38.

Considering key money as income for the period in which it is received is not the only problem facing owners

of buildings. Landlords face other problems of determination of income when depreciation on buildings and maintenance expenses are not acceptable deductions from gross earnings.[1]

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[1]Legislative Decree No. 145, Article 5, and Buildings Tax Law of September 17, 1962, Article 29.

CHAPTER IV

CONCLUSION AND RECOMMENDATIONS

The two main problems of determination of business income discussed in this study arise from the Income Tax Law, the Buildings Tax Law and the Rent Law of Lebanon.

The problem of depreciation of tangible fixed assets arises due to the rigidity of the Income Tax Law with respect to depreciation allowances. Business firms are bound to depreciate their fixed assets in accordance with a uniform list of depreciation rates that does not take into consideration the nature of operations nor the degree of utilization of fixed assets. Industrial firms that conduct their operations in their own plants were allowed to deduct from gross earnings, in lieu of depreciation on buildings, the rental value of their place of business which included the rental value of machinery and equipment considered as immovables by design. The deduction of the rental value of the place of business more than compensated industrial firms for inadequate depreciation provisions. The Buildings Tax Law of September 17, 1962, has prohibited the deduction of rental value from gross earnings and thus led to inadequate deductions

for income tax purposes especially as depreciation on buildings is not an allowed deduction for income tax purposes.

The problem of key money faces both tenants and landlords. Key money paid by the tenant is considered by the Income Tax Law to be an intangible fixed asset that should not be subject to amortization while key money received by the landlord is considered by the Buildings Tax Law to be income for the period in which it is received. It was found that key money paid by the tenant is a prepaid expense that should be amortized over the useful life of the building and that the increase in the value of key money should be considered as an adjustment to the annual rental charge. It was also determined that key money received by the landlord is rent income over the useful life of the building and should be so treated.

The two problems discussed in this study are not the only problems of determination of business income arising from the tax laws of Lebanon. Various other problems exist, some of which are the problem of bad debts and the problem of treating stock dividends as income.

The Income Tax Law does not allow as a deduction from gross earnings any provision for bad debts not even any write-off of accounts receivable that prove to be uncollectible. The only provision for bad debts that is acceptable is the

provision set for the accounts of customers who might be declared bankrupt by court.[1] Hence, if a business firm has customers with delinquent accounts and these customers are not expected to be declared bankrupt, no write-off of their accounts or a provision for their probable uncollectibility is acceptable. After all, only merchants can be declared bankrupt. A business firm should take into consideration the probable uncollectibility of some accounts receivable regardless of income tax considerations in order to achieve a better matching of revenues and expenses on the income statement and a better valuation of accounts receivable on the balance sheet.

In accordance with the Income Tax Law, stock dividends received from foreign corporations are considered as income from movable capital and are subject to a tax of 10%.[2] Stock dividends and cash dividends received from Lebanese corporations are not taxed.[3] It should be noted that stock dividends are not income since the receipt of a stock dividend by a stockholder does not change his equity in the corporation he is investing in. When stock dividends are declared and issued, the same stockholders' equity will be divided over

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[1]Legislative Decree No. 144, Article 7.

[2]_Ibid._, Article 69.

[3]_Ibid._, Article 71.

a greater number of shares thus reducing the book value and usually the market value per share.

However, the problems of bad debts and stock dividends are not peculiar to Lebanon and hence they do not represent special accounting problems of determination of business income in Lebanon.

At the time of writing this study, the Chamber of Ministers issued a draft of a law to amend the Income Tax Law.[1] The draft suggests, among other things, the inclusion of depreciation on buildings among the accepted deductions from gross earnings but does not suggest a rate of depreciation to be followed. The draft also initiates other revisions to the Income Tax Law to render it more in conformity with the Buildings Tax Law of September 17, 1962.

The recommendations that can be put forth at this point have to do with some further revisions to the Income Tax Law and some revisions to the Buildings Tax Law. They are enumerated below:

(1) The Income Tax Law should be revised to allow taxpayers a reasonable freedom to determine the useful life of their depreciable assets. The useful life of any asset should not be determined by a decree

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[1]See 'Al-Anwar' newspaper, No. 1321, dated December 5, 1963, p. 7.

from the Minister of Finance. The only people qualified to estimate the useful life of an asset in a manner to account for the degree of utilization of that asset and for the rate of obsolescence are the businessmen. The Income Tax Authorities should issue a statement showing the estimated useful lives of various assets to be used for the guidance of taxpayers and that should not be binding.

(2) The Income Tax Law should be revised to allow taxpayers the freedom to choose a method of depreciation from a list of acceptable depreciation methods to the Income Tax Authorities.

(3) The Buildings Tax Law should be revised to allow the deduction of maintenance expenses and a reasonable allowance for depreciation on the buildings from gross rent income.

(4) The Income Tax Law should be revised to allow different income tax rates on corporations. It is not fair to tax a corporation at the progressive rates that apply to individuals. The present tax system discourages the formation of big corporations with a great number of stockholders. The Income Tax Law should either allow a generous exemption from earnings for corporations, allow reduced progressive tax rates or allow

a uniform flat rate on corporate profits. The Buildings Tax Law of September 17, 1962, allows a 25% reduction of the progressive tax to all corporations, and hence, the Income Tax Law should provide similar exemptions or deductions.

(5) The Income Tax Law should be revised to accept the periodical amortization of key money paid by the tenant against rent expense over the useful life of the building or over an arbitrarily determined period of time.

(6) The Buildings Tax Law should be revised to allow the amortization of key money received over the useful life of the property or over an arbitrarily determined period of time.

As mentioned in the introductory chapter, a proposal was submitted to the Lebanese Parliament to eliminate the income tax of Lebanon and replace it by indirect taxes. The economic and social aspects of this proposal are not part of this study, but the accounting aspect is important. It is the firm belief of the writer that if the income tax of Lebanon is eliminated, the standard of accounting in Lebanon will rise in those firms that will continue to keep accounting records. At present, many businessmen hire incompetent bookkeepers to do their bookkeeping work and to handle their

tax matters. The abolishment of the income tax will do away with the unethical and improper accounting practices. Those firms that will continue to keep accounting records will keep them for the benefits to be derived out of them and in a manner that best reports their income and not in a manner that complies with the Income Tax Law or that will attempt to understate the net income so as to evade income tax. It should not be understood, however, that the writer is in favour of the elimination of the income tax.

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