The small enterprise tax concept

Experiences in the past couple of years have proven that SMEs are unquestionably the growth engines of the European economy and therefore the Hungarian government considers the issue of SMEs a priority. It has been obvious that there cannot be a recovery from the financial and economic crisis without small enterprises which have to be freed of burdens weighing on their activities. The small enterprise tax about to be introduced also serves this end. This tax will set a new direction in the income tax system.

Although certain elements of the system which has been presented in the parliament may still be modified via the expected social and parliamentary debate, but it includes – besides a more favourable tax rate – two conceptual differences compared to current general regulations:

1. The tax will be levied on labour income and capital gains simultaneously and with the same rate,
2. Incomes will be calculated on the basis of cash flow accounting.

The first point may do away with the prevalence of capital gains taxation compared to labour income taxation at enterprises. Thereby tax liabilities payable by employers will in fact be independent of wages. This solution will namely be a uniform levy on the entire income which the company has generated, no matter how much of that is spent on employee remuneration or the hiring of new labour force (see attached table).

	Corporate tax	lower wage expenses	higher wage expenses (i.e.: new employee)		Small enterprise tax	lower wage expenses	higher wage expenses (i.e.: new employee)
1,	Turnover	1000	1000	1,	Turnover	1000	1000
2,	Expenses (except for wage expenses)	200	200	2,	Expenses (except for wage expenses)	200	200
3,	Gross wages	500	623	3,	Gross wages	500	623
4,	Employment levies payable on gross wages : social contribution tax, vocational training contribution)	143	178	4,			
5,	Result (1.-2.-3.-4.)	158	-1	5,	Small enterprise tax base (1.-2.)	800	800
6,	Corporate tax (5. *10%)	16	0	6,	Small enterprise tax (5. *16%)	128	128
7,	Profit (5.-6.)	142	0	7,	Profit (1.-2.-3.-6.)	172	49
	Profit from sales (7./1.)	14%	0%		Profit from sales (7./1.)	17%	5%
	Taxes payable, total(6.+8.)	158	178		New taxes payable, total (6.)	128	128
					Tax reduction:	19%	28%

The second point however – parallel to considering more the current liquidity situation of a company – is primarily aimed at strengthening the growth potential of enterprises at issue. The explanation of the concept, however, requires a more detailed presentation.

The logic of dual tax systems

A key flaw of income tax systems is that they tax invested incomes more than incomes spent on consumption. Investments – in an ideal situation – already come from after-tax incomes and their yields are taxed again and again by the system regardless of new re-investments from them. Consequently, payable taxes tend to accumulate over time. As a result such taxes actually hinder saving and development based on capital accumulation.

Several countries, with Hungary among them, intend to correct the aforementioned flaw via dual tax systems. The essence of these is that they levy more favourable tax rates on capital gains than on labour income. This however – besides being a non-solution – creates several other problems which can only be mended with significant administration.

As although capital gains and labour income appear theoretically separable, in practice they are hardly distinguishable. This issue is most apparent regarding micro enterprises: for example how could/should the income of a taxi driver be divided into income from investment (due actually to his car) and income from labour? Although to a lesser extent but the issue is also detectable at bigger companies as well, which are mostly manifested by arguments at wage negotiations.

The aforementioned difficulties generate not only administrative drawbacks but several cases of fraud as well. To sum it up, the preferred taxation of capital gains is often misguided and thereby incapable of achieving even the original objective.

Cash flow taxation

The principles of cash flow taxation on the other hand offer a prompt solution. This solution – albeit popular in theory – is not widely utilized in practice which is largely a reason of hurdles associated with the transition to this system.

The essence of the concept is that the system focuses on the utilization instead of the resource of income. In other words tax allowances do not depend on resources of the income (capital) but on its utilization (investment).

The tax base of cash flow income tax is made up of the difference of the receipts and expenditures of a company or to put it in a slightly other way – as regards the future Hungarian small enterprise tax – it is constituted basically by the growth of the funds and financial assets of the company (including of course funds withdrawn from the enterprise as well).

The current, account balance-based tax base mostly differs from the aforementioned system because it reflects the change in the assets of the company. Thus, if an expense item is spent on increasing the wealth of the enterprise (i.e. equipment, stocks) according to the current tax system it does not reduce the tax base; it can only be reduced by decreasing asset value (equipment amortization or utilizing stocks). Cash flow-calculated tax base, on the other hand, makes it immediately possible to deduct such items.

Such a cash flow-calculated tax base may prompt a "slow growth" company to account certain items differently from capital gains tax calculation but as a whole the result will be similar. (A further advantage may arise as this tax scheme is simpler from several aspects than current taxes and it can be better tailored to the liquidity situation of a company.)

In case of a dynamically developing company, however, the difference is already striking: the income re-invested in assets (tangible assets) of the enterprise will reduce the tax base. In other words, the company is eligible to paying taxes only after investments have yielded profits.

Flexible framework

Due to fiscal restrictions and labour force demand typical of small enterprises, enterprise tax will be available in 2013 only for enterprises with up to 25 employees and an annual turnover or amount of balance of up to 500 million HUF. The regulation will pay special attention to minimize curbing growth of enterprises at issue as much as possible.

To this end, for example, the limit of 25 employees will only be an initial requirement for this tax scheme; enterprises will be allowed to keep utilizing this tax system until the number of their employees reaches 50.

One can therefore conclude regarding the concept of the small enterprise tax that by establishing a uniform taxation of capital gains and labour incomes it will significantly contribute to creating an employment-friendly tax system. Furthermore, it will introduce a framework which is better aimed and simpler than before and can improve the competitiveness of small enterprises capable of dynamic growth.